Flexible Trust Strategies and other Important Topics

- ***Todd L. Janower, JD, LLM, ChFC, CLU,*** Todd joined the Allstate Financial Advanced Sales team in July 2002. Todd received his B.S. degree from Boston University and his Law and Masters in Taxation degrees from The John Marshall Law School. Before joining Allstate, Todd was an associate at Chicago area law firms, where he specialized in estate and retirement planning for high net worth individuals, post-death administration and business succession planning. Todd currently consults on a wide variety of advanced and financial planning topics and leads the estate planning, charitable planning and retirement planning sections of the group. Todd is a frequent speaker at seminars for financial service providers.

- ***Curtis L. Lundquist, CLU,*** Curt joined the Allstate Financial Advanced Sales team in March, 1996. He received his B.S. degree in Mathematics from Taylor University. Curt has more than 30 years of experience in the life insurance industry, consisting of work in the fields of actuarial science, marketing, sales, software development, tax and advanced planning. He currently consults on a wide variety of advanced and financial planning topics and leads the executive compensation, business succession planning and advanced life insurance sections of the group. Curt is a frequent speaker at seminars for financial service providers.

- **Allstate Advanced Sales: Who are we and what do we do?**

  - **Allstate Advanced Sales** - We provide advanced planning services to Allstate agents and financial specialists. We offer professional and objective planning advice, immediate answers to most questions, and the willingness to research more complex issues. The Advanced Sales team consists of attorneys and financial services professionals with many years of consulting experience in financial planning. Our combined backgrounds encompass the education and experience necessary to help design customized solutions to meet the customers' specialized planning needs. Moreover, we deliver the highest level of technical planning support with the highest degree of objectivity. Professional integrity is a hallmark of our service.

- **Flexibility in estate planning**

  - **Estate Planning deals with uncertainty** - To a great degree, estate planning is the art of dealing with uncertainty. When will someone die? What will his or her estate be worth at that time? What will happen in the meantime? How will beneficiaries turn out?

  - **Estate Tax Laws are uncertain** - Furthermore, the current state of transfer tax legislation adds one more aspect of uncertainty: What will the tax laws be in the future? For most clients, what happens to the transfer tax rules this year or next year is not particularly relevant. Most clients considering their estate plan now are going to live for decades into the future. The transfer tax rules are likely to change multiple times before their estate plan (at least the "at death" portion) is implemented.

- **What are the Responses? -** One response in the face of so much uncertainty is to do nothing—freeze up. Another, better, response is to plan, but with as much flexibility as possible in order for an estate plan to adapt to changes in the future. But with planning that is irrevocable—irrevocable life insurance trusts (ILITs) in particular—flexibility seems impossible. Yet, this is not so. With a little creativity, much flexibility can be incorporated into even an ILIT. The discussion that follows explores ways to do this.

- **Clients are unwilling to commit to long-term estate solutions**

  - For flexibility there must be an exit strategy, or at the minimum a way to revise or amend the estate strategy so any changes in law will not render it undesirable. This means moving away from some the traditional strategies that we have recommended for customers in the past and going towards solutions that contain the necessary flexibility that will ease your customers' minds.

- **Typical objections to Irrevocable Life Insurance Trusts are:**

  - An ILIT is irrevocable. It can't be changed. Once signed, its set in stone.
  - How do I know what my beneficiaries are going to be like in 30 or 40 years. They are only toddlers now.
  - Setting up a trust is expensive. I don't want to pay so much
  - Since it's irrevocable, I can't get to any of the assets in the trust, including the cash value of any life insurance policy. Why would I do that?

- **Irrevocability refers to the Grantor**

  - However, just because the ILIT is irrevocable, doesn't mean it can't meet future needs. It doesn't mean it can't be flexible. Irrevocability refers to the grantor of the trust. The trust can have certain terms created by the grantor or have other individuals hold different positions that allow for some future control.

- **Some "Flexible" Alternatives**

  - **Include "more" withdrawal beneficiaries**
    - A typical ILIT gives a group of people the right to withdraw contributions to the trust so that they have a present interest in the gifts to the trust. Doing this allows the gifts to qualify for the gift tax annual exclusion. The number of beneficiaries who are given withdrawal rights often depends on the anticipated size of the annual gifts to the trust—i.e., the amount of the premium for the life insurance policy.

    - Consider whether other people should be added as withdrawal beneficiaries.

- First, in situations where the annual premium is large, annual exclusion gifts to children, spouse, and even grandchildren, may not allow for large enough nontaxable gifts to pay the premium.

- Second, it may be useful to make larger gifts—and have those additional gifts also qualify for the annual exclusion—in the future.

