WRMarketplace

An AALU Washington Report

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TOPIC: Out with the Old, In with the New - Revitalizing or Unwinding Existing ILITs.

MARKET TREND: With recent changes in federal gift and estate tax exemptions, many clients may want to take a new look at their old irrevocable life insurance trusts ("ILITs").

SYNOPSIS: In legacy and life insurance planning, using ILITs to acquire life insurance was almost automatic. Now, with lower federal estate tax rates and higher exemptions, some clients may feel saddled with old ILITs that no longer match their goals or provide the intended tax benefits, even though retention of the life insurance makes financial and investment sense. Yet, clients should understand that terminating the trust is not their only option. The ILIT still may provide many practical benefits and often can be updated to meet current family needs through decanting, judicial or non-judicial trust reformations, or the sale of the policy to a new trust. If termination is selected, the trust creator ("grantor") may be able to re-acquire and repurpose the insurance policy for his or her personal planning needs by purchasing the policy from the ILIT or swapping it for assets of equal value. The trustee also could decide to distribute the policy to the grantor's spouse, if a beneficiary.

TAKE AWAY: In trust planning, irrevocable no longer means inflexible. Keeping this in mind, clients and advisors should review existing ILITs and weigh the trust's potential practical benefits against the impact of termination, including the loss of creditor protection and centralized asset management for the beneficiaries,. Federal tax laws also may change, re-creating the estate tax exposure the ILIT initially addressed. Whether modification or termination is selected, clients, advisors, and trustees should ensure that the trustee's actions with regard to the ILIT or its assets do not violate any fiduciary duties owed to the beneficiaries.

In legacy and life insurance planning, using ILITs to acquire life insurance was almost automatic. Now, with lower federal estate tax rates and higher exemptions, some clients may feel saddled with old ILITs that no longer match their legacy planning goals or provide the intended tax benefits, even though retention of the life insurance makes financial and investment sense. Clients, however, should understand that terminating the trust is not their only option.

GET RID OF THE OLD ILIT? NOT SO FAST

Clients and advisors should consider carefully the impact of ILIT termination. Federal tax laws may change, re-creating the estate tax exposure the ILIT initially addressed.[1] Clients or ILIT beneficiaries also still may face state estate tax exposure, depending on their residence. The ILIT's termination will eliminate any creditor protection and centralized management of the trust assets. Clients who want to retain these benefits but revitalize their trusts to resolve issues or revise outdated provisions should consider the following:[2]

Decanting. Decanting allows the trustee of an existing trust to transfer assets to a different "receiving" trust (new or existing), which has terms better suited to meet the original trust's overall goals, to adapt to changing beneficiary needs, and/or to adjust to new tax, legal, or economic circumstances.

- *Why/When to Use:* Decanting has become very common in trust planning, with over 25 states adopting decanting laws. As discussed in more detail in *WRMarketplace Nos. 14-21* and *17-30*, decanting can accomplish numerous planning objectives, such as:
    - Simplifying the transfer of a life insurance policy from one ILIT to another. Decanting can avoid the use of a trust-to-trust sale or substitution of trust assets, which eliminates the need to value the policy for transfer purposes or to fund another trust with assets sufficient to acquire the policy from the original trust.
    - Broadening investment powers or segregating assets into separate trusts (e.g., to separate asset classes, or to move a first-to-die policy out of a survivorship ILIT).
    - Splitting or consolidating trusts to minimize conflicts among beneficiaries, or to reduce administrative costs, improve investment power, and streamline trust management.
    - Modifying trustee administrative provisions and/or adding other fiduciaries (such as investment advisors, trust protectors, etc.).
    - Changing the trust's situs and governing law to a state that provides more robust trust laws, creditor protection, or other advantages.
    - Modifying distribution standards, potentially to make trust distributions fully discretionary or to help maximize the time for assets to remain in trust.
- *What to Consider:*

- An independent trustee may be required to initiate the decanting, and the original trust may need to provide the trustee with broad, discretionary distribution powers.

