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An irrevocable life insurance trust (ILIT) can be an excellent vehicle for providing controlled distributions of assets to heirs, while at the same time keeping the trust proceeds outside the grantor's taxable estate. One major drawback, however, is that in order to accomplish these objectives, gifts to an ILIT must be irrevocable and the grantor/insured must not possess any incidents of ownership over the trust. Because clients often fear relinquishing access to the permanent life insurance policy's cash value, those who would otherwise benefit from creating an irrevocable trust are often stifled from doing so.

Fortunately, for those clients who fear irrevocability, there is help. There are two special ILIT designs that provide a grantor's spouse limited accessibility during the spouse's life, while keeping the assets within the ILIT out of both the grantor's and the spouse's taxable estates. These are known as the "Spousal Support ILIT" or "Spousal Lifetime Access Trust (SLAT)" and the "Survivorship Spousal ILIT" or "Survivor Life SLAT."

STRUCTURE OF AN IRREVOCABLE *Trust...*

With an ILIT, an individual known as the grantor (also known as the settlor or trustor) enters into an agreement with the trustee of the trust. The trust agreement names the beneficiaries, specifies the dispositive provisions of the trust (who gets what and when), establishes rules for



the administration of the trust, and specifies the powers of the trustee. The grantor relinquishes the ability to revoke the trust or change it in any way.

An ILIT is typically “unfunded”. It requires annual contributions from the grantor to pay life insurance premiums. The gift tax annual exclusion allows a donor to give an unlimited number of donees up to \$13,000 each in a year without gift tax. I.R.C. §2503(b)(1). This \$13,000 amount is referred to as the “annual exclusion” and will increase due to inflation in future years. I.R.C. §2503(b)(2).


Only a gift of a “present interest” qualifies for the gift tax annual exclusion. A gift of a “future interest” is ineligible for the annual exclusion. I.R.C. §2503(b)(1). A gift to a trust is a gift of a present interest only under certain conditions: (1) when the beneficiary has a right to withdraw the amount of the gift from the trust, (2) when the beneficiary has the present right to trust income*, or (3) when the trust is for the exclusive benefit of a minor and meets certain requirements. Treas. Reg. § 25.2508-3(b), IRC § 2503(c).

**The present interest value is limited to the income interest.*

STRUCTURE OF A SPOUSAL LIFETIME ACCESS

Trust

A SLAT is an irrevocable trust that owns permanent life insurance and/or other assets, but permits the trustee of the trust to make distributions to the non-insured spouse during the spouse’s lifetime while



continuing to prevent inclusion of the death benefit in the grantor's estate.

As more fully discussed below, in order to accomplish these objectives:

- ◆ The trust must be irrevocable and the grantor/insured must not have any incidents of ownership in the insurance policy.
- ◆ Someone other than the insured should serve as trustee* of the trust. Eligible trustees may include the grantor's spouse, an independent trustee, a family member, or a close friend. If the grantor's spouse is to serve as the trustee of the SLAT, his or her rights to make discretionary distributions to himself or herself should be limited by an "ascertainable standard."
- ◆ As a beneficiary of the trust, the spouse's right to withdraw assets from the trust in any one year should be limited to the greater of \$5,000 or 5% of trust assets.
- ◆ The grantor's separate property should be used to fund the trust.
- ◆ There should be only one SLAT between the married couple.

** Legal commentators have historically believed a discretionary trust will likely result in no estate inclusion. However, Restatement of Trusts Third ("Restatement Third") has resulted in concern among lawyers. The Restatement Third provides that a beneficiary almost always has an enforceable right to a distribution in a discretionary trust that has any type of a standard.*




ESTATE TAX ISSUES

The primary goal of creating an irrevocable trust is typically to remove the trust assets from the grantor's gross estate for estate tax purposes. There are, however, several ways an irrevocable trust can be includible in the grantor's estate. First, Section 2036 of the Code provides that a decedent's taxable estate includes any property transferred by the decedent in which the decedent retained a beneficial interest (including the right to income) or the right to control who owns or enjoys the use of the property. I.R.C. §2036(a)(2). Section 2036 may apply indirectly if the trustee has the ability to control the ownership or use of the property and the grantor can replace the trustee with himself or herself. Additionally, IRC § 2036 will cause the trust to be included in the grantor's estate if the trustee can be required to use the trust assets for the support of the spouse/beneficiary. Treas. Reg. § 20-2035.1(b).

