# Irrevocable Life Insurance Trust Producer Guide

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VOYA FINANCIAL™

# Irrevocable Life Insurance Trust (ILIT)

Over the last several decades, life insurance policies have become accepted as valuable wealth transfer tools. Policy death benefits have the potential to create cash to increase family wealth and efficiently provide income tax-free funds to pay estate expenses, debts and estate taxes. One of the biggest challenges with a life insurance policy is how to prevent the death benefits from being included in the insured's taxable estate. When death benefits result in an increase in a decedent's estate taxes, it is as though the policy owner named the IRS as a partial beneficiary of the policy. To avoid losing some of the death benefits to estate taxes, attorneys and tax advisors often recommend that clients not own policies that insure their lives. They often advise clients with potential estate tax problems to have another person or entity own the policy.

## Risks When an Insured's Children Own the Policy

When parents purchase life insurance policies for estate planning purposes, their children are the ones who usually receive the most benefits. Consequently, parents often wonder if it makes sense for their adult children to own the life insurance policy. This ownership alternative can avoid estate taxes because the parents do not have any incidents of ownership in the policy that would cause it to be included in their taxable estates.

While initially having the children own the policy may appear to be an attractive alternative, it should be studied carefully. There are several potential risks when adult children own a life insurance policy insuring a parent.

Some of these risks are:

1. **The Children Must Manage the Policy Together—** When a policy is owned by multiple parties, the insurance company generally requires the written consent of all owners in policy management decisions. Thus, all the children must agree on how the policy will be handled. Each will have to sign any forms and documents the insurer needs. If one child refuses to participate or sign the paperwork, no changes can be made. Thus, sibling rivalries and disagreements may impact how the policy is managed.
2. **The Policy May Be Subject to Claims from the Children's Creditors—**Each child's ownership interest is his/her personal asset. If a child has financial troubles, goes bankrupt or gets divorced, that child's creditors or ex-spouse could wind up taking over all or part of the child's interest in the policy. Having someone outside the family become a partial owner of the policy could be objectionable.
3. **Parents May Make Gifts of Premium Dollars to the Children—**Funds to pay policy premiums will usually come from the parents. Cash gifts from parent to child are often used to give the child the funds required to pay his/her share of the premiums. Direct gifts to the children will usually qualify for the $14,000 gift tax annual exclusion. Then each child will have to use his gift to pay his/her share of the annual premium. From time to time a child may forget to send a check to the insurer or may use his/her gift for other things. If a parent decides to avoid this problem by paying the entire premium directly to the insurer, the payment may not qualify as an annual exclusion gift. Instead, it may be treated as a future interest gift that reduces the parent's lifetime gifting exemption and the estate tax unified credit.
4. **The Parents Have No Ownership or Access Rights—** When the children own the policy, the parents have no control. They have no ownership rights and the policy does not give them any way to control how it will be managed. If their financial position changes or if they change their minds, they can't get back any of the funds they have used to pay premiums and they cannot get access to any policy cash values. The only way they can get something from the policy is if all the children who are owners agree and act as a group. They are totally dependent on the children.

# I. The Irrevocable Life Insurance Trust (ILIT) as a Policy Ownership Strategy

Purchasing a life insurance policy for wealth transfer purposes and having it owned by the adult children can look good on paper, but in reality it may present difficult problems. Parents should think carefully before adopting this strategy. For many years the Irrevocable Life Insurance Trust (ILIT) has been a viable alternative to policy ownership by the children. ILITs have helped families accomplish their estate planning goals for decades. The ILIT is a proven way to own life insurance so that policy death benefits can be used to pay estate taxes and costs without subjecting the death benefits to estate taxes. Over the years the ILIT has successfully survived IRS challenges and has become a wealth transfer planning tool.

## Funding the Trust with Gifts

Contributions to ILITs generally come from parental gifts. The parent transfers money to the trustee annually so the trustee can pay the policy's annual premium. Gifts can be either of two types: (1) annual exclusion gifts or (2) gifts using the lifetime gift tax exemption.

Gifts are usually made to the ILIT so they qualify for the $14,000 gift tax annual exclusion. These gifts are commonly used because annual exclusion gifts are "renewable" each year. Lifetime exemption gifts are not renewable. In order to qualify for the gift tax annual exclusion, the recipient must have a "present interest" in the gift. That means the recipient must have knowledge of the gift and the ability to take personal possession of it immediately. A present interest is usually created in a gift to an ILIT by giving the beneficiaries a limited withdrawal power. The trust directs the trustee to give each beneficiary written notice of his/her right to withdraw a pro rata share of all the contributions made to the trust during the course of the year. After receiving notice of this withdrawal right, each beneficiary has a specific period of time (usually 30 days) to notify the trustee of his/her desire to receive their share of money. These limited withdrawal powers are often called "Crummey powers" after the court case in which they were first recognized. Failure to demand payment from the trustee within the specified period means that the withdrawal power lapses and the beneficiary has lost the opportunity to receive the distribution.

