THE ILIT IN A NEW ERA

Exploring the tax, administrative, and fiduciary ramifications of a taxpayer invented trust vehicle, as time and tax laws change…

Fran M. DeMaris
Executive Vice President
Cannon Financial Institute, Inc.

Where Did We Start?

- Crummey vs the Commissioner dated 1968
- Gift Tax Annual Exclusion at $3,000/year
- Estate Tax Exemption Equivalent Amount at $60,000/person

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Where Are We Now?

- Gift Tax Annual Exclusion is $14,000/year with a COLA under the TRA of 1997, which causes incremental changes of $1,000
- Gift and Estate Tax are Unified in 2015 with an Exemption Equivalent Amount of $5.43 million on a COLA each year…

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Where Are We Now?

- According to the comments made at the January 2015 Heckerling Conference, only the top .2% of Americans will now need to focus on Transfer Taxation in Planning

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Where Are We Now?

- Additionally, “Portability” is permanent under the law since ATRA of 2012
- Portability allows the first-to-die spouse in a marital situation to shelter any unused Exemption Equivalency to be used at the second spouse’s death, IF AND ONLY IF, a 706 Estate Tax Return is filed at the first death requesting the portability

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Portability –When?

- The use of portability requires some appropriate planning:
  - Filing the 706
  - Balancing the Income Tax growth potential vs the Credit Shelter Growth outside the surviving spouse’s Estate; of particular concern with Dynasty Trust choices
  - Portability is unavailable for GSTT Exemption

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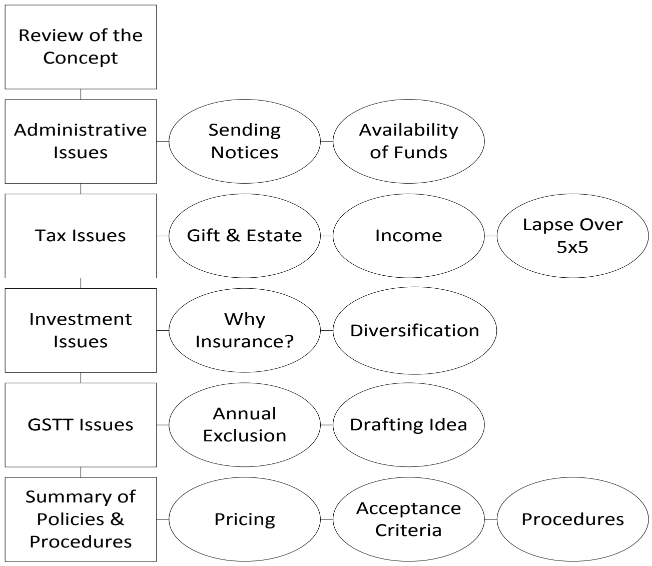
Learning Map



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Review of the Concept

- Make an irrevocable trust qualify for the gift tax annual exclusion by creating a "present interest" (4 methods):

  * Outright   * Minor's trust

  * Simple trust   * Crummey Power

- Multiply annual exclusions by the number of beneficiaries
- Make gifts up to the exclusion amount without any use of applicable credit amount, including potential Gift Splits

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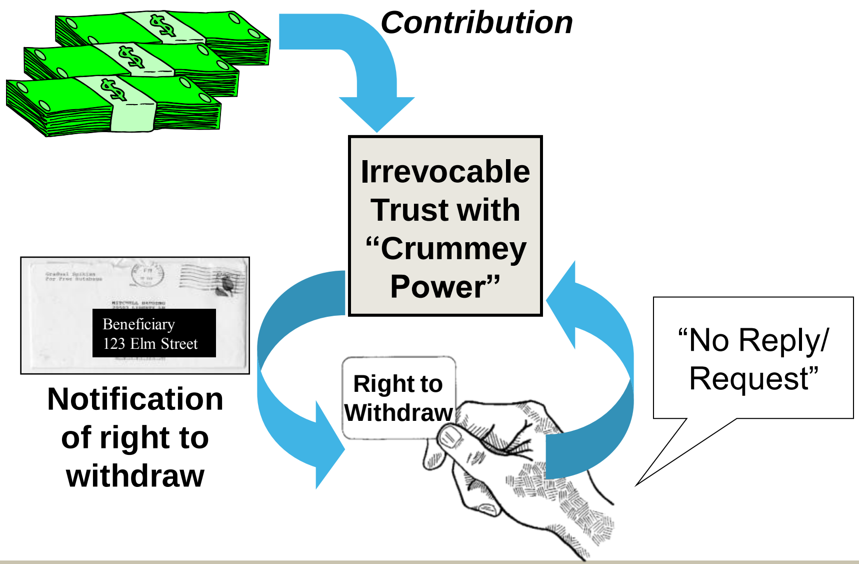
Review of the Concept



