Advanced Strategies

Trusts and Asset-Care® Products

What are the merits and/or pitfalls of placing ownership of asset-based long-term care (LTC) policies in the hands of someone other than the insured? For example, what issues arise when a trust established by the insured owns an asset-based LTC policy? Are there situations when trust ownership is advisable? Are there situations where trust ownership of such policies should be avoided?

Care Solutions products provide some of the most flexible protection in the LTC marketplace. Learn how this flexibility can be beneficial when trust ownership of policies is being considered.

Questions and Answers

Trusts and Asset-Care® Policies

Q: May Asset-Care policies be trust-owned?
A: The question of ownership generally arises in situations where the insured is purchasing a life insurance product with LTC benefits, like Asset-Care, and has a sizeable estate which may be subject to estate taxes. Because the death benefit may be exposed to estate taxes if the insured owns the policy at death, the insured may desire third party ownership of the policy. The most common third party owners of life insurance policies are children of the insured and Irrevocable Life Insurance Trusts (ILITs) set up by the insured.

The first question in this analysis is whether the policy can even be owned by someone other than the insured, and if so, are the LTC benefit provisions affected by that ownership. The policy language on Asset-Care policies states that the policy will pay benefits when the insured has an unreimbursed LTC claim. The company will pay the medical provider directly or will pay the owner of the policy. There is not a requirement that the insured be the owner of the policy. Thus, a child or trust could own the policy and the benefit payment provisions would be unaffected.

Transfer tax issues

The next question is how to get LTC benefits, or the equivalent thereof, to medical providers for the insured. In other words, how to pay the LTC claims. IRC section 2503(e), and the regulations thereunder, provide that payments made to medical providers for medical care of another person are exempt from gift taxes. The regulations include LTC benefits, as well as LTC premiums, in the definition of medical care. Thus, a payment to a hospital or doctor made by a child on behalf of a parent, or a payment made by a trust for long term care provided to the trust's grantor, would be exempt from gift taxes.

The estate tax issues are, however, more troublesome. Generally, a person sets up an irrevocable trust in order to have the assets, which have been placed in that trust, outside of the person's estate at death. IRS rules provide that if the grantor of a trust retains the right to income from, or retains an interest in, assets of the trust, then the trust assets will be pulled into the person's taxable estate at death. A trust grantor may, however, retain certain rights with respect to the trust that will not cause the trust assets to be included in the person's estate. The right to substitute property of equivalent value is an example.

The problem with an irrevocable trust, with provisions for paying the medical expenses of the trust's grantor, is that this is a benefit retained by the grantor that would pull the trust assets back into the grantor's taxable estate. This would expose the death benefit of Asset-Care to estate taxes. Therefore, the task at hand is to determine how to arrange for payment of LTC benefits, and yet keep the policy outside of the grantor's taxable estate.

Sometimes an irrevocable trust will provide that a trustee (who is not the grantor) may distribute trust principal or income to trust beneficiaries for the health, education, maintenance or support of such beneficiaries. In these cases, the trust could, theoretically, distribute trust funds to a trust beneficiary, a child for example, as reimbursement for LTC expenses that the child paid to LTC providers of the grantor. The child's payment of the grantor's LTC expenses would not be a gift because of the IRC section 2503(e) exemption noted earlier.

However, this scenario rests on the good will of the beneficiary to act accordingly. The beneficiary may well decide that a tax free death benefit from Asset-Care is more valuable than some other asset that may be inherited from the grantor's estate, which would otherwise have to be liquidated to pay LTC claims if the Asset-Care LTC provisions are not used to pay such claims. This is in addition to the complexity of drafting a trust that can legitimately distribute funds to a beneficiary who has paid LTC expenses of the grantor.

Perhaps a better way to arrange for Asset-Care LTC benefits to ultimately be used for the grantor's LTC expenses is for the trust to contain provisions providing for loans from the trustee to the grantor. The grantor's power to borrow using secured demand notes at fair market rates is similar to the right to substitute property of equal value. The right to substitute property of equal value has been ruled not to include trust property in a decedent's estate.