The grantor's spouse can consent to allow his/her own $14,000 gift tax annual exclusions to be used in making gifts to the trust. This can be done even though it is the grantor who supplies all the funds used to make the gifts. This strategy of using both spouses' annual exclusions is known as "gift splitting." It is specifically permitted under the Internal Revenue Code Section 2513 but can only be used by married couples. Gift splitting can be extremely beneficial because it permits twice as many dollars to go into the trust gift tax free without reducing either spouse's lifetime gift tax exemption. For example, a grantor who creates an ILIT with four Crummey beneficiaries can contribute $56,000 to the trust for premiums using his/her own annual gift tax exclusions. If the grantor's spouse agrees to the split gift, up to $112,000 can go into the trust using their combined gift tax annual exclusions. An added advantage is that gift splitting does not make the spouse a grantor of the trust. The spouse can continue to have the "access" rights described in this guide without bringing the trust assets into his/her estate at death.

Once a child's withdrawal power ends, the trustee can freely use the grantor's contributions to pay the life insurance policy premium. The Crummey power may well be the child's only opportunity to get money out of the trust prior to the death of the grantor's spouse. Once a Crummey power lapses, the trust can be drafted to delay distributions to the child until after the grantor's spouse has passed away or some other future date.

Any gift that does not qualify for the gift tax annual exclusion is a gift that is charged against the grantor's lifetime exemption. Such gifts include those in which the trust beneficiaries do not have a present interest and those where there is a present interest but the amount of the gift exceeds $14,000 for any beneficiary. Some grantors may actually prefer to fund their ILITs with gifts that don't qualify for annual exclusion. These gifts do not require the trustee to give the beneficiaries notice of the gift. Further, these gifts can be made without giving the beneficiaries any withdrawal rights (Crummey powers). By using the lifetime exemption, a grantor can keep the gifts private and can avoid giving all the beneficiaries an opportunity to take money out of the trust. In drafting the trust, the grantor may retain the right to inform the trustee at the time a gift is made each year whether it should be treated as an annual exclusion gift or a lifetime exemption gift.

## Other Ways to Fund the Trust

Gifting is not the only way to put money into the trust. Other planning strategies include:

- Loans from the grantor (also known as private loans)
- Loans from commercial lenders (also known as premium financing)
- A private split dollar arrangement with the grantor

These techniques are not discussed in this guide. The Voya™ Life Companies have created other producer guides to explain how these strategies can be used to pay premiums on policies owned by an ILIT or by the children/grandchildren of the insured.

## Income Taxation of the ILIT and the Grantor Trust Rules

Federal income tax law generally is not favorable to income earned by trusts. The income tax rates for trusts are compressed and the trust usually pays more income taxes than an individual with the same taxable income. For example, in 2012 a trust reaches the maximum tax rate of 35 percent when its taxable income exceeds $11,650. Single individuals reach the 35 percent tax rate at $388,350 of taxable income. Even corporations don't reach the 34 percent rate until they have $75,000 of taxable income.

An ILIT that has a life insurance policy as its only asset and which will distribute the income tax-free death benefits shortly after the insured's death may not have much of an income tax problem. Sometimes, however, income-producing property is contributed to the trust. Also, some trust management decisions may have income tax consequences.

Income taxes to the trust can be avoided if the trust qualifies as a "grantor trust." This is a trust that meets the criteria contained in Internal Revenue Code sections 671-678. These rules can be complex and we will not discuss them in any detail in this guide. However, it can be valuable to know some of the consequences of grantor trust status:

- The trust's taxable income is added to the grantor's taxable income.
- The grantor pays the income taxes on the trust's taxable income.
- By paying the taxes on the trust's income, the grantor may effectively make a tax free gift to the beneficiaries of the trust.
- Transactions between the grantor and the trust are not taxable because the grantor is deemed to be entering into a transaction with him/herself.

Structuring an ILIT as a grantor trust may help parents and grandparents transfer more wealth to their children and grandchildren. However, it is usually best for only the person who creates the trust to be classified as the grantor. If the grantor's spouse is given rights in the trust, it is usually advisable for that spouse not to be a grantor.

# II. Making an ILIT "Flexible"

Some clients may be reluctant to use an ILIT because they fear it may weaken their personal financial position. They may see it as a financial tool that benefits everyone but them. In particular, they may be concerned that:

1. They may have to spend thousands of dollars in legal fees to set up the trust.
2. The annual life insurance premiums are expensive.
3. Someday they may have to cut back their lifestyle to continue the premiums.
4. They pay the premiums through gifts to their children.
5. They can't take back their gifts if they need the money later.
6. Their kids may be getting a lot of money as it is; why should they get more?
7. The financial benefits the ILIT produces may wind up "spoiling" their kids.

