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Tax Reform Opens the Door for Multi-Purpose ILITs

Perhaps the standard term insurance plan and ILIT should give way to a more robust vehicle.

Barry D. Flagg , Thomas Tietz , Martin M. Shenkman | Jan 29, 2018

The Tax Cuts and Jobs Act brings direct changes to the tax treatment of insurance and significant indirect changes to planning with life insurance.

In a previous article , we highlighted the major changes. We'll now cover the new and interesting life insurance planning opportunities these changes present in particular multi-purpose irrevocable life insurance trusts.

Related: Life Insurance Planning After Tax Reform

Multi-Purpose ILITs

Irrevocable life insurance trusts, so-called ILITs, have often been the keystone of an estate plan. For many clients, insurance held in an ILIT, may remain the keystone of their plan, but the insurance may be different and the trust, in some instances, should be crafted differently. Income taxes are now more of a concern than estate taxes for many clients. So, the tax-favored envelope of a permanent insurance policy might be more valuable in certain situations, for example, when state and local tax deduction restrictions are relevant to the client. Insurance might be used to address capital gains costs instead of estate taxes for some clients. Insurance might provide some clients investment balance if the stock market heights have them nervous.

Perhaps the standard term insurance plan and ILIT should give way to a more robust form of ILIT—a Multi-purpose ILIT. ILITs traditionally only held an insurance policy and a nominal bank account. A MILIT might hold a permanent life insurance policy, the cash value of which the client might access during retirement and which might have some long-term care feature, as well as other assets. For some clients, a more robust trust that can eliminate the need for multiple trusts and provide several benefits will be more appealing than the traditional ILIT that many clients view as primarily removing insurance from an estate that they may no longer believe to be taxable.

An MILIT should include express grantor trust provisions. Traditional ILITs relied on the use of income to pay insurance premiums to assure grantor trust status. MILITs should also include swap/substitution powers to address the new emphasis on basis maximization planning whereas traditional ILITs didn't. MILITs should hold more assets than a traditional ILIT would to provide broader asset protection,

growth outside of the grantor's estate to minimize estate tax in a decoupled state and simplification (for example, substituting for an ILIT, grandchildren's trust and more).

Non-reciprocal MILITs can provide an even more robust asset protection plan for a couple. Traditional ILITs were often focused solely on removing insurance proceeds from the estate and little more and, in too many cases, did little or nothing to address the reciprocal trust doctrine. That doctrine, if applied by the Internal Revenue Service or a creditor, could serve to uncross two nearly identical trusts, making assets included in each settlor's estate reachable by claimants. MILITs should be more carefully crafted with substantive differences between them (for example, different powers of appointment, different beneficiaries and different "Crummey" powers). MILITs should also include a trust protector, change of situs/governing law and other provisions to facilitate enhancing the protection and tax advantages. Often MILITs are formed from inception in a trust-friendly jurisdiction, whereas ILITs were almost universally formed in and remained in the client's home state.

Lastly, MILITs may not require written Crummey powers. Clients universally hate the annual ritual of written Crummey powers and too often fail to carry out those requirements properly. ILIT plans almost universally relied on written notices. MILITs, especially for clients likely to be under the federal exemption, may not. Written notice isn't required for Crummey powers to be valid under any authority. The perception that notice is required to qualify is, according to some commentators, a misperception of existing authorities. There are three cases: *Crummey*, *Holland* and *Turner*, all of which don't require notice. Thus, there's substantial authority that no notice is required. Private letter rulings say that if there must be reasonable actual notice. Both failing to give notice and permitting only a short withdrawal were necessary to deny the annual exclusion. Since written notice isn't required for moderate wealth estates under the federal exemption, written notice might not be required in trust instruments. If the MILIT is funded with other assets to provide protection for those assets, using the increased temporary

exemption, then there may be no need for annual gifts, so all Crummey notices issues may be obviated.

This structure could greatly simplify administration of these trusts (one trust instead of several, no annual gifts or Crummey notices). It could also make insurance trusts more palatable to protect insurance proceeds even if the client can't anticipate any federal estate tax savings, as the annual rituals, and the commensurate cost and complexity can potentially be avoided.

Prudent Selection and Proper Management of Trust Assets

Just like any trust, the benefits actually received from a MILIT will be a function of the assets held in the MILIT. If MILIT assets have high expenses and/or poor performance, then expected tax savings, planning benefits and the costs of establishing and administering the MILIT will be wasted. Costs charged inside life insurance polices vary by as much as 80 percent between best-available rates/terms and worst-available rates/terms. Costs are also too often opaque and misunderstood. The performance of life insurance has also been among the most disappointing asset types relative to client expectations for decades.

As such, prudent selection and proper management of MILIT assets should: (1) involve periodic examination of costs being charged inside the life insurance policy account(s) relative to the universe of peer-group alternatives and actual historical performance of invested assets underlying policy cash values relative to both the universe of peer-group alternatives and benchmarks for the asset classes appropriate to the client's/grantor's/insured's risk tolerance, asset class preferences, time horizon and expectations; and (2) avoid illustration comparisons (that is, comparisons of hypothetical premiums, cash values and death benefits) that are now considered "misleading," "fundamentally inappropriate," and unreliable by financial, insurance and banking industry authorities. Understanding what's actually being charged inside trust assets and what's actually reasonable to expect in performance substantially improves the likelihood that client expectations will be met.

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