Trust Connection

Building Lasting Relationships for the Benefit of our Mutual Clients

Trust News and Information From Your Trust Representative Office

Welcome to ***Trust Connection***, a regular communication from Valley National Trust Services. The Trust Representative Office model provides a framework for cohesively connecting all of the client's key advisors: the Estate Planning Professional, the Financial Advisor and National Advisors Trust. Instead of encountering obstacles when working together, our "team approach" provides a solid trustee and investment management solution for clients' complex financial situations. As a Trust Representative Office of National Advisors Trust, we represent the largest federally-chartered trust company created by Registered Investment Advisors (RIAs). Our trust service model is built on the strength of the local support and responsiveness provided by you—the local estate planning professional, Valley National Advisers— the local and trusted investment advisor and National Advisors Trust serving as the trust administrator. This combined expertise allows us to excel in the services we provide delivering the best possible outcomes for our mutual clients.

Structuring and Managing ILITs

Irrevocable Life Insurance Trusts (ILITs) are used primarily to purchase and/or maintain life insurance policies on the life of the settlor without causing inclusion in the settlor's estate, while simultaneously qualifying contributions for the gift tax annual exclusion. In fact, the sole purpose of the so called Crummey power is to create a withdrawal power that will make the contributions qualify for the annual exclusion.

These very useful planning tools are generally created for three reasons: liquidity, building an estate, or replacement value.

Liquidity. Many wealthy clients, while their net worth is high, do not have substantial liquidity. Their estate may consist primarily of family business assets, or real estate, or lifestyle assets such as planes, yachts, antiques, art, etc. As such, a taxable estate at death may require the quick production of liquid assets at an inopportune time. Insurance in the trust can be used as a "willing buyer" of assets from the estate to infuse needed liquidity from a pool of assets not included in the estate.

Building an estate. Often younger people have a lifestyle that is dependent on earned income and not accumulated investment assets, as with retired persons. Thus, a risk exists that if one or both of the couple were to die prematurely, the remaining family members would not be able to maintain their accustomed lifestyle or afford top educational opportunities. This can be ensured by the creation of a pool of assets sufficient to produce the money needed to achieve family objectives. This can include simply creating a guaranteed pool of assets so the settlor can use their accumulated assets as they wish, having assured their legacy funds.

Replacement Value. The attraction and tax advantages of techniques like a Charitable Remainder Trust often involve the use of charitable giving, reducing the pool of assets otherwise available to the family and, thus, are often coupled with an ILIT to replace the donated funds back to the family estate tax free.

Once the reason for the trust is confirmed, care should be taken to draft and administer the trust properly in order to enjoy the benefits without challenge by the IRS or by beneficiaries. There are administrative responsibilities, tax responsibilities, and investment responsibilities to attend to in order to ensure the benefits can be enjoyed. Creative drafting may also enable the trust to enjoy special benefits.

Administration. Administering a Crummey trust properly can be easy, but it is not simple. First, the annual contributions must be collected and early, meaning well in advance of the premium due date, in order to give time to properly notify the beneficiaries of their right to withdraw and for the time period for withdrawal to expire. Without this the trustee is sometimes put in a position of having to pay the insurance premium before the withdrawal period runs out, strengthening an argument that there is a preexisting "understanding" that the funds will not be withdrawn, which may jeopardize the "present interest" argument needed to keep the gift from being taxable under the annual exclusion. Arrangements to simplify annual notification, like single notice provisions, seem to work for the tax purpose but could jeopardize the fiduciary's duty to the beneficiary to keep them informed. Likewise we regularly see monthly premium payments made, but with only annual notification, not matching the language of the document that requires notice of each contribution. The bottom line is to administer the Crummey power faithfully, as it is the key to obtaining the annual exclusion, making the gifts tax free into a trust that will ultimately be estate tax free.