- What about other family members (or friends for that matter) they wish to provide for. While courts have consistently required nothing more for a gift to qualify for the annual exclusion than a valid withdrawal right that cannot be legally resisted by the trustee, the Service's test requires a bit more. The Service has indicated in an Action on Decision in response to the *Estate of Cristofani* case that it normally will not dispute withdrawal rights given to people who are either (1) current income or (2) vested remainder beneficiaries. If adding these "additional" beneficiaries as remainder beneficiaries does not make sense, consider adding them as current permissible income beneficiaries. In fact, if the clients' intent is to provide for these people, it may make sense (although certainly not necessary from a tax standpoint) to give the trustee the ability to make principal distributions to them as well.

- **Give donors the ability to "toggle" withdrawal rights**
  - An irrevocable trust will typically name—either specifically or by category—those people who have a right to withdraw contributions to the trust. The donor's ability, when each gift is made to the trust, to choose which beneficiaries (within that group) have a right of withdrawal for that gift allows the donor to adjust to future changes.

- **Allow distributions during the insured's lifetime**
  - Frequently a life insurance policy has significant cash value in addition to providing a death benefit. This is particularly true with life insurance policies used for estate planning where a permanent policy, rather than a term policy, is often needed. While certainly the intent during planning is that the policy will be used for its death benefit, if circumstances change, it may be helpful to use the policy's cash value for the benefit of the trust beneficiaries.
    - For example, if assets in the estate go down in value (as they sometimes do), the trust beneficiaries may have greater need for policy value currently and the estate may no longer be subject to an estate tax. By drafting the ILIT to allow for distributions during the insured's lifetime, the trustee will have the flexibility to make use of the policy cash value if circumstances warrant.

- **Allow distributions to other trusts**
  - How often has a client asked to revise his or her ILIT? While not impossible—some states' statutes allow amending an irrevocable trust by petitioning the court or even via decanting statutes—it is certainly not an easy task. An alternative is to give the trustee of the original ILIT the power to distribute trust assets to a new trust for some or all of the same beneficiaries. A provision like this certainly adds flexibility. But it should not be included lightly, as this gives the trustee tremendous power to alter the disposition of the trust.

- **Do not require mandatory income distributions**
  - ILITs, like credit shelter trusts, frequently provide that after the first spouse's death, all income is to be distributed to the surviving spouse. This may seem sound at first, but consider this question: Are the trust assets the ones the surviving spouse should use first? If the surviving spouse owns other assets outright, they will be included in his or her estate. Thus, those assets typically should be spent first. The assets in the ILIT (or a credit shelter trust for that matter) are *not* included in the surviving spouse's estate; why not leave them in the trust to pass to the remainder beneficiaries free of estate tax?

    While that analysis make sense most of the time, in certain situations it makes sense to use trust assets for the surviving spouse's needs. For instance, a surviving spouse who does not have enough assets of his or her own is unlikely to face an estate tax. Also, the surviving spouse's other assets may be ones that are better preserved than spent (e.g., perhaps a family vacation home). For these reasons, give the trustee the *ability* to distribute income to the surviving spouse, but do not make it mandatory. The trustee can then evaluate the situation and make the best decision.

- **Use limited powers of appointment**
  - Giving someone, other than the donor, a limited power of appointment (i.e., the power to appoint trust assets to anyone other than oneself, one's creditors, one's estate, or the creditors of one's estate) will not cause trust assets to be included in the power holder's estate. This allows someone— perhaps the spouse or children—the ability to alter the disposition of the trust assets if circumstances change. For example, a trust may provide that at the second spouse's death, trust assets are distributed equally among the children. Suppose that a son is later found to have a disability that entitles him to government benefits. If he inherits a share of the trust assets, he will likely be disqualified from those benefits. If the surviving spouse has a limited power of appointment, that spouse could, instead, appoint the son's share to a special needs trust.

- **Consider trust provisions carefully**

- Some ways to incorporate flexibility into an ILIT requires giving the trustee a lot of power. This makes it even more important to ensure (1) the trustee and successor trustees are people or entities the clients trust, and (2) there is a clear, well thought out plan for naming successor trustees. Too often trusts simply name a trustee and a successor with no directions for choosing another successor if the one named is unable to serve. A better plan is to name those people or entities the donor would like to name as trustee and then to indicate a plan for selecting subsequent successors. For example, the trust may permit the majority of the adult income beneficiaries to name the successor. Be careful to limit who may be chosen as a successor trustee; other interest or powers may cause estate inclusion for particular people if serving as trustee.

- **Include 'standby' special needs provisions**
  - When a client has a beneficiary who has special needs, it is common to draft the trust for that beneficiary so as not to disqualify him or her for government benefits that have income and asset limits. This is certainly good and common planning. But the client cannot always know when the trust is drafted which beneficiaries may have disabilities in the future—both those resulting from accident or illness and those not diagnosed until later. For that reason, it makes sense to include a trust provision that limits distributions to a beneficiary who is entitled to government benefits so as not to disqualify that beneficiary from benefits.