If an ILIT is presented solely as a way to create estate liquidity and reduce estate shrinkage, it may be seen as a tool that benefits the children, with little or no benefit to the parent(s) creating it. These parents may ask: **"What's in this ILIT for me?"**

## Flexible Provisions Let Parents Benefit from the ILIT

Clients may be more willing to use an ILIT when they understand that it can be structured to protect their own financial security first and benefit their children second. Over the years the courts and the IRS have allowed a number of ILIT provisions that could potentially benefit a parent without causing the life insurance death benefits to be included in their taxable estates.

**An ILIT can be drafted to work in two stages:**

**Stage One—During the Life of the Grantor's Spouse**

For the balance of the life of the grantor's spouse, the trustee can be instructed to manage the trust to be sensitive to the spouse's needs. Funds are often contributed to the ILIT through annual exclusion gifts. After the Crummey withdrawal powers lapse, the trustee may postpone paying benefits to the children until both the spouse and the grantor are deceased. During this period the spouse may be able to benefit from the trust's assets and the trustee may be given the authority to make discretionary distributions to the spouse for his/her health, education, support or maintenance.

**Stage Two—After the Spouse's Death**

After the spouse has passed away, the trustee may make distributions to the children as the terms of the trust dictate.

## What "Access Rights" Can Be Reserved for the Spouse?

An ILIT can have a number of specific provisions that allow benefits to flow back to the grantor's spouse. These provisions are sometimes called "access rights" and they may be used exclusively for the spouse's benefit. These rights position the trust assets to potentially enhance the spouse's financial security. The children generally don't get access rights in an ILIT.

**Commonly used spousal access rights include the rights to:**

1. Receive all trust income annually (the trustee can be given the discretion to pay trust income to the spouse, if the spouse is an insured).
2. Withdraw the greater of $5,000 or 5 percent of the trust assets annually.
3. Request distributions from the trustee for health, education, support and maintenance annually (the trustee is not required to make these payments but has the discretion to do so).

## Control Without Ownership

These "access rights" potentially give the spouse a degree of control over the money in the trust without having legal ownership. None of the access rights listed above appear to create an incident of ownership that would cause the funds in the trust (including the life insurance policy death benefits) to be taxed in either spouse's estate at death. An ILIT with spousal access rights may potentially give the non-grantor spouse estate tax-free access to the trust assets, including the life insurance policy. An ILIT with spousal access provisions is sometimes called a "Flexible ILIT." Appendix I of this guide contains a series of technical questions and answers about the access rights in a Flexible ILIT.

## Control Over the Trustee

Generally, the ability to receive distributions for health, education, support or maintenance is one of the most powerful of the access rights. However, the spouse can't have a unilateral right to receive funds for these purposes. Only the trustee can authorize distributions for the spouse's health, education, support or maintenance. The spouse can ask for distributions, but only the trustee can decide to make them. Thus, the trustee is a critical player in making an ILIT flexible. Neither the grantor nor the spouse who can benefit from these powers should be the trustee. The trustee has incidents of ownership in the life insurance policy in his/her fiduciary capacity as trustee. If either the grantor or the spouse served as trustee, the policy death benefits could become subject to estate taxes. For this reason, an independent person or institution should serve as trustee.

An ILIT can have two provisions that may help influence the trustee to make decisions favorable to the grantor's spouse. First, the trust can have a liberal standard for distributions. That is, the trust language may allow the trustee to disregard other resources available to the spouse in deciding whether to make the requested distributions. The trustee can be instructed to be liberal in exercising this discretionary power and to give the spouse the benefit of the doubt when making the decision. Second, the grantor can retain the right to fire the trustee and replace that trustee with an independent trustee. Thus, if the trustee doesn't go along with the grantor's wishes, the trustee could be fired and a new independent trustee could be hired to manage the trust.

## The Grantor May Receive Funds from the Spouse

The parent who creates the trust (the grantor) can't retain any access rights for him/herself, now or in the future. If the grantor retained any of these rights, he/she would be considered to have retained an interest in the trust and the entire value of the trust (including the policy death benefits) would be taxed in his/her estate. Thus, when the ILIT is funded with gifts, the only way the grantor can hope to be able to receive any of the funds in the trust is through his/her spouse when he/she is a trust beneficiary. The spouse may obtain money from the trust through these access rights and then share the money with the grantor. However, if there is a divorce or if the spouse dies before the grantor, it may be very difficult for the grantor to enjoy any of the funds in the trust.

