

RX FOR A “BAD” ILIT

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Life insurance agents and client advisors often encounter irrevocable life insurance trusts (ILITs) that no longer reflect clients’ current intentions. Even the most well-planned, flexible ILIT can go “bad,” for of a number of unforeseen reasons. Typically, these problems involve a change in the circumstances that existed when the ILIT was created. For example, client family dynamics may have changed or the beneficiary might be in an unexpected financial situation. Changes in applicable tax or trust law may also cause the client to reconsider the ILIT’s terms.

Although the terms of an ILIT may appear to be irrevocable, there are a few options available to repair a bad ILIT. At the outset, an attorney licensed in the state that governs the ILIT needs to do a thorough review of the governing instrument and the facts and circumstances of the case. Such a review may uncover possible solutions.

There are many ways to fix a broken ILIT:

- The ILIT may include favorable discretionary distribution language that would allow the trustee to distribute the insurance policy to one or more beneficiaries.
- The ILIT may include a power of appointment, the power to amend the trust (held by a special trustee or a trust protector) or a savings clause that offers a remedy.
- The trustee may consider selling the policy to the insured or to a partnership or LLC in which the insured is a partner.
- The trustee could simply terminate the policy and start over with a new ILIT holding a new policy.

As always, the solution depends on why the existing ILIT is no longer working for the family. Just as the ILIT needs to fit the client’s intentions, the solution needs to fit the problem.

If the ILIT itself does not provide a solution, trust law may provide the answer. From trust modifications and decanting to the transfer of a policy to a new ILIT, numerous techniques can address unforeseen problems and effectively alter the terms of the existing ILIT.

TRUST LAW

Trust law may provide the solution to a bad ILIT through judicial or nonjudicial means. Historically, modification of an irrevocable trust was possible with the consent of all beneficiaries through a court-approved equitable deviation. In recent years, there has been a trend toward allowing courts greater flexibility in deciding whether to modify or terminate a trust.¹ Moreover, a number of states have enacted trust-decanting statutes and, in doing so, have provided additional options to remedy bad ILITs. While it is beyond the scope of this paper, the income and transfer tax consequences of modifying or terminating an ILIT deserve careful consideration.

TRUST DECANTING

In the context of trusts, decanting allows the trustee to transfer trust assets to a different trust that benefits one or more of the same beneficiaries. Decanting can offer the trustee a flexible and useful tool to remedy a bad ILIT. When authorized, subject to fiduciary obligations, a trustee may unilaterally decant trust assets into another trust with different terms. Although decanting may offer a solution to the ILIT problems, the tax consequences of decanting deserve careful consideration.



While trust decanting arguably exists under common law, 23 states, listed in the chart below, have enacted decanting statutes. Although the power to decant can be found in both common law and decanting statutes, the existence of a state statute gives the trustee statutory authority for the distribution, which can be particularly important when the new trust is substantially different from the old trust.

Although decanting statutes do not generally require court approval or the consent of the settlor and/or beneficiaries, there are certain statutory prerequisites for exercising this power, and they vary from state to state.² For example, all of the states with decanting statutes require the trustee to have the power to invade the trust corpus in order to decant.

However, Florida and New York prohibit a trustee from decanting when the power to invade principal is limited to an ascertainable standard. While the provisions of a state decanting statute may be limiting, it does allow a trustee to maintain the anonymity of the trust's provisions, which is not an option when a court is involved in a trust reformation.

TRUST DECANTING STATE RANKINGS CHART³

Rank	State	Has Decanting Statute?	Can Decant Trust with Ascertainable Standard?	Notice to Beneficiaries Required?	Can Decant Trust with Ascertainable Standard into Discretionary Trust? / Can Remove Mandatory Income Interest?	Allow Grant of Power of Appointment in Second Trust to Beneficiary for the Benefit of Non-Beneficiary?	Can Accelerate Remainder Beneficiary's Interest
1	South Dakota	Yes	Yes	No	Yes / Yes	Yes	Yes
2	Nevada	Yes	Yes	No	Yes / Yes	Yes	Yes
3	Tennessee	Yes	Yes	No	Yes / No	Yes	Silent
4	New Hampshire	Yes	Yes	No (except for charitable trusts)	Yes / No	Yes	Silent
5	Delaware	Yes	Yes	No	No / Yes	Yes	No
6	Ohio	Yes	Yes	Yes	No / Yes	Yes	No
7 (tie)	Alaska	Yes	Yes	Yes	No (except after the first trust would have ended) / No	Yes	No
7 (tie)	Illinois	Yes	Yes	Yes	No / No	Yes	Silent
9	Indiana	Yes	Yes	Yes	Yes / No	Silent	Silent
10 (tie)	Missouri	Yes	Yes	Yes, only to beneficiaries of second trust	No / Yes	Silent	Yes
10 (tie)	Wyoming	Yes (short provisions)	Yes	No	Yes / Silent	Silent	Silent
12 (tie)	South Carolina	Yes	Yes	Yes	No / Yes	Yes	No
12 (tie)	Texas	Yes	Yes	Yes	No / No	Yes	Yes
14	Virginia	Yes	Yes	Yes	No (except if court approval) / No	Yes	No
15 (tie)	Kentucky	Yes	Yes	Yes	No / No	Yes	No
15 (tie)	North Carolina	Yes	Yes	Yes	No / No	Yes	No
17	Rhode Island	Yes	Yes	Yes	Silent / No	Silent	No
18 (tie)	Arizona	Yes (short provisions)	Yes	No	Yes / No	Silent	Silent
18 (tie)	Michigan	Yes	No	Yes	No / No	Yes	Silent
18 (tie)	Minnesota	Yes	Yes	Yes	No (except after first trust would've ended) / No	No	No