A second basis for inclusion is Section 2038 of the Code. That section requires inclusion of assets transferred if the decedent retained the right to alter, amend, revoke, or terminate the terms of the recipient's enjoyment of the property. I.R.C. §2038(a)(1). Section 2038 may apply indirectly if the trustee has the ability to change the terms of the beneficiaries' enjoyment of the property and the grantor can replace the trustee with himself or herself.

A third basis for estate inclusion is Section 2042 of the Code. If the trust owns permanent life insurance policies on the grantor's life, Section 2042 could require inclusion of the proceeds of the policies in the grantor's estate if the grantor/insured has any incidents of ownership



over the policies. An example might be the right to borrow* against the policy's cash surrender value.

Therefore, a properly drafted SLAT will not:

- ◆ Grant any beneficial interest to the grantor,
- ◆ Give the grantor any power to replace the trustee with himself or herself, or
- ◆ Give the grantor any incidents of ownership in the policy.


Finally Section 2035 of the Code would cause inclusion of the policies in the insured's taxable estate if the grantor/insured transferred existing policies on his or her life to the trust and died within three years of the transfer, estate.

** Loans against your policy accrue interest at the current rate and decrease the death benefit by the amount of the outstanding loan and interest.*

SELECTING THE TRUSTEE[†]

In a single life SLAT, the spouse may serve as trustee; however, certain limitations must be placed on his or her powers to make distributions to himself or herself in order to avoid inclusion of the trust principal in his or her estate. The concern is that if an individual is both a trustee and a beneficiary, and the trustee has discretion to distribute assets to himself or herself, under I.R.C. §2041, such discretion can amount to

[†]*The selection of the trustee and the distribution language is extremely important. See Estate Tax Issues infra pp.3-4.*




a general power of appointment, which causes inclusion in the powerholder's estate. To avoid this result, the trustee's power to distribute assets to himself or herself should be limited to an "ascertainable standard" (one a court can enforce) related to health, education, support, and maintenance. I.R.C. §2041(b)(1)(A).

BENEFICIARY'S RIGHTS OF WITHDRAWAL

In a SLAT, if the spouse/beneficiary is given a right to withdraw assets from the trust, such a right should be limited each year to the greater of \$5,000 or 5% of trust assets. If the spouse can withdraw more, the IRS could include a portion of the trust assets in the spouse's estate. The lapse of the right to withdraw assets above the \$5,000 or 5% amount is likely the release of a general power of appointment. The release of the general power of appointment and the transfer back into the trust could result in a part of the trust being included in the spouse's estate at his death. I.R.C. §§2041(a)(2), 2514(e), 2036(a)(1).

A trust agreement will typically provide that a beneficiary's withdrawal right will lapse after a certain time (e.g., 30 days, 60 days, etc.). If the trust has more than one beneficiary, the lapse can trigger deemed taxable gifts between the beneficiaries. A withdrawal power is also a general power of appointment because the powerholder can appoint property to himself or herself. I.R.C. §2514 provides that the lapse of a general power of appointment is a taxable transfer to the extent the amount subject to all general powers of appointment exceeds the five or five amount. The deemed gift is a gift of a future interest and is not eligible for the annual exclusion.




If the grantor's spouse must serve as trustee, a combination of the 5 or 5 power and the ascertainable standard may exclude the value of the trust property from both the grantor's and the spouse's estate, while at the same time provide substantial access to the life insurance policy's cash value (or other trust assets).