If the irrevocable trust is a defective grantor trust, the payment or accrual of interest to the trust should not create taxable interest income for the trust. "Defective" trusts are trusts that are considered to be a single entity with the grantor for income tax purposes. This means that some transactions between the grantor and trust may be disregarded for income tax purposes, although the trust assets may be outside of the grantor's estate for estate tax purposes. The grantor trust rules provide that for a loan to be disregarded for income tax purposes, the loan must provide for adequate interest and adequate security. Obviously, the grantor must have assets with which to secure the loan from the trust.

Q: Do grantor trusts with loan provisions make sense?

A: Does the kind of loan transaction described above make any sense? Yes, if the payment of LTC expenses would require the sale of assets, and if the assets are illiquid (such as a home) or if they have a low cost basis and their sale would trigger extensive capital gains taxes, then a loan from the trust to pay LTC expenses would be welcome.

The scenario might unfold as follows. The client is a prospect for Asset-Care. The client has a sizeable estate and is concerned about transfer taxes. The client creates an irrevocable trust and names a third party (neither the grantor nor the grantor's spouse) as trustee. The trust is a defective grantor trust for income tax purposes and contains a provision that permits loans from the trust to the grantor that bear adequate interest and security. The trustee purchases an Asset-Care policy on the grantor. Some years later the grantor requires LTC and desires access to the Asset-Care LTC benefits via secured loans from the trustee. The trustee makes a claim for payment of Asset-Care benefits to the company and receives payment.

The trust now has funds from which it can make a loan. The grantor executes a note secured by property pledged by the grantor. The note accrues interest at a fair market rate at least equal to the appropriate applicable federal rate for the type of note and the term of the loan. When the grantor dies, the cumulative loan and accrued interest are paid back to the trust from the grantor's estate. The loan and accrued interest payment should be deductible from the insured's gross estate as a bona fide debt. The effect of this deductible loan and accrued interest payment is to transfer a substantial portion of the decedent's estate to the trust free from transfer tax.

A caveat to this analysis

Research reveals no direct authority in case law or IRS rulings on this exact scenario, although legal journals, financial planning magazines and industry commentators have favorably reviewed the secured loan technique for many years. The favorable commentary is based on a combination existing case law from analogous cases, on the language of the grantor trust rules and on the fact that there is no statutory or regulatory language that prohibits it. The analysis remains, however, an application of existing law to a particular circumstance that has not yet been tested in the courts or specifically addressed in rulings by the IRS.

Q: What about trusts that are no longer needed?
A: Due to changes in federal estate tax law in 2013 that increased the amount of assets that can be sheltered from federal transfer tax, there are clients who may have an Irrevocable Life Insurance Trust (ILIT) that may no longer be needed for estate liquidity. In a typical ILIT situation, the grantor — usually Mom or Dad (or both) — made gifts of premium to the trustee for life insurance. The gifts were normally completed present interest annual exclusion gifts and may not be given back to the grantor. If the ILIT is a grantor trust and the life insurance policy had gain, surrender of the policy inside the trust could create taxable income to the grantor even though the property itself may not be returned to the grantor.

If the policy is no longer required for estate liquidity, the trustee may consider an IRC section 1035 exchange to an Asset-Care policy. If the insured requires LTC, the policy benefits could be distributed to the trust beneficiaries or via loan to the grantor as described above.

Alternatively, if the grantor is no longer insurable, an exchange could be made to a hybrid deferred annuity with LTC benefits product. This would be attractive in avoiding current income taxes, providing LTC protection and deferring potential income taxes until the grantor's death.

The existing bypass trust

Complex trusts and estates encounter the highest tax rate at a very low level of income. This reality can present difficulties to the trustee who is investing trust assets in situations where complex trusts are not distributing current year income to trust beneficiaries.

The following is a hypothetical example:

A husband's will created a bypass trust at the husband's death. The trust provisions provide that the trustee may pay income and principal to the surviving wife for the wife's health, education, maintenance and support. At the wife's death the remainder of the trust is to pass to the couple's children. The surviving wife, however, has sufficient income from other sources and does not require or request any distributions from the trust. The wife desires that the trust funds be allowed to grow so that distribution to the children after her death is maximized. Her only concern is that an extended LTC event would minimize the legacy left for her children.