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18 (tie)	New York	Yes	Yes	Yes	No / No	No	No
18 (tie)	Wisconsin	Yes	Yes	Yes	No / No	Silent	No
23	Florida	Yes	No	Yes	No / No	Silent	Silent

UNIFORM TRUST CODE

The Uniform Trust Code (UTC) is the first comprehensive national codification of trust law. As of October 2016, the UTC had been adopted or introduced in some form in 32 states plus the District of Columbia. This is significant because the UTC permits the modification or termination of an irrevocable trust in certain circumstances. As a result, the UTC may provide the ILIT trustee additional techniques to remedy a bad ILIT. However, while a trustee may decant trust assets without the consent or approval of trust beneficiaries, most UTC modifications or terminations require consent from all of the beneficiaries.

The most frequently used provisions of the UTC to support modification or termination of an ILIT include:

- With the consent of the settlor and all beneficiaries, an ILIT may be modified or terminated for any reason.⁴
- With beneficiary consent and court approval, an ILIT may be modified or terminated so long as the continuance of the ILIT is not necessary to achieve any material purpose of the trust.⁵ This provision does not require the consent of the settlor or the trustee. Moreover, in certain circumstances, a court may approve the modification or termination even if all the beneficiaries do not consent.⁶
- A court may modify a trust's administrative or dispositive terms, or terminate the trust if, because of changed or unanticipated circumstances, the modification or termination will further the trust's purposes.⁷ This approach requires a demonstration that the purpose of the trust has been frustrated and that the proposed modification or termination will provide a remedy.⁸

In addition, the UTC provides for reformation and for modifications dealing with uneconomical trusts and trustee arrangements, mistakes, impractical administrative terms and adjustments to achieve the settlor's tax objectives.⁹ Finally, UTC §417 permits a trustee to combine or divide trusts after giving notice to the beneficiaries if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust.

Both decanting and the UTC may offer solutions for a bad ILIT. The choice of decanting or invoking the UTC as the legal basis for the potential remedy depends on the nature of the problem, the situs of the trust and a number of other facts and circumstances.

TRANSFER OF EXISTING POLICY

Transferring a life insurance policy from an existing ILIT to a new ILIT may be the solution to a client's concerns. However, any transfer of a life insurance policy for valuable consideration may be impacted by the transfer-for-value rule (Rule). As a result, no transfer of a life insurance policy for valuable consideration should be made without carefully considering the Rule.

The Rule does not apply to transfers between the grantor and a grantor trust or between two grantor trusts.¹⁰ In cases where the Rule does apply, a portion of the death benefit may be subject to income tax — a potential disaster. Specifically, under Internal Revenue Code (IRC) §101(a)(2), if a policy or any interest in a policy is transferred for valuable consideration, the death benefit will only be exempt from income taxation to the extent of the consideration paid, plus net premiums paid by the transferee after the transfer, plus non-deductible interest on policy loans.

Nevertheless, certain exceptions to the Rule apply, including transfer to:

- The insured
- A partner of the insured
- A partnership in which the insured is a partner
- A corporation in which the insured is a shareholder or officer¹¹

In addition, the Rule does not apply where the basis of the policy is determined in whole or in part by reference to the transferor's basis. In situations where a policy is transferred from a non-grantor trust to a grantor trust wholly owned by the insured, the transfer is excepted from the transfer for value limitations under IRC §101(a)(2).¹²

In situations where an ILIT has gone bad, a new ILIT may be created and funded to purchase the existing life insurance contract from the existing ILIT at fair market value. Typically, the new ILIT would acquire the funds necessary to purchase the policy from the existing ILIT with gifts or loans from the grantor.