## Single Life Policy or a Second-To-Die Policy?

The Flexible ILIT can work with either a policy on the grantor or a second-to-die policy insuring both the grantor and the spouse. The spouse can have access rights regardless of which type of policy is in the trust. However, if a second-to-die policy is used, the spouse should not have the unilateral right to receive income from the trust. The IRS has held that a beneficiary's right to take income from a trust that owns a policy on the beneficiary causes the policy death benefits to be taxed in the beneficiary's estate.

In most cases, a single life policy on the grantor will provide more benefits to the spouse because the trust may receive the death benefits while he/she is alive. This is beneficial to the spouse because the death proceeds will cause the trust to grow considerably. As a result, the spouse's income rights and 5 & 5 withdrawal power will pay out more money. Plus, a second-to-die policy may need premium payments to continue after the grantor's death.

# III. Making ILIT Distributions Flexible (Family "Incentive" Trusts)

One concern many ILIT grantors have is that the trust distributions may "spoil" their beneficiaries (children) by making them overly dependent on the trust. Parents and grandparents considering an ILIT may ask themselves, "Why should I go to the trouble and expense of maximizing the value of my estate if the extra money will undermine my children's or grandchildren's incentive and productivity?" The last thing they want is to turn younger generations into lazy, spoiled brats. No parent/grandparent wants to make gifts that will wind up hurting a child or grandchild in the long run.

## ILIT Distributions Can Be Conditional

Parents and grandparents who are concerned about potential negative consequences of trust distributions need to know that the distributions to trust beneficiaries don't have to be automatic. Rather, the ILIT can be drafted so that the beneficiaries are not assured of getting anything from the trust. Instead, distributions can be conditional; they can be postponed until a beneficiary meets criteria established in the trust. When the grantor establishes the trust, he/she has the opportunity to set terms and conditions that a beneficiary must satisfy before any distributions will be made.

Just as the funding stage of an ILIT can be flexible, so, too, can the distribution stage. The grantor can design the distribution phase of the trust to meet whatever objectives he/she believes are important. Significant flexibility can be built into the ILIT's distribution phase.

## The ILIT Can Be an "Incentive Trust"

The ability to create an ILIT in which beneficiaries do not automatically receive distributions offers grantors a potentially exciting opportunity. They can structure the trust's distribution provisions to create incentives for the beneficiaries to live what the grantor considers to be a productive, useful life. In other words, the distributions can be made as a reward after the beneficiary has satisfied conditions or requirements stated in the trust. In this way grantors can use the distribution provisions to guide children, grandchildren and other beneficiaries toward behaviors that the grantor believes will make their lives better.

ILITs with conditional distribution provisions are sometimes known as "Family Incentive Trusts" or "Values Trusts." They are attractive to parents and grandparents who want to encourage and reward specific life choices. By the same token, they can be used to discourage and punish other life choices. In doing so, it is hoped that they give the beneficiaries significant incentives to adopt values and/or habits the grantor believes are important.

Flexible distribution provisions put the beneficiaries in the position of making choices. Neither the grantor nor the trustee can require them to live in a certain way or to work toward specific goals. If they choose to meet the conditions in the trust, they will be rewarded with distributions. If they choose not to do so, they will not lose anything. They just won't receive distributions from the trust.

## A Combination Approach– Some Distributions Automatic and Some Flexible

Just as some grantors may not be comfortable with an ILIT that makes all distributions automatic, other grantors may be uncomfortable with one that makes all benefits conditional. Many grantors will be comfortable with a combination approach in which some distributions are automatic and others are contingent. For example, the ILIT could direct the trustee to pay $100,000 in benefits to each beneficiary with the payments to be made in $20,000 installments each year for five years. The trustee would be empowered to make additional distributions in any year in which a beneficiary satisfied any of the incentive provisions in the trust.

## Possible Incentives Provisions

There are many ways a Flexible ILIT can be designed to promote positive life choices. The values and behaviors the trust can promote are limited only by the objectives and the creativity of the grantor and attorney drafting the trust. The following incentives are commonly found in these trusts:

### The Earnings Incentive

Grantors may not want beneficiaries to rely on the trust for all or his/her income. They want beneficiaries to be out in the working world, earning their own way. The trust can be drafted so that a percentage of the beneficiary's earned income qualifies for a matching distribution from the trust. This can be a dollar-for-dollar match or a percentage match with maximum ceiling.

### The Public Service Incentive

Positions in non-profit organizations and government often pay less than positions in the private sector. A grantor may feel it is important for a beneficiary to consider public service-oriented employment. The trust can mitigate or eliminate the financial loss from a smaller salary by making distributions that supplement the salary of a beneficiary who chooses to work in the non-profit sector or in government.