Taxation. Proper administration of the Crummey power is the first step to empowering the tax advantage of Irrevocable Life Insurance Trusts (ILITs), but there is more with regard to estate, generation skipping and income tax issues. As mentioned, these trusts will be estate tax free to the donor/insured if properly structured, meaning that the donor insured has no "incidents of ownership" over the policy and has not had such for at least three years. There is nothing wrong with contributing an existing policy, but be aware that a three year period must run before the gifted policy is out of the estate for estate tax purposes. Better to purchase the policy from inside the trust by contributing cash and having the trustee purchase the policy since this is out of the estate from day one. Second, the policy contribution is clearly a gift, and while it qualifies for the gift tax annual exclusion, generally does not qualify for the Generation Skipping Transfer Tax (GSTT) annual exclusion which utilizes a separate test. What this means is, if the objective is to potentially have this trust continue after death, and perhaps skip a generation, it may be worth designing the trust to qualify for both. This often involves a separate trust for each grandchild with testamentary general powers of appointment. These features can make the trust GST tax free with no use of the GSTT exemption. Even if such a structure is not desired, consider filing a Gift Tax return and allocating GSTT exemption to the contributions to make the trust GST tax free.

An ILIT is generally a Grantor Trust for income tax purposes due to the power to purchase life insurance on the life of the grantor with trust accounting income of the trust. As such, it is a disregarded entity for income tax purposes and its income implications would flow out to the grantor annually. With life insurance as the primary, or only, investment, this should cause little to no effect since life insurance is a very tax efficient investment. Keep in mind, however, that an ILIT is not limited to investing in life insurance and other investments could cause a flow through of taxation.

A final note on taxation is that we often simplify the result of the trust by describing that the trust will simply pay the estate tax, in the case of our liquidity reasoning above, yet in reality that would generally be a violation of the terms of the trust as well as of our fiduciary duty to the beneficiaries of the trust. If the life insurance is payable to the estate, or to someone for benefit of the estate, it would be included in the estate for estate tax purposes. In fact, the trustee generally purchases assets from the estate for fair market value, thus infusing the needed cash but in an arms length transaction. This underlines the need for a knowledgeable trustee to manage and care for all of these tax implications to ensure that the trust in fact accomplishes its objectives.

Investment. Lastly, let's briefly discuss the investment implications of the trust. The trustee should take care to ensure that the choice of insurance is properly documented as the investment of choice, since investing 100% of an account in insurance is not standard operating procedure. One thing to address is why the choice is to buy life insurance in the first place. This should relate back to our initial reasoning in the creation of the trust. Life insurance is the only investment that will create an immediate solution of those issues. The other assets of the individual are presumably set up for long-term growth, but only life insurance will create a guaranteed solution in the event of the grantor's premature death. Second, in fiduciary law, diversification is a foundational principle in investing, yet in this trust there is a distinct lack of diversification. This can be explained by its special purpose and that the ILIT should be considered as a part of the grantor's overall transfer tax plan and thus total asset picture. The trustee should document these issues in the file to explain to later potential beneficiary questions as to why insurance was purchased rather than a standard operating procedure securities portfolio. In most cases we will live a long and happy life, and with 20/20 hindsight, beneficiaries sometimes question the comparative returns. Life insurance is designed to outperform other assets when death is premature, so documenting the thought process is important at the time of the investment.

Summary. An ILIT can be a very effective tool in the estate plan, yet often not enough care is taken in the proper structuring and managing of the trust. It is important to use an attorney who specializes in drafting these instruments to ensure it meets your needs. A "tailored" solution will fit most of us better than an "off the rack" document. Likewise, the trustee should be selected based on expertise. Too often people think the trustee on an ILIT is simply receiving the gift, sending out a few notice letters and paying the premium, but this is far from a fair representation of their role. The trustee must pay attention to the immediate details and the long-term implications in order to make this valuable tool operate as anticipated. As always, it is critical to assemble the right team of advisors to ensure that you meet your estate planning goals.

About Our Firm

Valley National Financial Advisors is an independent one-stop financial services group of companies that offer personalized, comprehensive and coordinated financial services. Established in 1985, Valley National has developed a reputation for innovation, financial strength, and quality. Our financial professionals are experts in delivering financial needs-analysis, wealth accumulation, risk management and planning instruction and counsel in a professional, useful manner. Valley National Advisers works within a planning structure that has as its single goal the best interests of each client. Each financial recommendation is based on personal interviews, data gathering, document review, and a thorough understanding of the client's financial goals. With a complete planning process, advisor recommendations are made with an understanding of the "big picture." We see a greater need for trusts with today's ever-changing estate tax environment and family dynamics. With National Advisors Trust Company, you stay involved and your client's benefit from low trustee fees. Contact us for more information on how we can support you in business succession planning or trust services.

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