The wife and children are not in the highest federal income tax bracket. However, the trust, because of the compressed brackets, is subject to a 43.4 percent federal tax rate. When the federal, state and local tax exposure is considered, the trustee faces the loss of half of the trust income to taxes.

If the trustee distributes current income to the beneficiaries the tax burden is lowered to the beneficiaries' rates. However, distribution of current income does not accommodate the wife's desire that the trust principal be allowed to grow, and this also does not address her LTC concerns.

In situations such as this, the investment of trust assets in an Asset-Care policy may be a good choice. These products enjoy tax deferral as their cash values increase, and a life insurance policy death benefit is received income tax free. Since a bypass trust already has provisions to provide distributions to the surviving spouse, the payment of LTC claims the surviving spouse incurs is not a problem. If no distributions are needed for LTC and the policy pays the death benefit at the surviving spouse's death, the funds are received income tax free by the trust. The distribution of these death proceeds from the trust to the trust beneficiaries will, likewise, be income tax free to the beneficiaries.

The result is a triple win for the trustee. Loss of trust income to taxes is minimized, LTC risk is covered and the beneficiaries receive any remaining death benefit income tax free.

In situations where the surviving spouse is uninsurable or highly rated, Annuity Care may be a viable alternative. Normally, a deferred annuity owned by a non-individual does not enjoy tax deferral on gain in the contract. However, trusts that hold deferred annuities "as an agent for a natural person" do enjoy tax deferral. The IRS has ruled that bypass trusts, that hold deferred annuities on the lives of trust beneficiaries, are holding as agent for natural persons and the contracts enjoy tax deferral. Also, when a trust owns a deferred annuity, the mandatory payment at death rules are triggered by the death of the annuitant, whereas the death of the contract's owner triggers payment when the contract is owned by an individual.

The result is the trust enjoys tax deferral, tax free distributions for qualified LTC expenses and any remaining annuity benefits pass to the children at the surviving spouse's death.

Trusts as Owner or Beneficiary

of Care Solutions Products

There are many different types of trusts which are created for various client purposes. In many situations, a Care Solutions product may be suitable for use with the trust.

Trust as owner

A copy of the trust document is required. Alternatively, an attorney-completed certification of trust or trust certificate may be substituted. Before the beneficiary can receive any benefits the trust must provide a tax identification number.

A. Grantor Revocable ("Living") Trust

A revocable trust is a trust whereby provisions can be altered or canceled dependent on the grantor, also known as the "settlor" or "creator" of the trust. During the life of the grantor, income earned is distributed according to the trust document, but typically to the grantor. Income taxation is to the grantor of the trust. The beneficiary is also the trust, which will typically become irrevocable upon the death of the grantor. See Letter C.

Annuity Care

Single Annuitant — Typically, the grantor is also the Annuitant. The trust must be an agent for a natural person plus beneficiaries of the trust must each be a natural person to enjoy income tax deferral of the annuity cash value increases. See IRC Section 72(u). If the trust becomes irrevocable at the death of the grantor/annuitant, IRC Section 72(s) requires distribution of the annuity contract proceeds no later than the fifth anniversary of the Annuitant's death.

Joint Annuitant — Because IRC Section 72(s) requires distribution at the first death of joint "holders", joint Annuitants are not recommended for a trust-owned annuity. Rather, if the two Annuitants are spouses, joint ownership of the annuity is recommended with the surviving spouse as beneficiary which will allow the annuity to continue without required distribution. After the initial death, the Annuity can then be transferred, if desired, to revocable trust ownership. Joint ownership of an annuity between non-spouses is never recommended.

Asset-Care

Single Insured — Typically, the grantor is also the Insured. The trust becomes irrevocable at the death of the grantor/Insured.

Joint Insured — Typically, the grantor is one of the Insureds. The trust can either become irrevocable at the death of any grantor/Insured or at the death of the last surviving Insured.