On the other hand, if the client is looking for the most flexibility, in order to avoid the limitations of the 5 or 5 power and the ascertainable standard, a discretionary trust could be created. This would provide greater access to the trust principal. Because a trustee other than the spouse would be used, however, there is a risk that the trustee would be unwilling to make the desired distributions to the non-insured spouse. This risk may be mitigated by using a friendly trustee (i.e., family member, close personal friend).

FUNDING THE SLAT WITH SEPARATE PROPERTY

When funding a SLAT, it is important that the grantor use his or her own separate property. If any contributions to the trust are from property owned by the beneficiary/spouse, the uninsured spouse would be treated as a grantor of the trust, and his or her status as both grantor and beneficiary would cause inclusion of the trust property within the taxable estate at the beneficiary/spouse's death. It is particularly important to take preventative measures to avoid contributing assets of the beneficiary/spouse in community property states where both spouses are considered to own half of all community property. This may be accomplished by partitioning community assets into separate property and using the grantor's partitioned assets for contributions to the trust.



Also, if the grantor is considering the transfer of an existing life insurance policy to the trust, the uninsured spouse should gift any interest he or she owns in the policy to the spouse before transferring the policy to a trust. (In community property states, partitioning of the policy may be required first.)


RECIPROCAL TRUST DOCTRINE

While at first blush it may appear that each spouse establishing a SLAT for the other's benefit could achieve additional leverage, it is important that only one SLAT be created. If two SLATs are created, the IRS could look through the transactions and apply the reciprocal trust doctrine. This doctrine assumes that each spouse established a trust for his or her own benefit, thus resulting in estate inclusion for each spouse of the trust property.

ADDITIONAL CONSIDERATIONS

One major drawback of the SLAT is that the ability to access the trust comes only through the spouse's interest as a beneficiary. If the spouse should die before the grantor, or if there is a divorce, this access may be lost. The SLAT can be drafted such that if the grantor remarries, his or her new spouse will become the trust beneficiary. If the grantor does not remarry, he or she may still have access to the trust assets if the trustee has the power to lend trust property to the grantor. Repayment would, however, become an obligation of the grantor and/or the estate.

It should be stressed that access to the trust is not unlimited. If the spouse exercises a withdrawal right and then uses those distributions



for the grantor's benefit, this could be considered a retained interest, thus triggering inclusion of the trust principal within the grantor's estate. To avoid this error, trust distributions should be used for the exclusive benefit of the uninsured spouse.

SURVIVOR *Life* SLAT

An alternative to the Single Life SLAT is known as the Survivorship Life SLAT. Here, instead of using a single life policy to fund the ILIT, a survivorship policy is used.

ADDITIONAL ISSUES

There is very little authority on Survivor Life SLATs. As a result, some conservative attorneys may not approve of the use of a survivor policy in a SLAT. The primary difference between the Single Life SLAT and the Survivor Life SLAT (other than the type of policy used to fund the trust) is in the selection of the trustee. In order to avoid creating an incident of ownership and thereby inclusion of the trust-owned life insurance policy within either spouse's estate, neither spouse should serve as a trustee of the Survivor Life SLAT. Instead, a family member or close friend should be named trustee.

As in a single life SLAT, only one of the two spouses should be the grantor of the trust, the grantor would want to be sure to use separate



property to fund the trust, and only one trust should be created to avoid the reciprocal trust issues.

The only authority for a Survivor SLAT is a 1997 private letter ruling (PLR). A PLR, of course, is only binding on the parties to the letter, but it can provide insight into the IRS's position in the matter. In PLR 9728029, the spouse was a beneficiary of a SLAT that was funded with a survivor life policy. The PLR stated that to avoid inclusion in the spouse beneficiaries estate it was important that the

- ◆ Beneficiary/spouse is not the trustee;
- ◆ Trustee is an independent trustee; with discretionary distribution powers as to the beneficiary/spouse;
- ◆ Beneficiary/spouse does not contribute funds to the trust or pay the premiums;
- ◆ Beneficiary/spouse does not have a power of appointment;
- ◆ Beneficiary/spouse cannot withdraw more than \$5,000 any year;
- ◆ The trust is not legally bound to pay expenses to or for the beneficiary spouse.