- Decanting procedures and permitted changes are state-specific, and state laws vary significantly. For example, some states, like Delaware, have flexible decanting provisions that permit several differences between the original and new trust and may not require notice to the trust beneficiaries, while others limit changes and have detailed notice requirements. A trustee may consider changing the trust jurisdiction to fall under a more favorable decanting statute. Alternatively, the trustee may be able to decant pursuant to the terms of the trust agreement, if it includes decanting provisions.[3]

- Clients and trustees should proceed cautiously if there are any differences in the tax status of the trusts (e.g., generation-skipping transfer ("GST") tax exempt status, grantor/non-grantor trust status) and/or changes in any beneficial interests and consider any possible gift, GST and/or income tax consequences. There is little definitive guidance on these issues to date.[4]

- The trustees should review their fiduciary obligations carefully and ensure their actions do not breach any fiduciary duties to the existing trust or any beneficiaries (e.g., duties of loyalty and impartiality among beneficiaries). Notification to the trust beneficiaries or judicial approval may still be sought, even if not required, to address these concerns.

- While common, the ability to decant should not be assumed. Courts have invalidated decanting when it failed to comply with the trust terms or applicable state law.[5]

Judicial/Non-Judicial Trust Reformation. Before decanting became mainstream, irrevocable trust modifications often involved a reformation of the existing trust agreement. Depending on state law, reformation can be: (1) non-judicial, typically requiring the consent of all trust beneficiaries (and possibly the grantor and trustee); or (2) judicial, requiring court approval.

- *Why/When to Use:* Trust reformations may be sought when: (1) decanting is not an option, either due to the lack of decanting provisions in the trust agreement or under applicable state law (and assuming the trust situs cannot be changed); (2) the objective is to modify the grantor's original intentions with regard to the trust; and/or (3) the proposed changes significantly alter the trust beneficiaries, distributions provisions, and/or fiduciary compensation or other rights. Further, from a fiduciary perspective, reformations may offer more protection to trustees, since they involve court approval and/or consent from all beneficiaries.

- *What to Consider:* As with decanting, trust reformation is state law dependent. Some states may only allow judicial reformations, and some may only permit reformations (judicial or non-judicial) in certain circumstances (e.g., to correct mistakes or because of unanticipated circumstances or the inability to administer trust effectively, etc.). Further, given the required court proceedings and/or notice and consent requirements, reformations may be costlier and more time-consuming than other alternatives. Finally, as noted in *WRMarketplace No. 19-05*, recent cases have shown that, despite the consent of all parties, courts may still reject trust reformations if they do not comply with the applicable statutes or the trust's original purpose/intent.

Sale to Another Irrevocable Trust. An existing ILIT can sell the policy to a new ILIT with different terms.

- *Why/When to Use:* A trust-to-trust sale may be an option if decanting or reformation is not available or feasible. Neither notice or consent of the ILIT beneficiaries may be required. Further, if the policy sale is for fair market value between ILITs that are wholly-owned grantor trusts with regard to the insured, there should be no transfer tax ramifications, transfer for value issues, or other income tax consequences triggered by the sale.

- *What to Consider:*

    - If the policy sale is between ILITs that are not wholly-owned grantor trusts as to the policy's insured, potential transfer for value and associated income tax issues should be carefully reviewed.

    - The purchasing ILIT must have assets/cash available to acquire the policy from the selling ILIT, which may necessitate a gift or other funding arrangement between the grantor and the purchasing ILIT.

    - Determining the policy's fair market value for a sale can be tricky and may require a valuation by a professional appraiser (who will charge a fee), not just reliance on the policy's interpolated terminal reserve value, as issued by the insurance carrier.

    - Each ILIT trustee must consider the appropriateness of the transaction in light of their fiduciary obligations, particularly if the beneficiaries of the ILITs differ.

UNWINDING ILITS

Even with the practical benefits offered by ILITs and the potential to modify them, clients may still decide that they would like to retain the policy, but not the trust. The options for unwinding an ILIT, however, will vary based on its terms and the desired recipient of the policy.

Distribution to Beneficiaries. Depending on the ILIT's distributions provisions, the trustee can distribute the policy outright to one or more of the current trust beneficiaries.

- *Why/When to Use:* If the grantor's spouse is a current beneficiary, distributing the policy to the spouse may be the simplest way for the family to reacquire the policy and keep ownership in the hands of a single owner.

- *What to Consider:* Spousal distributions will not be permitted if the spouse is not a beneficiary (as in a survivorship ILIT). Also, if the trust has multiple current beneficiaries, fiduciary concerns may caution against distributions to just one beneficiary unless the trust terms authorize discretionary and unequal distributions among beneficiaries and/or give priority to certain beneficiaries (such as a spouse), or the trustee has otherwise obtained the consent of all beneficiaries. Distribution of the policy to multiple beneficiaries, however, can result in fractional ownership of the policy (including ownership by minor beneficiaries, if any), creating policy management issues and the potential for conflict.

