



Estate Planning

Accessing Cash Value in an Irrevocable Life Insurance Trust

When the American Taxpayer Relief Act of 2012 was signed into law, the federal estate tax exemption was permanently set at \$5 million (indexed for inflation), as well as “portability” of a deceased spouse’s unused exemption, which allows a married couple to transfer \$10 million (indexed for inflation) of assets without federal estate taxation and without creating a non-marital or bypass trust at the first death. The high exemption limits, coupled with the fact that the net worth of many individuals have declined over the past few years due to economic conditions, have made estate tax planning less important for many. As a result, individuals or couples who have previously created irrevocable trusts funded with cash value life insurance may now want or need to access those cash values. But, can they?

Depending on how the trust was drafted, it may be possible for you or your spouse to access policy values, directly or indirectly.

The American Taxpayer Relief Act of 2012

The Act made “permanent” the \$5M exemption (indexed for inflation) and “portability”, so that married couples can effectively escape federal estate tax on an estate of \$10M (indexed for inflation). However, “permanent” means until Congress decides to take the issue up again and amend the law, so even if you do not have a federal estate tax problem now, you may in the future. Further, individuals with estates right around the exemption amount may have a future estate tax problem simply due to asset growth (i.e., the growth of your estate may exceed the rate of inflation that is applied to the exemption).

State Death Taxes

Depending upon the state in which you live, you must also be cognizant that many states have their own estate tax or inheritance tax. Irrevocable life insurance trusts can shelter death benefits from these taxes.

Lifetime Economic Value of Life Insurance

For the remaining parts of memo, let’s assume that as a result of the new Act, you no longer require the estate planning benefits of life insurance owned by an irrevocable trust. Over long periods of time, certain types of cash value life insurance policies have performed well as a lifetime accumulation fund.

You may be noticing that the cash value accumulations in the policies owned by your irrevocable trusts are an attractive source of money that may help for retirement or other financial needs. How do you access the cash values of that policy?

Let’s use the following scenario to think about during our discussion. Years ago, an individual created an irrevocable trust funded with cash value life insurance issued on his or her life for estate planning purposes. The grantor has been making gifts to the trust so that the trustee has funds to pay premiums. When the grantor created the trust, the federal estate tax exemption had just been increased to \$1,000,000. Currently, the cash value of the policy is \$500,000 and the death benefit is \$2 million. The grantor is no longer concerned about estate taxes because of the increase in the federal estate exemption, and wants to access policy values for his or her retirement.



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1. Indirect Access to Cash Value

Depending upon how the trust was drafted, the grantor may be able to indirectly access the cash value. It is not uncommon for a trustee, particularly an independent trustee, to have the discretionary power to distribute trust income and/or trust principal to the grantor's spouse or children during the grantor's lifetime. This power may be completely discretionary, or based on what are known as "ascertainable standards" relating to a beneficiary's health, education, maintenance and support. Alternatively, a spouse may have the power to invade trust principal, based on the same ascertainable standards. A distribution made to the spouse would be used to indirectly benefit the grantor.

Note, however, that the trustee should *carefully* exercise any discretionary power regarding distributions to the spouse. The trustee has a fiduciary responsibility to manage trust property for the benefit of *all* beneficiaries which may include children or grandchildren. Some trusts, however, direct the trustee to take into consideration the financial needs of a spouse over the needs of any other trust beneficiary.

In addition, in most states, trustees are subject to the Uniform Prudent Investor Act (UPIA) or other similar statute. This law requires trustees to manage trust assets based on a variety of factors that may include assessing risk and taking into consideration the purposes of the trust and the "relevant circumstances of the beneficiaries". In general, loans or surrenders of cash values that are distributed to a beneficiary during the insured's lifetime may affect the death benefit of the policy and may not be deemed in the best interests of all trust beneficiaries. Withdrawing cash values out of the policy would reduce death benefits or could cause the policy to subsequently lapse. Even if the trustee has complete discretion, he or she should consult with counsel before making substantial discretionary distributions.

2. Sell Assets to the Trust

A second way a grantor can indirectly access policy values is by selling property to the trust in exchange for cash obtained from the policy, or perhaps even the policy itself. The sale should be an arms length transaction, which means the property should be sold to the trust at *fair market value*. The property's value should be determined by an independent appraiser.

Note, however, that if the policy itself is used for the purchase, that means that the trust no longer holds life insurance, which may impact future estate planning concerns. In addition, the UPIA rules mentioned above still apply and the same concerns exist with regard to the trustee's fiduciary duties towards all of the trust beneficiaries. There are other concerns as well. For example: What if the trustee sold the policy and the insured died a short time thereafter? Clearly, the value of the property acquired by the trust will be less than the value of the policy death benefit. Would the trust beneficiaries have a cause of action against the trustee? Did the trustee investigate the health of the insured at the time of sale? How did the trust beneficiaries benefit from this sale? Accordingly, it is recommended that a trustee consult with counsel before any transaction takes place.

