

FAQ



Building a Flexible Irrevocable Life Insurance Trust

Question: When I discuss the use of an irrevocable life insurance trust (ILIT) with clients, I often meet resistance. The grantor does not want to be locked into a plan that may not meet future needs or becomes outdated by tax law changes. Is there some way to make an irrevocable trust “less irrevocable?”

Answer: By its very nature, an ILIT requires some guesswork on the part of the grantor as to the future needs of the beneficiary(s). In order for an ILIT to accomplish its purpose of keeping policy proceeds out of the insured’s taxable estate, it must be irrevocable. That does not, however, mean that it needs to be inflexible.

The key to a flexible ILIT is good legal counsel. You and your client need to work with someone who is experienced in the estate planning area.

With careful drafting, a client’s specific circumstances and concerns can be addressed and incorporated into the trust document. As a financial consultant, you can aid the process by helping the client to identify his/her feelings and concerns.

For example, a couple who has a long and happy marriage may be trying to give the surviving spouse the greatest possible financial control without sacrificing estate tax savings. On the other hand, second marriage clients might want to place financial restrictions on the surviving spouse in order to provide for children from a first marriage. Identifying these needs is the key to successful trust drafting.

Let’s take a look at some of the basic drafting techniques used to maintain trust flexibility and meet client concerns. Be aware these methods are discussed in generalities only. Their use and application may vary depending on the parties to the trust and the specific needs and circumstances of the individuals involved.

Addressing Changes in Marital Status. The trust may provide that the insured’s spouse ceases to be a beneficiary or trustee in the event of a divorce. The trust often limits the term “spouse” to the person to

whom the grantor is married at the date the trust comes into existence.

The Need to Change the Trustee. The ability to replace a trustee can be addressed in a number of ways. For example, the trust document can be drafted to give the beneficiary (or all the beneficiaries together) the right to replace a trustee. Often the trust provides for a triggering event – such as the attainment of a certain age or death of a prior trustee – which then results in the beneficiary assuming a trustee or co-trustee role. Where a beneficiary replaces the trustee, additional trust provisions are needed to limit the beneficiary’s powers so as to prevent inclusion in his/her estate of any or all of the trust assets.

Another approach to ensuring competent management of the trust assets is to give the trustee the power to hire a money manager.

Finally, developments in the law have given the grantor broad power to replace a trustee without incurring adverse estate tax consequences. Since a 1995 revenue ruling, the grantor can be assured that having the right to remove the trustee and appoint an individual or corporate successor trustee that is *not related or subordinate to the grantor* will not bring the trust property back into his/her estate for estate tax purposes.¹

Limitations on Crummey Power Holders. To protect against a beneficiary who becomes financially irresponsible, a grantor can be given the right to remove a *Crummey* power holder or to exclude a beneficiary from exercising a withdrawal power. *Note: Removing a Crummey power holder may lead to an insufficient number of power holders to qualify transfers to a trust for the annual gift tax exclusion.*

Guaranteeing Sufficient Crummey Donees. By naming alternate power holders in the event one or more *Crummey* power holders should die or be removed, the grantor can ensure a sufficient number

¹ Rev. Rul. 95-58, 1995-2 C.B. 191.



of persons in order to avoid gift taxes on transferred premium dollars.

Giving Broad Power to the Trustee. By selecting a trustee that understands the grantor's personal and estate planning objectives; who personally knows the strengths and weaknesses of the trust beneficiaries; and who has demonstrated good business judgment, a trust management platform can be built that allows for additional trust flexibility through discretionary trustee decisions.

The trustee can be given the power to change non-dispositive provisions – such as custody of assets, management advisors, the power to allocate between principal and income, etc.

In addition, a non-beneficiary trustee may be given the power to distribute property to the beneficiaries on a discretionary basis. Or the trustee may be given the power to make arms-length loans to any person, including the grantor. The trustee may also be given the power to change the trust or merge with another trust with similar provisions. The trustee can even be given the power to terminate the trust and distribute the assets including any life insurance policies to the trust beneficiaries.

Use of a Co-Trustee. If a trustee is a personal trusted friend but lacks sufficient business acumen or more technical knowledge is needed, an experienced co-trustee – such as a trust company or a trust department of a bank – can be authorized.

Powers of Appointment. A limited power of appointment is a powerful tool for building flexibility into an ILIT. A power is considered a limited power of appointment when the power holder (or donee) is authorized to appoint an interest in property only to specified individuals or a class of individuals excluding the donee, the donee's estate, or creditors of the donee or his/her estate. It is possible to create a power that can be exercised either during the lifetime or by means of the will of the power holder.

Through the use of limited powers, the grantor of the ILIT may give considerable control to a non-trustee beneficiary, making it possible for the power holder to change the outcome of the trust in ways the grantor might have wanted if he/she could have foreseen future events. The power holder may be thought of as an agent, delegated by the ILIT grantor to make changes in the distribution plan of the trust as circumstances warrant.

Limited powers of appointment can be used if a grantor is concerned that the trustee may not exercise discretionary powers over the trust or may do so in too restrictive or too generous a manner. A limited power of appointment may allow a surviving spouse to make a distribution of the final balance of a trust based on how children have "turned out" or on their relative financial situations. A limited power of appointment may also be used when a child has gotten into financial difficulties; the power holder may choose to establish an "asset protection trust." Finally, a limited power of appointment may be used to appoint property to a charity where the power holder feels the heirs have sufficient assets.

Trusts using powers of appointment must be carefully drafted to avoid creating a "general" power of appointment resulting in estate and gift tax consequences. A general power of appointment allows the power holder to give the interest in the property to anyone he/she chooses, including himself/herself. It results in the inclusion of the property subject to the power in the estate of the power holder at his/her death. In addition, the exercise, lapse, or release of a general power during the power holder's life is treated as a gift subject to gift tax.

Ascertainable Standards. Under IRC §2041(b)(1)(A), if a power may be exercised only in accordance with an ascertainable standard relating to health, education, support, or maintenance, it is not treated as a general power of appointment. Thus a beneficiary may be given the power to appoint trust assets to himself/herself, subject to an ascertainable standard, without having the assets included in his/her estate. This is a very useful exception where a grantor's spouse serves as trustee of the ILIT.

In Summary. While an irrevocable trust appears by its nature to be an inflexible instrument, it is important to convey to your client that competent legal counsel can draft "flexibility" into the trust document so that the trust may be able to effectively deal with future changes within the confines of the trust instrument. The key is to build this flexibility into the trust at its inception.

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