### The Achievement Bonus

The grantor can give beneficiaries incentives to achieve specific goals by directing the trustee to make a distribution when a milestone is reached. Such milestones can include: graduation from college or graduate school, earning a professional license, buying a home, etc.

### The Venture Capital Fund

A grantor may want to encourage beneficiaries to start their own businesses. If so, the trustee can be directed to make a distribution to supplement money a beneficiary raises to start his/her own business venture. This could be a matching distribution or one with a maximum ceiling.

### The Happy Marriage Incentive

A grantor may want to encourage beneficiaries to marry and stay married. If so, the trust can have a provision that pays a bonus upon the date of a marriage and/or at specified anniversaries (e.g. fifth, 10th, 15th, 20th, 25th anniversaries).

### The Grandchild Incentive

Some grantors may want grandchildren or even great grandchildren. To give children a financial incentive to produce grandchildren, the trust could make a single payment or a series of payments to children who have children of their own.

### The Elected Office Incentive

A grantor may believe a beneficiary or the family can benefit from pursuing election to a public office. If this is the case, the trust can have a provision that makes a distribution to a beneficiary who runs for election to a national, state, county or local office. This distribution could be used to pay campaign expenses or to compensate the beneficiary for the time spent in organizing and implementing the campaign.

### The Family Reunion Fund

Some grantors may believe it is important for the family members to meet on a regular basis. If so, it can direct the trustee to make distributions to fund a private family gathering at regular intervals.

Flexible ILITs can be designed to promote almost any behavior that grantors wish to encourage. It all comes down to two choices: the choice of the grantor to make part of the transfer of his/her wealth contingent on meeting certain goals or standards and the choice of the beneficiary to take advantage of the opportunity.

## Negative Incentives

Flexible ILITs can also include provisions that can result in the loss of benefits. There are two general reasons why a grantor might give the trustee the power to withhold benefits. First, the grantor may wish to discourage certain behaviors and lifestyle choices the grantor believes are negative or offensive. Second, grantors often do not want trust funds to be used to finance damaging or dangerous behaviors. Negative incentives could be used to forfeit, halt, reduce or delay distributions to an offending beneficiary. Examples of negative behaviors that could result in the reduction, postponement or even loss of distributions include:

- Conviction of a crime
- Spousal or child abuse
- Gambling addiction or substance abuse
- Professional ethical complaints
- Divorce or birth of illegitimate child

Any negative incentives contained in the Flexible ILIT will reflect the concerns and values of the grantor. Just as positive incentives act as a "carrot" to guide beneficiaries toward positive life choices, negative incentives may act as a "stick" to direct them away from damaging life choices.

## Allocation of GST Exemption

It is common for grantors who establish Flexible ILITs to want them to benefit both children and grandchildren. When a Flexible ILIT benefits grandchildren, great grandchildren or potential beneficiaries more than 37 years younger than the grantor, it will be treated as a generation skipping trust for transfer tax purposes. To avoid the adverse impact of the generation skipping tax, a portion of the grantor's generation skipping tax exemption may be allocated to all gifts made to fund the trust. When these gifts are used to pay life insurance premiums and generation skipping tax exemption has been allocated to them, the life insurance death benefits may potentially be free from the generation skipping tax. This is true even though the dollar value of the death benefits may be far greater than the premiums paid to produce them.

## Communicating the Concept

What's a good way to introduce the idea of a Flexible ILIT with flexible distributions? Consider questions/comments like these:

"Are you concerned about the lifestyle choices your kids and grandkids may make?"

"Are you concerned about what might happen to them if they inherit a lot of money?"

"Are you willing to use some of your money to guide them to make positive choices with their lives?"

"You can add a component to your estate plan that may give your children and grandchildren strong incentives to build productive lives while at the same time minimizing estate taxes you may owe to the IRS."

"Would you like to see how this concept might work for you?"

## Conclusion

A Flexible ILIT can be a valuable and versatile estate planning tool. It may be drafted to contain provisions that make it an excellent vehicle for transferring funds to younger family members. Some of those provisions can give the grantor's spouse the opportunity to acquire funds in the trust. Flexibility features can also be built into the trust's distribution provisions to make sure that the beneficiaries do not become overly dependent on the trust funds. These provisions may give beneficiaries strong incentives to pursue positive goals and to build productive lives.

A Flexible ILIT can add a unique, positive dimension to a family wealth transfer plan that may provide liquidity and lifestyle guidance to younger family members for several generations. The Voya Life Companies have created a number of marketing materials to explain how an ILIT works. Some are training materials for agents, while others are approved for use with clients.

# Appendix I

## Technical Questions & Answers about ILITs

ILITs can be complex, detailed documents. Fortunately, over the years, court decisions and IRS public and private letter rulings have shed light on how ILIT transactions can be structured. Here are answers to some frequently asked questions regarding the Flexible ILIT concept.