In such a transaction, the purchase price of the policy must accurately reflect fair market value. However, the fair market value of the life insurance policy sold to the new ILIT may pose valuation difficulties. IRS guidance in this area is limited and, in many cases, outdated. Specifically, the existing IRS guidance that provides policy valuation safe harbors applies to gift and estate tax values, as well as to situations related to compensation and qualified plan distributions.¹³ None of the IRS safe harbors specifically relate to the sale of a life insurance policy in the circumstances described here.

Another issue trustees face when determining the value of an existing policy is their fiduciary duties to the trust's beneficiaries. The selling trustee has a fiduciary obligation to obtain the highest selling price possible, whereas the purchasing trustee has the obligation to pay the least amount possible for the policy. These two conflicting fiduciary duties can make the sale of the policy challenging for the trustee, particularly when the same individual is trustee of both trusts but the beneficiaries are not the same.

Life insurance policy valuation is an inexact science that is outside the scope of this white paper. Given the complexity of the sale of the policy, the lack of guidance from the IRS and the trustee's fiduciary duties, many trustees seek court approval for the transaction, including the value assigned to the policy.

The transfer of a policy from a bad ILIT to a different ILIT with more satisfactory terms – whether involving two existing trusts or an old trust and a trust created expressly to receive the policy – is a viable technique for removing a life insurance policy from an otherwise unsatisfactory irrevocable trust.

FIDUCIARY CONCERNS

Even in the best of times, the office of trustee is challenging. A trustee is often called on to balance the interests of current income beneficiaries with the interests of the remainder beneficiaries, interpret ambiguous trust language, manage trust assets and exercise distribution discretion. The trustee has a duty to deal impartially with all beneficiaries while acting in the best interest of all of the trust's beneficiaries. In doing so, the trustee must act impartially in investing and managing the trust property after taking into account the differing interests of the beneficiaries. He or she must act in good faith and with reasonable judgment at all times. The trustee is likely required to account to the beneficiaries and inform them of pertinent information that relates to their interest in the trust. Consistent and thorough communication with beneficiaries often demonstrates the trustee's good faith.

In situations where there is family discord or a dispute among the beneficiaries, state law can provide the trustee with some measure of protection from liability. Specifically, the trustee may petition a court for instructions or to confirm the trustee's proposed action, such as decanting, sale or transfer of policy to a new trust, or distributing the policy to beneficiaries. In situations where the settlor is alive and requests that the trustee take steps to effectively alter the terms of the ILIT through any of the methods described herein, the trustee may be in a difficult position. After all, his fiduciary obligations are to the ILIT beneficiaries, who may not agree with the settlor. Although it is not required in all situations, a trustee may wish to seek some protection from liability by obtaining either beneficiary consent and/or court approval of the proposed action.

TECHNIQUES TO CONSIDER WITH A BAD ILIT

- **Purchase a new policy.** If the policy does not have significant cash value and the insured remains insurable, the trustee of the bad ILIT could stop making payments on the policy and let it lapse. A new ILIT with more favorable terms could then be created and funded. Thereafter, the new ILIT could purchase a new policy.
- **Distribute the policy.** If the terms of the ILIT permit it, the trustee of the bad ILIT could distribute the policy to one or more beneficiaries.
- **Sell the policy to the insured.** The trustee of the bad ILIT could sell the policy to the insured or to a partnership or LLC in which the insured is a nominal, non-controlling partner. Absent a subsequent gift of the policy – or interest in the FLP/ LLC that purchased the policy from the bad ILIT – by the insured, this approach would result in inclusion of all or part of the policy proceeds in the estate of the insured.
- **Transfer policy to a new ILIT.** The trustee of the bad ILIT could transfer the policy to a new ILIT with more favorable terms for full and adequate consideration. This approach may pose valuation issues and potential fiduciary liability concerns for the trustee of the bad ILIT.
- **Modify or terminate the bad ILIT.** This approach is limited by state trust law.
- **Decant.** The trustee of the bad ILIT could decant the policy to a new ILIT with more favorable terms. Currently, this approach is limited to states in which there is a decanting statute or situations in which the state's common law and the trust's terms combine to permit decanting.

- **Create a life settlement and split-dollar.** The trustee of the bad ILIT could settle the policy and loan the policy proceeds to the new ILIT, pursuant to a split-dollar arrangement with the new ILIT. The new ILIT would use the funds to purchase a new policy. As with any life settlement transaction, consideration should be given to the taxation of the proceeds as well as the impact on the insured's capacity to purchase additional life insurance following the life settlement transaction.

THE BOTTOM LINE

Although the terms of an ILIT are irrevocable, a number of techniques can effectively alter the terms of a bad ILIT. When presented with an ILIT that no longer reflects a client's intentions, life insurance agents and advisors should consider whether any of the methods described above may offer a solution. The options available depend heavily on the situs of the trust and other facts and circumstances of the case. However, with the number of states that have enacted decanting statutes, a trustee of a bad ILIT has an additional flexible and potent tool to remedy the situation.

Contact your advisor for more information.

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