B. Grantor Irrevocable Trust

Income taxation is to the grantor or creator of the trust. A typical example is an irrevocable life insurance trust ("ILIT"). The trust is the beneficiary and must obtain a tax identification number when it becomes a simple or complex irrevocable trust. See Letter C. Until that time, the grantor's Social Security Number (SSN) may be used.

Annuity Care

Single Annuitant — Typically, the grantor is also the Annuitant. The trust must be an agent for a natural person plus beneficiaries of the trust must each be a natural person to enjoy income tax deferral of the annuity cash value increases. See IRC Section 72(u). IRC Section 72(s) requires distribution of the annuity contract no later than the fifth anniversary of the Annuitant's death.

Joint Annuitant — Because IRC Section 72(s) requires distribution at the first death of joint "holders", joint Annuitants are not recommended for a trust-owned annuity. Rather, if the two Annuitants are spouses, joint ownership of the annuity is recommended with the surviving spouse as beneficiary which will allow the annuity to continue without required distribution. After the initial death, the Annuity can then be transferred to irrevocable trust ownership. Joint ownership of an annuity between non-spouses is never recommended.

Asset-Care

Single Insured — The Grantor is usually the Insured. The death benefit is excluded from income tax as proceeds received as a result of death of the insured.

Joint insured — Typically, the grantor is one of the insureds.

C. Simple or Complex Irrevocable Trust

The trust is the income tax payer, or, if the trust distributes income to the trust beneficiary, the beneficiary pays income tax on the distributed income. The trust has a separate tax identification number, which must be provided.

Annuity Care

Single Annuitant — The Annuitant is usually someone other than the Grantor. IRC Section 72(s) requires distribution of the annuity contract no later than the fifth anniversary of the Annuitant's death.

Joint Annuitant — Because IRC Section 72(s) requires distribution at the first death of joint "holders", joint Annuitants are not recommended for a trust-owned annuity. Rather, if the two Annuitants are spouses, joint ownership of the annuity is recommended with the surviving spouse as beneficiary which will allow the annuity to continue without required distribution. After the initial death, the Annuity can then be transferred to irrevocable trust ownership. Joint ownership of an annuity between non-spouses is never recommended.

Asset-Care

Single Insured — The Insured is someone other than the Grantor. The death benefit is excluded from income tax as proceeds received as a result of death of the insured.

Joint Insured — The Insureds are someone other than the Grantor. The death benefit is received at the death of the last surviving Insured and is excluded from income tax as proceeds received as a result of death of the insureds.

Trust as Beneficiary

A copy of the trust document is required. Alternatively, an attorney-completed certification of trust or trust certificate may be substituted. Before the beneficiary can receive any benefits the trust must provide a tax identification number.

Testamentary trust as beneficiary

A trust that is created under an insured's will is referred to as a testamentary trust, and such a trust may be the beneficiary of life insurance and annuity contracts.

Sample language

"The primary beneficiary of this policy is the trust created in Article IV of the insured's Last Will and Testament dated May 1, 2015."

Inter Vivos trust as beneficiary

Life insurance and annuity contract may name a trust created by the insured during his or her life, referred to as an "inter vivos" trust, as beneficiary of proceeds.

Sample language

"The primary beneficiary of this policy is (trustee's name) as trustee of the (trust grantor's name) living trust, dated (date of trust creation)."

Taxation

It is important to note that State Life pays LTC reimbursement benefits to the policy owner. We are unable to provide advice concerning trust taxation or trust creation. Please contact an attorney, CPA, or tax advisor on how to implement your trust for the benefit of the client, and for more information concerning taxation of the trust.

Note: Products issued and underwritten by The State Life Insurance Company® (State Life), Indianapolis, IN, a OneAmerica company that offers the Care Solutions product suite. Asset Care Form numbers: L301 and R501 and SA31; Annuity Care Form numbers: SA34 and R508. Not available in all states or may vary by state. Provided content is for informational purposes only and is not intended and should not be relied upon as individualized tax, legal, fiduciary, or investment advice.

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