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White paper

How to repurpose an ILIT for long-term care

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Key highlights

- Review/modification of the trust document
- Sale of the policy to a new ILIT
- Decanting to a new ILIT
- Loan terms
- The process of taking the collateralized loans

It is estimated that people reaching age 65 will have a 70% chance of needing long-term care at some point in their life.[1] At the same time the dramatic increase in the estate tax applicable exclusion has exempted 99.8% of the population from federal estate tax exposure.[2]

The significance of this contrast evidences the fact that a lot more people need long-term care insurance than have to worry about the estate tax. Yet, a number of people likely facing the need for long-term care have no such insurance but have established irrevocable life insurance trusts (ILITs) to provide estate tax liquidity they no longer require.

The solution to this predicament for those people may be the repurposing of their ILITs to provide long-term care.

Review/modification of the trust document

The first step in repurposing an ILIT would be to determine whether the terms of the trust document authorize the trustee to do a 1035 exchange from the trust's existing coverage to a policy that could carry the type of LTC rider desired.

Secondly, if the trustee is authorized to do the 1035 exchange there remains the question of whether the ILIT contains language that enables the Grantor/Insured to access trust assets through a series of demand loans that are secured by property pledged by the Grantor/Insured, with interest payable at a fair market rate.

If the ILIT does not contain the desired language to permit the requisite loan arrangement the trust document may include a power to amend by the trustee or a trust protector to create such language. Lacking this option, states have historically permitted the modification of an irrevocable trust with the consent of all the beneficiaries through a court approved equitable deviation.[3] The courts generally require both an unforeseen and unforeseeable change in circumstances and a frustration of the settlor's main objective if the trust conditions are strictly followed.[4]

The problem this presents is that the court's focus on the settlor's original intent for the trust would presumably not include making loans to the Grantor/Insured for long-term care. On the other hand, the Uniform Trust Code that has been adopted in 31 states permits the modification or termination of an irrevocable trust for any reason with the consent of the Grantor/Insured and all the beneficiaries.[5]

Sale of the policy to a new ILIT

In any case, if the existing trust document cannot be modified to include the loan language, the Grantor/Insured might create a new ILIT with the loan provision and provide the new ILIT with funds to purchase the existing policy from the first trust. That raises the question of the transfer for value rule which if violated would subject a portion of the death benefit to income tax.

Fortunately, there is an exception to the rule for transfers between the grantor and a grantor trust or between two grantor trusts, as in these cases the assets are treated as owned by the grantor.[6] This means that the problem can be avoided by having the Grantor/Insured make the new ILIT a grantor trust.

The next potential issue has to do with situations where the new ILIT has different beneficiaries or distribution terms than the existing ILIT. In such a case, the valuation of the existing policy may be of significance to the beneficiaries of the old ILIT as well as the trustee. The trustee has a duty to act with impartiality with regard to all the beneficiaries, and a beneficiary might see the sale of the policy to the new ILIT as being against their interest. In addition, the valuation issue is important because if the purchase price does not reflect the fair market value of the policy, the IRS may see the transaction as part sale/part gift. This means that if the insured dies within three years of the sale, the IRS might seek to include the death proceeds in the Grantor/Insured's gross estate.[7]

Facing such a situation, besides reasonably determining the fair market value of the policy, the trustee might seek protection by getting the written consent to the sale from all the beneficiaries or by obtaining court approval for the transaction. In any case, assuming that the existing policy is successfully sold to a new ILIT with the requisite loan provisions the trustee may proceed with the 1035 exchange to a new policy with a LTC rider.

Decanting to a new ILIT

Alternatively, state trust law may provide a solution through the process of decanting.

For this purpose "decanting" is defined as a power held by the trustee of an irrevocable trust that allows the trustee to invade the corpus of the trust (in whole or in part) in favor of another trust for the benefit of one, some, or all the original trust's beneficiaries.