- **Make it a grantor trust**
  - In estate planning, one of the common reasons for designing a trust as a grantor trust is that it allows the grantor to make an "extra" gift to the trust in the form of an income tax payment on the income earned by the trust. While this is certainly a good reason to have a grantor trust, most trusts owning just life insurance do not have income while the grantor (typically also the insured) is alive. However, circumstances may change; creating an ILIT as a grantor trust may be helpful if future planning involves transferring income producing assets to the trust. Trusts that own, or may own, life insurance should be structured as grantor trusts for an additional reason: transfer for value. Making the trust a grantor trust makes the sale of a life insurance policy to the trust not run afoul of the transfer for value rule. This rule results in the life insurance death benefit being subject to income tax.

- **Flexible Product**

  - **Need to unwind trust**
    - We are aware of reasons why one may want to unwind a trust and some of the flexible provisions mentioned above may assist in that. However, since the reason for unwinding an ILIT is because the

insurance isn't necessary anymore, it is also important to be able to "unwind" a life insurance policy to get cash back in an efficient manner.

- **What makes a flexible survivorship policy**
  - We also need a policy that is "flexible". One that has a so-called "escape hatch", to be able to get the cash value out efficiently. Most 2nd to die policies have a 19 or 20 year surrender period – the time period you would have to pay a charge to surrender a policy. But what if changes occur before then. When the tax laws changed in 2001 with increasing exemptions, companies started to change their products to allow for a waiver of surrender charges upon complete surrenders before the surrender period expired, realizing that insurance may be needed for a $2,000,000 estate but not a $7,000,000 estate. These provisions usually came in three varieties.
- **Three options in industry**
  - No "escape hatch" – no waiver and surrender charges would apply depending on the year of surrender
  - Limited to tax law change – waiver would apply, usually only at specific years, contingent on a federal tax law change, usually a complete repeal of the estate tax – We will never see that! Limited flexibility
  - Unlimited escape – waiver would apply at specific years, but there is no contingency on a tax law change. The trustee could surrender for any reason he/she sees fit.

- **Actuarial Guideline XXXVIII (AG38)**

  - **National Association of Insurance Commissioners (NAIC)**

    - In Paul v. Virginia (1869) the Supreme Court reaffirmed that insurance be regulated at the state level. Because of the inherent variations incumbent in such a structure, it was not long before the NAIC was established in 1871. Its mandate was to benefit state regulators and insurance consumers by promoting uniform laws and regulations among the states and to make it easier for insurance companies to comply with the laws and regulations in all states in which they do business. As such, the NAIC acts as a forum for the creation of model laws and regulations. Each state still decides whether to pass each NAIC model law or regulation, and each state may make changes in the process of enactment, but the models are widely adopted.

  - **AG38**

    - Actuarial Guideline 38 was created in 2003 to clarify the reserve requirements first imposed in Regulation XXX on universal life products

employing secondary guarantees (ULSG).

As the design of ULSG products continued to evolve, AG 38 was revised in 2005 to deal with certain ambiguities in the guideline as applied to sophisticated shadow fund contract designs.

Now AG38 is being revised again by adding Section 8E to respond to regulators' concerns about reserve calculations for recent product designs.

This section of the model was approved by the NAIC on 9/12/12 and is expected to be quickly adapted by the several states.

"While the Model is a complex regulation, its intent is clear: reserves need to be established for the guarantees provided by a policy. These revisions represent a resolution that ensures adequate reserves to protect consumers while maintaining a level playing field and competitive markets for companies issuing these products," stated Kevin McCarty, Florida Commissioner of Insurance Regulation and NAIC President.

- **What effect will it have?**
  - **Carriers will be faced with one of three options:**

    No longer offer current guaranteed contracts

    Increase premiums

    Reduce guarantees
  - Second to die contracts will be among the last to be converted over, which means that there will be a period of time where very little to no options will be available.
- **When will this happen?**
  - **"For policies and contracts issued on or after January 1, 2013…"**

    Actuarial Guideline XXXVIII
    The Application of the Valuation of Life Insurance Policies
    Model Regulation
    ("Model 830")
    Section 8E

    - **Individual carriers will stop accepting applications at varying dates, with some having already done so**

- **How does this affect my practice?**
    - **You will continue to seek out strong, permanent guarantees for your clients**
    - **It will cost more to do so in 2013 and thereafter**
    - **There will be fewer options as many carriers will withdrawal from this segment**
    - **You will need to vet out carriers and products that have weakened their guarantees which may not be readily apparent**
    - **If it is at all possible, persuade your clients to act now**
    - If you have had three carriers with which you have worked in the past, you may now only have two, with one weakening their guarantees and one substantially increasing their premiums. This will necessitate finding more options for your clients.