In addition, the tax ramifications of a sale can be complicated if the trust is not a "defective trust" (also called a "grantor trust") for income tax purposes. The grantor would realize gain on the sale to the extent the fair market value of the policy on his or her life exceeds his or her cost basis on the property sold to the trust. The trust would also realize taxable income if the sales price exceeded the trust's cost basis in the policy. If the trust was a defective trust, however, gain would not be realized for income tax purposes by either party because the grantor is also considered the owner of the trust property for income tax purposes.



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Furthermore, before a sale is made, the trustee should review the investment powers set forth in the trust document. Typically, these powers give a trustee complete discretion regarding retaining or selling property. However, some trusts have restrictions regarding the sale of property to the grantor or spouse, or require the trustee to retain the insurance policy to the extent it is practical to do so.

3. Survivorship (Second-to-Die) Life Insurance in a Trust

Accessing policy values might be more difficult with a trust funded with survivorship life insurance. This is because the husband and the wife are the insureds, and neither will be a beneficiary of the trust. Therefore, the only way of indirectly accessing policy values is either by selling assets to the trust in exchange for cash taken from the policy, or the policy itself, or having the trustees distribute income or principal to adult trust beneficiaries, (typically the grantor's children), who then can make gifts back to either or both parents. All of the considerations mentioned previously apply.

4. Trust Decanting

Decanting is a form of trust amendment or revocation. It occurs when a trustee of one trust transfers trust property to another trust without consideration. In general, the reason to decant is to correct deficiencies in the original trust, but not to distribute trust property back to the grantor. For example, decanting can be used to:

- Correct a deficient withdrawal notice (a/k/a Crummey Power)
- Make a trust a grantor trust for income tax purposes
- Extend the term of the trust
- Correct drafting errors

Decanting is allowed by statute in Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota and Tennessee. Several other states may allow decanting based upon case law. Still others may allow decanting based upon broad distribution provisions in the original trust document. In either situation, decanting is a complex strategy and subject to tax and legal issues unique to a given state.

With regard to accessing cash values of life insurance policies in an irrevocable trust, decanting may be appropriate if the original trust document does not specifically state that such access is permissible. Decanting and transferring the insurance and other trust assets to a new trust may be beneficial and help to obtain access to the cash values because of more flexible provisions in the new trust. It can also help if the assets of a non-grantor trust are decanted into a trust that is a grantor trust, allowing for the more efficient sale of assets to the trust.

5. Unilateral Trustee Termination of the Trust

You may be asking yourself, why can't the trust simply be terminated so that the assets can be transferred back to the grantor? That would be too good to be true because during the creation and funding of the trust, you were taking advantage of certain income, gift and estate tax rules so the IRS would not look too kindly on the reversal. If a trust is terminated, the assets would be distributed to the beneficiaries, not back to the grantor. In addition, remember that the trustee has a fiduciary duty to act in the best interests of the trust beneficiaries. For example: it is not uncommon for a close relative or friend of the grantor to be named as trustee of an irrevocable trust, and may be tempted to do what he or she thinks is best for the *grantor*. Although the trustee has legal title to trust property and can transfer a trust asset, such as an insurance policy, back to the grantor, he or she will be violating his or her fiduciary responsibility if any act is not in the best interests of *the beneficiaries*.





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Regardless of the relationship between the trustee and grantor, the trustee must always act in the best interests of the trust beneficiaries, not the grantor. There can be significant penalties and personal liability against the trustee's own assets for violating that duty.

Conclusion

Depending upon how the trust was drafted and the laws of your particular state, there may be good news in terms of gaining direct or indirect access to the cash values of a life insurance policy held by an irrevocable trust. You must check with a local attorney experienced in estate and trust law. Remember, however, that courts hold trustees to a

high degree of care because of the fiduciary nature of the position. Just because the trustee of your trust is a close friend or relative is not enough to help you gain access to the policy cash values. There are a number of cases on record where trustees have been held liable for actions they thought were right but violated that fiduciary duty, resulting in judgments against them personally from law suits by the beneficiaries, and in court penalties. Trustees should always exercise caution whenever making a distribution that is not specifically allowed by the trust document and seek the advice of counsel.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

Lanny D. Levin, CLU, ChFC
LANNY D. LEVIN AGENCY, Inc.
1751 Lake Cook Road suite 350
Deerfield, IL 60015
(847) 597-2444
lanny_levin@levinagency.com

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