The source of this power may be common law, the express grant of authority of a governing instrument, or an applicable statute and in all cases without prior court approval or prior beneficiary consent.[8]

The decanting power of a trustee may exist pursuant to the law of each state.[9] Nonetheless, 24 states have chosen to enact a form of decanting statute.[10] These statutes generally do not require court approval or the consent of the settlor and/or beneficiaries. There are, however, certain prerequisites for exercising this power such as requiring that the trustee have the unfettered power to invade trust corpus.[11] The result is that where decanting is permitted, the Grantor/Insured will have to create a new ILIT with the necessary loan provisions and then transfer or decant the existing policy to the new ILIT for a 1035 exchange into a new policy with a LTC rider.

With respect to decanting, when a trustee exercises the power in accordance with its fiduciary obligations, and the limitations on its power to make distributions in further trust, the intended tax consequences to the trustee or the beneficiaries ought to result.[12]

Loan terms

With regard to the terms of the loan, it must be an arms-length fully collateralized transaction that is secured by property pledged by the Grantor/Insured. Specifically, the loan must be legitimate, with collateral pledged, interest charged, and an agreement to fully pay back the debt.

Collateral can be anything that covers the debt; a house, artwork, coin collections, etc. The interest rate charged should be reasonable but at least equal to the interest charged on the life policy. In most cases

the loan interest is allowed to accrue. Ideally, the loan interest should be paid back prior to the death of the Grantor/Insured to ensure the intended tax treatment of the trust. Principal can be paid back after death with no tax liability.

The process of taking the collateralized loans

When using the ILIT for getting long-term care rider benefits the process is:

- File a claim for the LTC benefit
- After 90-day elimination period, a monthly check will be sent to the trust (as contract owner)
- The grantor then borrows money from the trust upon pledging property as collateral (These funds can be used to pay LTC bills)
- Interest is allowed to accrue to purposely increase the debt - but ideally paid back just prior to death
- At the grantor's death, the loan principal repaid from estate assets. The amount of the accrued interest, as well as the loan principal has been removed from the estate assets for taxation purposes according to appropriate tax principles
- Any interest repaid after death is income taxable to the trust.

Conclusion

Clearly, the Grantor/Insureds of obsolete ILITs that are no longer suited to their original purpose can benefit from repurposing the coverage to provide funding for their LTC. Moreover, if the transfer tax laws change in the future to again expose such Grantor/Insured's to estate tax liabilities the use of the collateralized loan concept will still leave the trust positioned to fulfill its original intent of offsetting such tax liability since repayment of the loan from estate assets will reinstate the intended value of the trust. With regard to the details of how to repurpose an ILIT there are, as previously discussed, legitimate alternatives with the appropriate choice, if any, depending upon state law, the facts and circumstances of the case and the interests of the parties involved. In any case, it is the responsibility of the Grantor/Insured and their legal counsel to make such an evaluation and assume the consequences of their actions.

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[1] CMM, U.S. Department of health and Human Services, http://www.medicare.govDecember 2015.

[2] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," March 16, 2015, https://www.jct.gov/publications.html?func=startdown&id=4744.

[3] Rx for a "Bad" ILIT, Tax Planning 2015.

[4] §8.15.20 Doctrine of Equitable Deviation [from Loring and Rounds: A Trustee's Handbook (2016), with post-publication enhancements].

[5] UTC §411(a).

[6] Let. Rul. 9041052.

[7] IRC § 2035.

[8] Blattmachr, Jonathan G.; Horn, Jerold I.; Zeydel, Diana S. C... PUB. DATE. April 2012. SOURCE. Real Property, Trust & Estate Law Journal; Spring2012, Vol.

[9] Supra 8.

[10] STATE DECANTING STATUTES PASSED OR PROPOSED As of April 28, 2016, compiled by M. Patricia Culler, Hahn Loeser & Parks LLP, Cleveland, OH.

[11] Supra 3.

[12] Supra 3.

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