### Question #1

**Should the non-grantor spouse ("spouse") contribute property to the ILIT?**

No. If the spouse is a beneficiary of the ILIT, then he or she should not contribute property to the ILIT. If the spouse does contribute to the ILIT, then some portion of the value of the ILIT (possibly including the policy death benefit) may be included in his or her estate at death. IRC Section 2036 requires that the ILIT value be included in the spouse's estate for estate tax purposes if the spouse contributes to the ILIT and has the right to income for life or for any period that does not terminate at least three years prior to the spouse's death.

> **Example:**
>
> Chris (grantor) creates an ILIT in which the income is payable to Maggie (spouse) for life and then the remainder to their two children (Dolly and Tamara). If Maggie does not contribute assets to the ILIT, the trust assets should not be included in her estate at her death even though she receives annually the ILIT income. If, on the other hand, Maggie does contribute to the ILIT (either actually or constructively), then at least some portion of the trust assets will be included in her estate since she has an income interest in the ILIT. Obviously, Chris (as grantor of the ILIT) should not have a right to income from the ILIT otherwise the ILIT assets will be included in his estate at death.
>
> Since the spouse typically has rights to income when the Flexible ILIT design is used, he or she should not actually or constructively contribute property to the ILIT.

### Question #2

**What are the typical ways a non-grantor spouse may actually or constructively contribute to an ILIT?**

A non-grantor spouse actually contributes to an ILIT by transferring his/her property (i.e. cash or income producing asset) to the ILIT.

> **Example:**
>
> Maggie may wish to make gifts to her two children (Dolly and Tamara) and she likes the idea of the gift leverage associated with life insurance. If she contributes $28,000 to the ILIT ($14,000 for Dolly and $14,000 for Tamara) for gifting purposes, then she makes an actual contribution to the ILIT.

A non-grantor spouse constructively contributes to an ILIT when:

1. The grantor spouse contributes community property funds or assets to the ILIT.

> **Example:**
>
> If Chris sets up an ILIT and makes a gift of cash that is considered community property, then the gift is considered as made by both Chris and by Maggie, thus Maggie has made a constructive contribution to the ILIT.

The community property status of Chris' gifts to the ILIT must be addressed prior to the contribution. Chris' separate property should be used to fund a Flexible ILIT. Also, gift-splitting can be effectively used in funding the Flexible ILIT as long as Chris' separate property is used. Maggie's decision to gift-split with Chris is not deemed to be a contribution to the ILIT that would classify Maggie as a grantor of the ILIT.

2. The spouse allows a Crummey power to lapse that is in excess of the $5,000 or 5 percent of trust assets rule (see Question #4 for more information).
3. The spouse has the right to ILIT income and instead of distributing the ILIT income to the spouse, the trustee retains the income and uses the income to pay ILIT expenses (i.e. premium payments on a second-to-die life insurance policy owned by the ILIT) or accumulates the income for future uses.

**Example:**

The ILIT owns a second-to-die policy on Chris and Maggie. After Chris' death, Maggie still has a right to income from the trust annually. If premiums are due on the policy, the trustee should not use income that is payable to Maggie to pay premiums or she will be considered as contributing to the ILIT and risk estate inclusion. Similarly, Maggie should not tell the trustee to keep the ILIT income, no matter how financially secure she is.

This problem can be avoided if the ILIT document gives the trustee the discretion to distribute the ILIT income to Maggie but does not require the trustee to do so. Such a provision would make ILIT income available to the spouse without creating an enforceable right to the income. Because access to the income would depend solely on the decision of a third party, the trustee's retention of any trust income would not be attributed to the spouse. In the previous example, if the trustee had discretion to pay the income to Maggie, but did not do so, the trustee could use the income to pay premiums without creating any taxable consequences to Maggie.

Many spouses are comfortable with the idea of trustee discretion. This is true for two reasons: (1) in most ILITs there is seldom any income to be paid out until the insured passes away (because most ILITs only own life insurance), and (2) the primary way to get money out of the ILIT to the spouse is through the provision giving the trustee discretion to distribute funds for the spouse's health, education, maintenance and support (see Question #5). If the spouse has a financial need or emergency, this is an excellent way to access principal of the ILIT. As long as there is appropriate language in the ILIT agreement directing the trustee to be liberal in assessing the spouse's financial needs and the spouse is comfortable with the person serving as trustee, relying on the trustee's use of discretion may not be a problem.

Remember, if the spouse has direct access to income from an ILIT, he or she should not actually or constructively contribute to the ILIT.