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Issues to be Addressed

1. Administrative & legal issues
   - Notice of Crummey powers
   - Availability of funds
2. Tax Issues
   - Tax consequences of power
   - Taxable lapse in excess of 5x5
3. Investment reasoning for buying insurance
4. GSTT implications

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ADMINISTRATIVE ISSUES

Notice of Crummey Power
Availability of Funds

Notice of Crummey Powers

- Beneficiaries should be notified of their right to withdraw
  - In writing gives best record
  - Return receipt for delivery of "lapsing notice"
  - For every contribution, not annually nor single
  - Notice to legal guardian for minors
- Contingent beneficiaries are okay as power holders, per case law in Maria Cristofani

Availability of Funds

- Power must be “substantial,” standard is 30 days (less is aggressive, more is unnecessary)
- Funds should be available for the withdrawal period
  - Premium due date
  - Group insurance has always been problematic

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TAX ISSUES

Gift Tax
Estate Tax
Income Tax
Taxable Lapse in Excess of 5x5

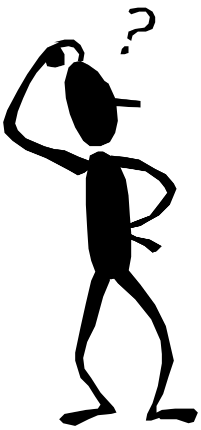
Transfer Tax Consequences

- Gift taxable transfer, but eliminated by annual exclusions ($14,000 each) and, if necessary, applicable credit amount
- Withdrawal right creates present interest by creating a lifetime general power of appointment (GPA) to power holder
- If power holder dies during withdrawal period, includible in estate of power holder
- Out of settlor's estate, if no retained power

Income Tax Consequences

- Most are considered Grantor Trusts, due to the power to purchase life insurance on grantor with income of the trust (§677)
- If not, then it is a Grantor Trust with respect to the portion subject to withdrawal right for that period
- No 1041 due if less than $600 income, but Grantor Information Letter due regardless

Taxable Lapse over 5x5



- When a GPA lapses there is a gift of the amount over the greater of $5000 or 5% of property subject to the power (IRC§2514(e))
- Often in ILITs this may occur because of the low value of the corpus
- *Example:* $14,000 in, $14,000 can be withdrawn but isn't, GPA lapses and is greater than 5x5 limit

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Potential Solutions to 5x5 Issue

Solution	Problem
1. Limit withdrawal right to lesser of annual exclusion or 5x5	1. Limits amount of present interest for contribution
2. Make lapse an incomplete gift as sole beneficiary or Testamentary GPA	2. Included in estate of power holder and limits ability to generation skip
3. Hanging powers	3. IRS may challenge and is a recordkeeping nightmare

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Fiduciary Liability for Purchase of Life Insurance

Liability Issue
3 Year Rule
Why Insurance?
Why This Policy?
Diversification

Fiduciary Liability Issues

- Trustee is not limited to buying insurance
- Insurance is not a standard investment for most trustees, thus must justify purchase
- Treat purchase and annual review same as other assets
  - TIC purchase approval and annual review
- Disclose conflicts of interest if you sell insurance and receive a commission

Protection from 3-year Rule

- A grantor who transfers cash to a trust which purchases life insurance on his life is not subject to the 3-year rule of IRC §2035 where the grantor has no incidents of ownership in the policy *Estate of Perry v. Comm'r 927 F.2d 209, rejected the "beamed" transfer rule enunciated in Bel v. United States 452 F.2d 683 (5th cir. 1971) consistent with earlier rulings in Estate of Leder v. Comm'r 893 F.2d 237 (1989) and Estate of Headrick v. Comm'r 918 F.2d 1263 (1990)*

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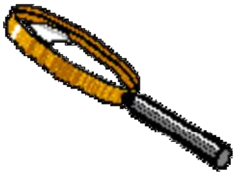
Why Insurance?