While following the parameters set forth in this PLR for a Survivor SLAT is not a guarantee that the assets will not be included in the spouse/beneficiaries estate, it should provide the best chance of success.



POLICY FUNDING CONSIDERATIONS

When designing the permanent life insurance policy for a Survivor Life SLAT, if the policy is to be funded with annual exclusion gifts from the grantor (as described above), the clients should also consider one or more alternative funding strategies in the event the grantor spouse dies before the premiums on the survivorship policy are fully paid. Otherwise, if the grantor is the first of the two insureds to die, the SLAT may lack the additional funds it will need to maintain the policy in force until the death of the second insured spouse.

One alternative funding strategy to consider is for the SLAT to purchase a term rider on the life of the grantor for a death benefit amount equal to the scheduled premiums. If the grantor dies while the term rider is in force, the SLAT could then use the death benefit proceeds it would receive upon the grantor's death to help it fund any remaining premiums on the survivorship policy. Alternatively, if the grantor lives long enough and completes the funding of the survivorship policy, the coverage could thereafter be dropped.

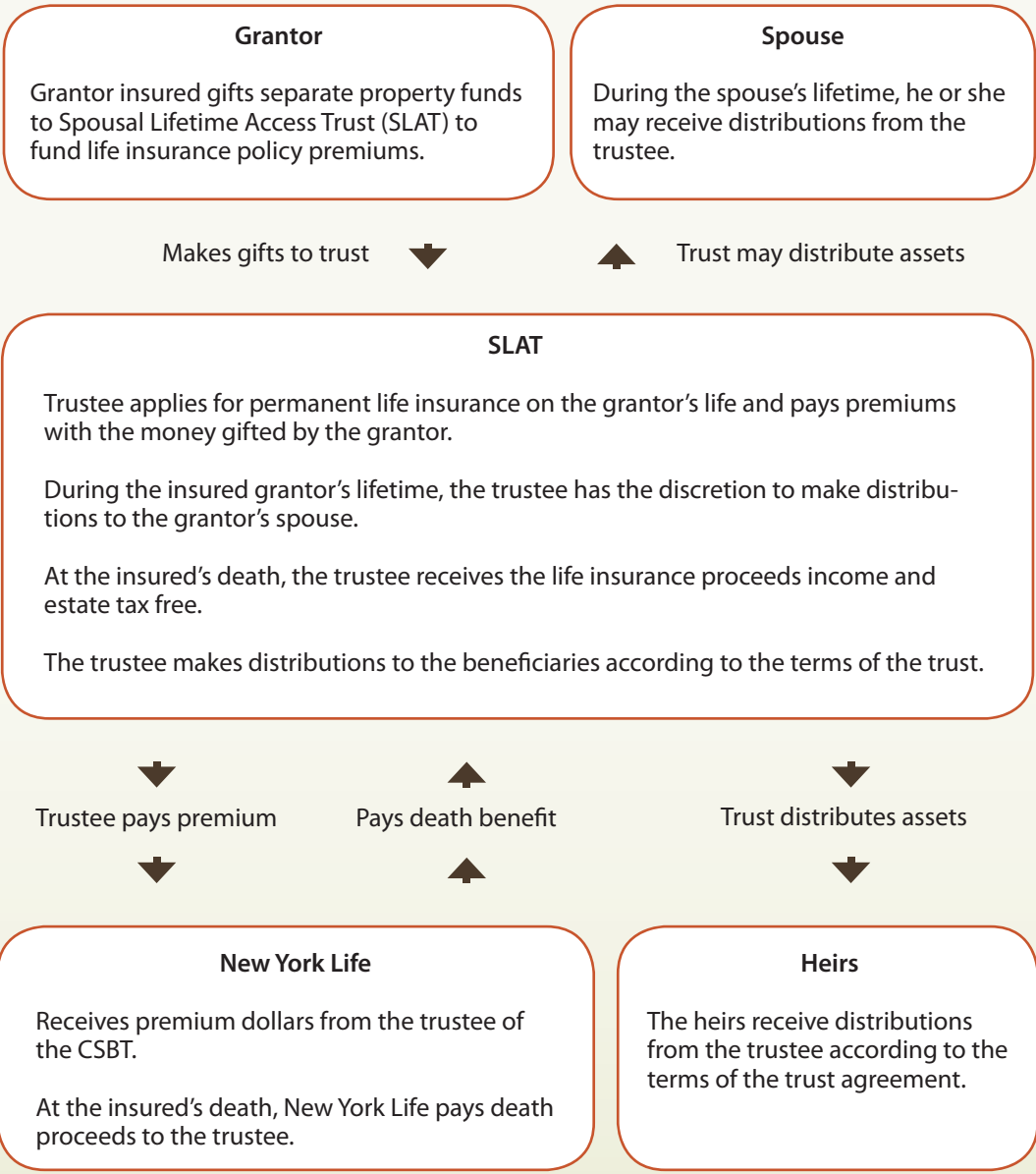
A second strategy to complete the funding of the SLAT in the event of the grantor's premature death would be for the grantor to bequeath to the SLAT the additional funds it would need to complete the funding of the survivorship policy. This strategy could easily be implemented pursuant to a formula clause in the grantor's will or living trust.