## Question #3

### Can the ILIT use income to pay premiums on a policy it owns?

Yes, however the ILIT agreement needs to be properly drafted to avoid inclusion in the spouse's estate. If the ILIT agreement states that ILIT income can be used to pay premiums, then the spouse's right (also detailed in the trust agreement) to ILIT income should be limited to income available for distribution after payment of premiums.

**Example:**

If the ILIT agreement states that all net income of the ILIT is to be paid to Maggie but only after premium payment on any policy owned by the ILIT, then the ILIT assets should not be included in Maggie's estate at her death because she does not make a constructive contribution to the ILIT (see Question #2).

Remember, if Maggie has the right to receive all ILIT income and the trustee, instead of distributing the income to Maggie, uses all or part of that income to pay premiums on the policy owned by the ILIT, then Maggie has constructively contributed property to the ILIT. Since Maggie is also an income beneficiary of the ILIT, the contribution of property to the ILIT will potentially cause at least a portion of the ILIT assets, including the policy's death benefit, to be included in Maggie's estate at death.

If Maggie has an annual right to the ILIT income, the trustee should distribute the ILIT income to her. However, with proper drafting, the trustee can use ILIT income to pay premiums and then distribute any remaining income to Maggie.

Also, if the trustee has the discretion to pay income to Maggie, but is not required to do so, the trustee can decide annually whether to use income to pay premiums, and if there is any excess, to pay it out to Maggie (see Question #2).

## Question #4

### Can the spouse have a Crummey withdrawal power?

Yes, however the spouse's lapse of a Crummey withdrawal power should be limited to the greater of $5,000 or 5 percent of the ILIT assets, otherwise the spouse makes a constructive contribution to the ILIT (see Question #2).

Generally speaking, the "lapse" or failure to exercise a Crummey withdrawal power is considered a "release," and a "release" is considered a contribution of property to the ILIT. However, there is an exception to the "lapse" rule that states a "lapse" is not treated as a "release" (and therefore not a contribution) to the extent the "lapse" does not exceed the greater of $5,000 or 5 percent of ILIT assets. Therefore, the spouse is not considered as making a contribution as long as the lapse of a Crummey withdrawal right is less than the greater of $5,000 or 5 percent of the ILIT assets.

**Example:**

Chris creates an ILIT in which the income is payable to Maggie for life and then the remainder to Dolly and Tamara. Since Maggie has an income interest in the ILIT, she does not want to actually or constructively contribute to the ILIT or she risks inclusion of the ILIT assets in her estate at death. Maggie, Dolly and Tamara are each given Crummey withdrawal powers in order to utilize the gift tax annual exclusion available to Chris.

Either of two approaches can be used to minimize Maggie's risk of estate inclusion:

1. Limit Chris' annual gift to the ILIT for which Maggie has a withdrawal right to $5,000. Or,
2. Limit Maggie's lapse of her withdrawal right (Crummey power) to the 5 x 5 rule (the greater of $5,000 or 5 percent) in the ILIT agreement and Crummey notice. Any gift in excess of the 5 x 5 power would not lapse but would continue to be available for withdrawal by Maggie in future years ("hanging powers").

When properly structured, the spouse can have a Crummey withdrawal power in an ILIT without causing the assets to be included in his/her estate at death.

## Question #5

### Can the spouse have a right to distributions from ILIT assets (other than income)?

Yes, but the right to receive ILIT assets (other than income) should be limited by an "ascertainable standard" to avoid the ILIT assets being included in the spouse's estate at death. The ascertainable standard relates to health, education, maintenance and support. If the spouse's right to ILIT assets (other than income) are limited to the ascertainable standard, then the ILIT assets should not be included in the spouse's estate at death.

**Example:**

The ILIT agreement states that at the trustee's discretion, he or she can make distributions of ILIT assets (other than income) for Maggie's health, education, maintenance and support. As long as the trustee's power to distribute assets is discretionary and limited to Maggie's health, education, maintenance and support, the ILIT assets should not be included in her estate at death.

## Question #6

### Can the grantor retain the right to fire and replace the ILIT trustee?

Yes, within limits. There can be a number of reasons to include a trustee removal and replacement provision in the ILIT agreement (i.e. the trustee is performing poorly or not acting in the best interests of the beneficiaries). The grantor can retain the right to fire the trustee and name a successor without bringing the trust assets into his/her estate if the provision is carefully drafted. By itself, the right to fire the trustee does not present a problem. However, the ability to name a successor trustee should be limited in two ways. First, the grantor should not be able to appoint him/herself as the successor trustee. Second, the grantor should only be able to appoint a new trustee who is independent of the grantor. Someone who is potentially subservient to or dependent upon the grantor should be specifically excluded from being appointed as a successor trustee. The grantor's spouse, children, grandchildren, their spouses, dependent relatives, employees (including professional advisors), and business partners are all potentially subservient to or dependent upon the grantor. Consequently, they are probably not suitable candidates to serve as a successor trustee. Perhaps the best choice would be an independent corporate trustee.