- Focus on "Grantor's Intent" in creating arrangement
  - Liquidity
  - Replacement value
  - Build an estate, or income replacement
- Only "immediate" solution to problems above
- Really premature death insurance



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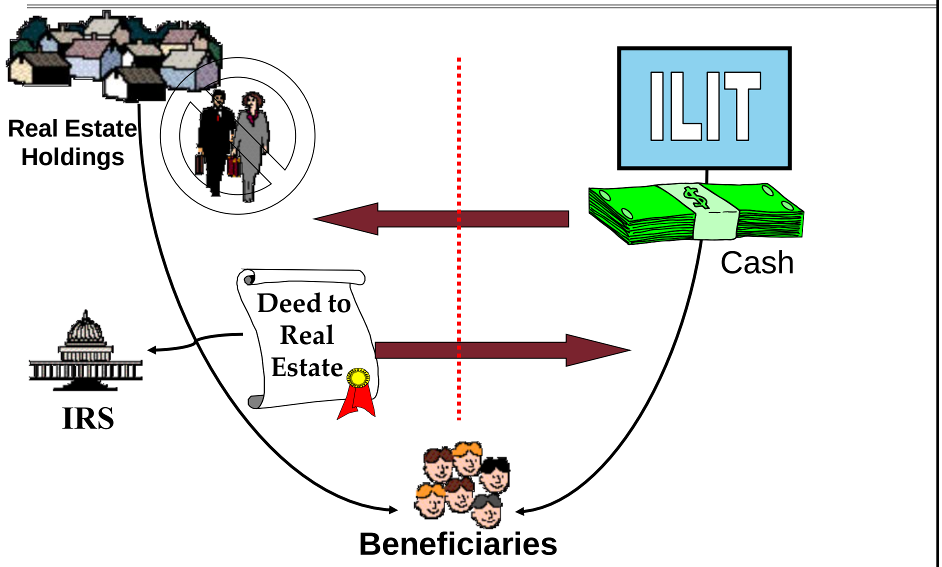
Liquidity



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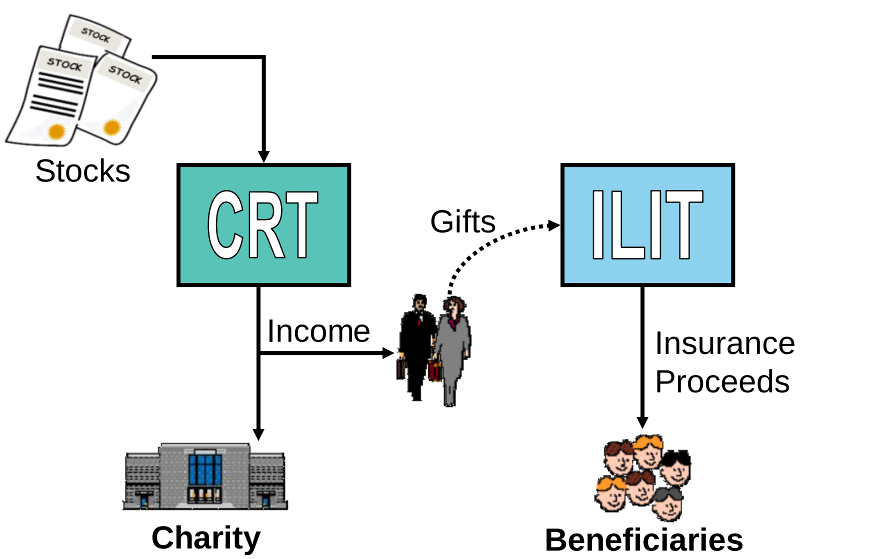
Replacement Value