Conclusion...

- ◆ Both the SLAT and the Survivor Life SLAT can be extremely useful estate planning techniques to help provide estate tax free death benefits to heirs, while at the same time providing the client access* to a permanent life insurance policy's cash values during the non-grantor spouse's life.
- ◆ Because estate and tax planning are extremely complicated areas of law, it is imperative that qualified legal counsel be retained to draft documents tailored to meet the individual client's needs. New York Life, its agents or employees may not give legal or tax advice. We recommend everyone seek and rely upon the advice of his or her own professional advisors.

** Loans and withdrawals reduce any available policy cash values. In addition, loans against your policy accrue interest at the current rate and decrease the death benefit by the amount of the outstanding loan and interest.*



Grantor
 Grantor insured gifts separate property funds to Spousal Lifetime Access Trust (SLAT) to fund life insurance policy premiums.

Spouse
 During the spouse's lifetime, he or she may receive distributions from the trustee.

Makes gifts to trust ↓

↑ Trust may distribute assets

SLAT
 Trustee applies for permanent life insurance on the grantor's life and pays premiums with the money gifted by the grantor.
 During the insured grantor's lifetime, the trustee has the discretion to make distributions to the grantor's spouse.
 At the insured's death, the trustee receives the life insurance proceeds income and estate tax free.
 The trustee makes distributions to the beneficiaries according to the terms of the trust.

↓
 Trustee pays premium
 ↓


↑
 Pays death benefit
 ↑

↓
 Trust distributes assets
 ↓

New York Life
 Receives premium dollars from the trustee of the CSBT.
 At the insured's death, New York Life pays death proceeds to the trustee.

Heirs
 The heirs receive distributions from the trustee according to the terms of the trust agreement.

A SLAT is a life insurance trust design that allows a client limited access to policy cash values without having the death benefit included in the insured's taxable estate. *(Note: Trust must be carefully drafted such that the assets are not included in either spouse's estate. Loans and withdrawals reduce any available policy cash values. In addition, loans against your policy accrue interest at the current rate and decrease the death benefit by the amount of the outstanding loan and interest.)*



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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately. 436729 01/31/2013