**Example:**

If Chris has an unrestricted power to remove the trustee and appoint anyone (including himself), then he risks estate inclusion of the ILIT assets at his death. Even if Chris does not retain the power to remove the trustee but has the power to name himself as trustee, the IRC indicates that the ILIT assets will be included in his estate.

On the other hand, if Chris can only appoint an independent successor trustee (other than himself) if the original trustee resigns or is removed, the ILIT assets should not be included in his estate. Similarly, if Chris may remove the trustee but has no power to name a successor trustee, the ILIT assets will not be included in his estate. Finally, Chris can retain the power to determine the trustee's compensation (which can influence the trustee to resign) without causing estate tax inclusion.

In summary, the grantor's and/or insured's powers over the trustee and the ability to appoint a successor trustee must be carefully drafted to avoid the ILIT assets being included in the estate at death.

## Question #7

**If the spouse has access rights to the ILIT that owns a second-to-die policy insuring the grantor and spouse, how are premiums paid once the grantor dies if the spouse cannot contribute to the ILIT?**

There are several possible ways an ILIT can pay premiums on a second-to-die policy after the grantor's death. First, death benefits from a single life policy on the grantor could be used to pay future premiums. Second-to-die policies usually give the owner the option of adding a "single life term insurance rider" to the policy. This is a separate term life insurance policy that pays death benefits when that insured dies, regardless of whether he/she is the first or second to die. Second, to the extent the ILIT owns income-producing property, the income these assets produce could be used to pay future premiums. Third, the surviving spouse or other family members could lend the ILIT the additional dollars needed to pay premiums. Fourth, the ILIT could borrow funds from a financial institution or non-family individuals to pay future premiums; this strategy is sometimes called premium financing. Fifth, the trustee could reduce or avoid the need for future premiums by choosing to reduce the policy death benefit. This is known as changing the policy to "reduced-paid up status."

## Question #8

**The grantor established an ILIT several years ago; it does not have any of the access rights for the grantor's spouse. Is there any way the trust can be revised to add spousal access rights?**

No, but other action may be possible. The trust generally can't be amended or revised to add new provisions unless there is a specific procedure contained in the trust document. However, there may be a way to solve the problem without trying to amend the trust. The grantor could establish a new ILIT that does have spousal access rights (and any other provisions that would make the trust a "Flexible ILIT"). Then the new ILIT could purchase the policy from the old ILIT for its fair market value. This would have the effect of putting the policy in a new, "updated" ILIT. Both ILITs could have the same trustee(s) and the same beneficiaries. If both ILITs are grantor trusts, then the purchase could qualify as an exception to the transfer for value rule. Of course, the new ILIT will have to be funded with enough money for the trustee to complete the purchase. The funds for the new ILIT can potentially come from two sources: (1) gifts from the grantor, or (2) loans from the grantor. After the policy is sold, the old ILIT will have only cash. Depending on the terms of the trust, it may be possible to distribute that cash.

Another potential way to "upgrade" the ILIT is to merge the old ILIT into a new ILIT. The old ILIT may have a provision permitting the trustee to merge it into another trust that has similar beneficiaries. Before using this alternative, the trustee of the old ILIT will want to consult with each beneficiary to give written approval to the merger.

## Question #9

**Can the grantor name someone as a "trust protector" and give that person the power to amend the trust?**

Possibly. Drafting the trust to include the position of "trust protector" has become a popular strategy in the last several years. The provision generally gives the "trust protector" the ability to revise or amend the terms of the trust in order to increase the likelihood that it will accomplish its stated objectives. The trust protector is really a special trustee who is not concerned with the day-to-day management of the trust. Rather, he/she is to help the trust respond or adapt to outside events so it can do what the grantor intended it to do. For example, the trust protector could revise the trust so it complies with changes in the state and federal tax laws. If new state laws affecting the power of trustees are adopted (e.g. Uniform Principal and Income Act or the Uniform Prudent Investor Act), the trust protector could amend the trust.

Giving someone (other than the grantor) the power to change the trust should not result in negative estate tax consequences for the grantor as long as the grantor cannot serve as the trust protector. Neither should the grantor's spouse or beneficiaries of the trust serve in that capacity. The trust protector should be independent of all grantors, trustees and beneficiaries. Generally, he/she should not be allowed to revise the trust to provide him/herself personal gain or advantage. Also the trust protector should be given the discretion to take action but should never be required to act. The provision may also include the appointment of a successor trust protector who can assume the position if the acting trust protector dies, becomes disabled, resigns or is unable to act for other reasons.

## For more information

Contact your Voya Life Companies' representative
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