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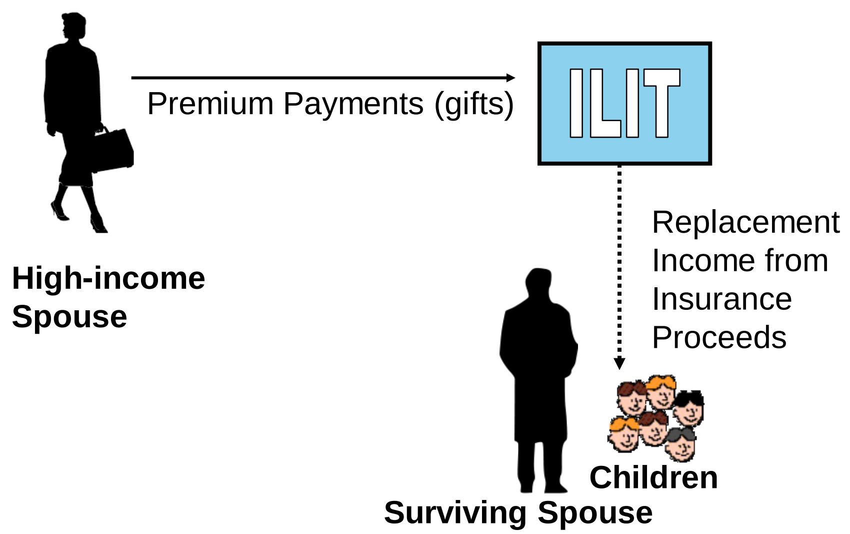
Build an Estate/Replace Income



Why THIS Insurance Policy?

- Have insurance investment guidelines
  - Does not have to be the "best," it needs to be appropriate for the situation
  - Issuer quality thresholds are a good idea
    - Major ratings services have coverage
- Consider using only your own insurance unit if they already do appropriate due diligence, but… disclose the conflict of interest and reason for use, in writing

Why Not Diversified?

- Diversification is fundamental to a trustees investment duties
- Looked at on it's face, an ILIT would appear to be undiversified, but…
- ...Not when looked at in the context of the Grantor's TOTAL estate plan
- The ILIT is just one specialized trust in a multi-faceted plan

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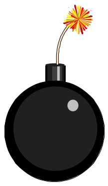
GSTT Issues

Annual Exclusion Problems
Drafting Idea

GSTT Consequences

- An ILIT, generally, does not qualify for the GSTT annual exclusion, and
- There's usually the possibility of a skip, and
- Most ILITs are not skip persons, so
- The inclusion ratio of most ILITs is "1" unless GSTT exemption is allocated on a gift tax return or at death (then on the death benefit value not premium value)



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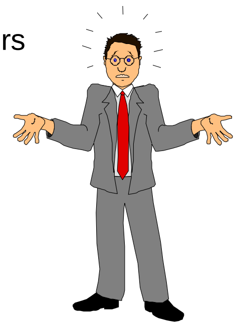
Different Rules for Gift & GSTT

<u>Gift Tax Annual Exclusion (Present Interest)</u>

- Outright
- Simple Trust
- Minor's Trust
- Crummey Powers

<u>GSTT Annual Exclusion (Non-taxable direct skip) TAMRA 3/31/88</u>

- Outright Direct Skip or
- Direct Skip to "Special Trust"
  - One current beneficiary
  - Includible in his/her estate



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Filing Requirements

- A transfer to an ILIT may qualify for the gift tax annual exclusion, thus no 709 needs to be filed
- The same transfer may not qualify for GSTT annual exclusion, thus either:
  - Leave trust exposed to GSTT (may be other better places to use exemption), or
  - File 709 to allocate GSTT exemption
  - Watch out for deemed allocation rules--may need to elect out

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Drafting Solution

- Create a trust that qualifies for both
- Provisions:
  - Trust for each grandchild (or other skip person)
  - Testamentary GPA to grandchild
- Qualifies for Gift AND GSTT annual exclusions, thus free of gift, estate and GSTT tax and has not used any applicable exclusion amount or GSTT exemption

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SUMMARY OF POLICY CONSIDERATIONS

Pricing
Acceptance Criteria
Procedures

Policy Considerations

- Pricing
  - Acceptance
  - Administration
  - Termination
- Acceptance Criteria
  - Size
  - Relationship (current or deferred)
- Procedures
  - Document analysis
  - Insurance review
  - TIC approval
  - Account set up
  - Sending notices
  - Creating ticklers

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