



**Grantor Access to Funds
in an Irrevocable Life Insurance Trust**
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This article discusses four alternative planning techniques that make irrevocable trusts much less irrevocable. It provides timely information for clients who are dawdling over wealth planning recommendations by introducing strategies that allow them to “act now” and “modify later”.

The major tax reason for making an irrevocable insurance trust (“ILIT”) the owner and beneficiary of a life insurance policy (or a split dollar interest in a life insurance policy) is to remove policy proceeds from the Insured/Grantor’s estate for estate tax purposes and, if married, to remove the policy proceeds from the Insured/Grantor’s spouse’s estate as well. In order to do so, the trust must be irrevocable. This means the Insured/Grantor cannot have the power to amend or revoke the trust and must give up all ownership interests in any insurance policy which is owned by the trust.

Below are four strategies that could provide the Insured/Grantor with access to funds from a policy that is owned by an ILIT. They are:

1. **Spousal Support ILIT:** Assuming a spouse is a beneficiary of the ILIT, a trustee can use policy withdrawals and/or loans to provide the cash flow for support payments to the spouse (to an ascertainable standard such as “support in the accustomed manner of living”). In a stable marriage, the Insured/Grantor could count on piggy-backing on such cash flow.

This approach will not work effectively if the Insured/Grantor and the spouse are the insureds (e.g. if a survivorship policy is used). Frequently, a survivorship policy is used in split dollar arrangements due to the extremely low economic benefit rates associated with such plans. In this case, use of a Spousal Support ILIT would be counterproductive.

2. **Loans from the Trust:** Another alternative exists through the use of an ILIT called a WRAP trust, also known as an Ultimate ILIT (“ULIT”). Regardless of the type of policy used, a ULIT enables the Insured/Grantor to access trust assets (e.g., life insurance cash values) through a series of demand loans that are secured by property pledged by the Grantor/Insured with loan interest payable at a fair market rate at least equal to the amount charged as interest by the insurance company on policy loans. The loan interest in these arrangements can be paid in cash or, with sufficient collateral, accrued. The Insured/Grantor’s power to borrow using secured demand notes at fair market interest rates is similar to the right to substitute property of equal value approved by the courts in *Estate of Anders Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq.*, *action on decision*, 1977-129 (April 15, 1977).

Assuming the ULIT is a so-called “defective” trust for income tax purposes, the payment of interest to the ULIT should not create interest income for the ULIT as the Insured/Grantor and the ULIT are considered a single entity for income tax purposes. (IRC Sections 671, 675, IRS

Reg. 1.671-2(c), and Rev. Rul. 85-13.) Obviously, the Insured/Grantor must have assets with which to secure the loans from the ULIT and, if assets are present, is there any realistic need for such loans? Yes, if the assets are either illiquid (such as a home) or if they have such a low cost basis that their sale would trigger extensive capital gains taxes. In either of these cases, loans from a ULIT could be welcome indeed.

There is no direct authority considering the use of a ULIT, and its suitability for a particular client must be determined by legal and tax advisers on a case-by-case basis; however, even very conservative clients may wish to include the language in their trusts in case the feature becomes desirable at a later date.

- 3. Successor Trust:** Access to funds in trust could be accomplished if the trust has a provision naming a limited power holder who has the right to move trust assets to a successor trust. If the limited power holder so chooses, the successor trust could have provisions to provide for the support of the Insured/Grantor. The successor trust might even be a *revocable* life insurance trust. In either case the Insured/Grantor could have access to the trust's assets. With either approach, any subsequent policy death benefits would undoubtedly be included in the Insured/Grantor's estate; however, this is hardly an issue if the Insured/Grantor is in need of funds later in life, or if estate taxes are ultimately repealed and the irrevocable trust no longer makes sense.

Due to potential coercion issues, a limited power holder should not be an employee of the Insured/Grantor or an employee of any entity controlled by the Insured/Grantor.

Below is specimen wording for Limited Power Holder appointments as it appears in Version 17.0 of InsMark's Documents On A Disk[®] and Documents On The Net[™] Systems.

During the lifetime of the Grantor(s) of this Trust, [NAME AND ADDRESS OF LIMITED POWER HOLDER] shall have a limited power to appoint Trust assets as follows: the Limited Power Holder (hereinafter, "LP") shall have the right at any time to transfer all or a portion of Trust assets, including any policy or policies of insurance, to a successor Trust.

LP is specifically precluded from naming any of the following as beneficiaries of said successor Trust: LP, creditors of LP, heirs of LP, creditors of heirs of LP, the estate of LP, or creditors of the estate of LP. If for any reason, LP is unable due to death, disability, or otherwise to exercise this limited power of appointment granted hereunder, [NAME AND ADDRESS OF SUCCESSOR LIMITED POWER HOLDER] shall become a successor Limited Power Holder and have the same limited power to appoint Trust assets, along with the same limitations, as described for LP above.

Counsel may wish to add successor limited power holders in the event a single limited power holder is deceased or otherwise unable to act. Counsel may also wish to provide for multiple limited power holders in which two (or more) must concur. Alternatively, counsel may wish to include multiple limited power holders in which *any one* may exercise the power granted.

Specimen wording for several variations of limited power holders is included in Version 17.0 of InsMark's Documents On A Disk[®] and Documents On The Net[™] Systems under the Irrevocable Trust category in a series of specimen trusts called Ultimate Irrevocable Life Insurance Trusts.

Note: The suitability of the limited power holder strategy for a particular client must be determined by legal and tax advisers on a case-by-case basis; however, even very conservative clients may wish to include the language in their trusts in case the feature becomes desirable at a later date. There is no

specific tax authority for delegating these powers to a limited power holder in an irrevocable trust so, if the technique appears useful to a client, be certain that the client's legal and tax advisers agree that its inclusion does not contaminate the estate tax free nature of the irrevocable trust from the inception of the trust.

- 4. Loan-Based Private Split Dollar ("LB-PSD"):** LB-PSD is a technique in which the Grantor/Insured lends -- rather than gifts -- funds to the trust. The interest rate, known as the Applicable Federal Rate or "AFR", is set to the long-term AFR rate in effect at the inception of the loan. With LB-PSD, the Grantor/Insured typically gifts funds to the trust to provide it with the cash flow for the loan interest due. The Grantor/Insured could indirectly encourage the trust to repay the loan by withholding the gifts and thus "starving" the trust of the funds for loan interest. This would be effective if the Promissory Note between the parties *requires* payment of the plan's loan interest in cash (instead of the option to accrue the loan interest if it is not paid in cash). Policy loans or withdrawals could be a source of cash flow for the needed loan interest, thus providing the Insured/Grantor with cash flow from this source; however, the trustee might decide that the long-range effect of invading policy values in this fashion makes it an unsound option. If so, non-payment of loan interest requires loan repayment, and policy cash values would provide the funds for such repayment.

LB-PSD can be illustrated in the InsMark Loan-Based Split Dollar System and its results can be imported into InsMark's wealth preservation system, Wealthy and Wise®.

Note: Version 17.0 of InsMark's Documents On A Disk® and Documents On The Net™ Systems contain specimen documents with provisions that support the first three alternatives covered in this report. Licensees for the InsMark Loan-Based Split Dollar System are provided with specimen documentation for LB-PSD as part of that System's support documentation. For information about any of the Systems, call 888-InsMark (467-6275).

Important Notice

This report is educational in nature and is not a substitute for advice from legal and tax advisers. None of the techniques discussed or specimen documents referenced should be used without their specific approval.

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