Asset Swap/Sale to Grantor. If the grantor wants to re-acquire the policy, he or she could exercise a substitution power (if provided under the trust) to swap assets of equivalent value for the policy.[6] Otherwise, the trust could sell the policy to the grantor for its fair market value.

- *Why/When to Use:* A swap or policy sale to the grantor may be the only way for the grantor to re-acquire the policy if his or her spouse is not a current beneficiary. Reacquisition of the policy also may provide more flexibility to update, change, or repurpose the insurance product to adjust to the family's current needs. It also avoids fractional ownership of the policy, allowing the ILIT to distribute the swapped assets or sale proceeds to the trust beneficiaries when terminating the trust, instead of the policy. Neither a swap or sale may require notice or consent to the trust beneficiaries (although the trustee may consider such actions to address the fiduciary concerns noted below).

- *What to Consider:* If the grantor substitutes assets for the trust policy, the trustee must ensure that they are of equivalent value, potentially requiring an appraisal of both the policy and the substituted assets (if they are not cash or marketable securities). A sale of the policy will trigger the same fiduciary and valuation considerations as a trust-to-trust sale (although transfer for value issues should be avoided assuming the grantor is the insured under the policy).

TAKE AWAY

In trust planning, irrevocable no longer means inflexible. Keeping this in mind, clients and advisors should review existing ILITs and weigh the trust's potential practical benefits, including the loss of creditor protection and centralized asset management for the beneficiaries, against the impact of termination. Federal tax laws also may change, re-creating the estate tax exposure the ILIT initially addressed. Whether modification or termination is selected, clients, advisors, and trustees should ensure that the trustee's actions with regard to the ILIT or its assets do not violate any fiduciary duties owed to the beneficiaries.

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[1] Although the current higher federal gift and generation-skipping transfer tax exemptions could be used to make larger gifts to fund ILIT premiums (instead of annual exclusion gifts and associated *Crummey* withdrawal notices to beneficiaries) or to unwind existing split-dollar funding arrangements, minimizing future administrative issues.

[2] Note that any trust changes or inter-trust transfers of policies or assets also should consider the impact of any outstanding trust liabilities, such as policy loans or split-dollar arrangements that are in place to fund the policy premiums (e.g., should the arrangement be terminated and re-paid or can it be assigned to the new trust, if any, receiving the policy)?

[3] *See In Matter of Hoppenstein*, 2017 NY Slip Opinion 30940 (March 2017), where the New York County Surrogate's Court upheld the decanting of a trust-owned life insurance policy to another trust that eliminated certain beneficiaries of the original trust. The court found the decanting was a valid exercise of the trustee's discretionary

power to distribute principal as provided under the trust instrument; since the trust terms authorized decanting, the process was not required to proceed according to New York's statutory requirements).

[4] In December 2011, the IRS issued Notice 2011-101 requesting comments regarding when, and under what circumstances, changes in beneficial interests resulting from decanting assets from one irrevocable trust to another will not trigger income, gift, estate and/or GST taxes; however, it has yet to provide follow up guidance.

[5] *See e.g., Ferri v. Powell-Ferri*, 2013 Conn. Super. LEXIS 1938 (2013); 2015 Conn. LEXIS 161(Ct. Supreme Court, 2015) (court invalidated a decanting that eliminated a beneficiary's vested rights over trust assets to protect them from a divorcing spouse's claims; the trust agreement did not give the trustee absolute discretion over trust distributions and the beneficiary had the right to withdraw trust assets upon reaching certain ages); *Petition of Katharine A. Johnson to Nullify the Decanting of the Trust Created under an Agreement made by Michael L. Johnson*, 2015 NY Slip Op 30017(U); 2015 N.Y. Misc. LEXIS 51 (2015) (New York decanting statute did not authorize a trustee to decant a trust to one that added successor and remainder beneficiaries); *Harrell v. Badger,* 2015 Fla. App. LEXIS 11183 (2015) (court voided decanting of a special needs trust without notice to all required beneficiaries; it also found breach of fiduciary duty).

[6] See Rev. Rul. 2011-28, holding that the grantor's retention of a nonfiduciary substitution power permitting him to acquire a life insurance policy held in trust by substituting other assets of equivalent value would not, alone, cause the value of the policy to be includible in grantor's gross estate as long as the trustee has a fiduciary obligation to ensure that the assets acquired and substituted by the grantor are of equivalent value and the substitution power cannot be exercised in manner that can shift benefits among trust beneficiaries.