

Financial Advisor

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Using irrevocable life insurance trusts (ILITs) to plan for U.S. estate tax

U.S. citizens living in Canada face the same exposure to U.S. estate tax that they would face if they lived in the United States. But they can also use many of the same strategies to deal with the tax liability as U.S. residents. One of those strategies is to own life insurance in an irrevocable life insurance trust (ILIT). But there are complications to this strategy for U.S. citizens living in Canada. This bulletin discusses the U.S. estate tax system, and how having a life insurance policy in an ILIT can help. It also discusses how a U.S. person living in Canada can structure an ILIT, and how a Canadian citizen and resident can use an ILIT if they own property in the United States.

Tax problems for U.S. citizens

U.S. citizens living in Canada must comply with U.S. and Canadian income tax laws, and with the U.S. transfer tax system. The U.S. gift and estate tax systems tax gratuitous transfers that a U.S. person makes during life and at death.¹ Still, it's possible to reduce the impact of transfer tax with proper planning.

For example, the annual gift tax exclusion lets U.S. citizens make gifts to anyone up to US\$14,000 per person per year² without having to file a gift tax return or pay gift tax (all figures are in U.S. dollars unless otherwise stated).³

Additionally, the unified credit eliminates gift or estate tax on transfers up to \$5.45 million (2016 amount, indexed for inflation).⁴ But to the extent you use the unified credit to shelter gifts from gift tax during life, the credit isn't available to shelter gifts from estate tax at death. The gift and estate tax rates are also progressive and cumulative. The tax rate starts at 18% for taxable gifts over \$10,000, and rises to 40% when cumulative lifetime taxable gifts exceed \$1 million.⁵ Taxable gifts attract tax first at the lower rates, and permanently occupy the lower tax brackets, forcing the taxation of later gifts into the higher tax brackets, and requiring greater amounts of the unified credit to eliminate tax.

¹ Internal Revenue Code (IRC) §§2001 and 2501.

² 2016 limit, indexed for inflation when cumulative years of inflation justify a \$1,000 increase in the exclusion.

³ IRC §2503(b).

⁴ IRC §2010(a).

⁵ IRC §2001(c).

Another deduction, the unlimited marital gift and estate tax deduction, eliminates tax for property transfers between U.S. citizen spouses.⁶ Although this deduction does not apply to transfers made to non-U.S. citizen spouses, a U.S. citizen can still give money or property worth up to \$148,000 per year to their non-U.S. citizen spouse without having to pay gift tax (2016 amount, indexed annually for inflation).⁷

Finally, charitable donations,⁸ and amounts paid directly to a school to pay for a person's tuition,⁹ or to pay someone like a doctor or hospital that provides medical care to a person,¹⁰ are not subject to gift or estate tax.

If a client's net worth exceeds \$5.45 million, some of their wealth may be lost to estate tax at death. To use a greatly simplified example, if a U.S. citizen worth \$7 million did no planning, and died in 2016, their heirs could expect to lose \$620,000 to estate tax (\$7 million - \$5.45 million = \$1.55 million, 40% of which is \$620,000).

Irrevocable life insurance trust (ILIT)

A client wanting to address this issue can buy life insurance to replace the money their estate will lose to taxes. But if a U.S. citizen owns a policy on their life, the death benefit will be added to the value of their taxable estate.¹¹ That's like naming the Internal Revenue Service (IRS) as a beneficiary for 40% of the insurance proceeds. An ILIT addresses this problem.

The grantor creates an ILIT to own a life insurance policy on their life. The grantor also appoints a trustee to administer the trust. Almost anyone can serve as the trustee, but some choices are better than others. The trustee cannot be a trust beneficiary or the grantor's spouse. U.S. citizens living in Canada should consider naming a Canadian citizen and resident as trustee, for reasons discussed below. The grantor will also name the trust beneficiaries – persons the grantor would name as policy beneficiaries if there were no ILIT to own the policy.

The grantor will have no rights to any trust or policy benefits. Some of those excluded rights include the right to transfer policy ownership to someone else, designate or revoke a beneficiary to the life insurance policy, take policy withdrawals, borrow from the policy cash values, and pledge the policy as security for a loan.

Because the grantor won't own the policy, or have any rights to policy or trust benefits, the policy death benefit won't be part of their estate. The death benefit won't attract estate tax, and will go tax-free to the grantor's beneficiaries.

Applying for the life insurance policy

The ILIT trustee applies for and owns the policy. If the ILIT doesn't yet exist, the best practice is for someone other than the grantor or their spouse to apply for the life insurance policy, to start the underwriting process. If the grantor or grantor's spouse applies for the policy the IRS could assert that the grantor had "incidents of ownership" in the trust assets by having applied for the life insurance policy. Incidents of ownership are any rights that give the grantor an economic benefit.¹² For example, in connection with a life insurance policy, the excluded rights noted above, though not an exhaustive list, would be incidents of ownership.

⁶ IRC §2523(a).

⁷ IRC §2523(i).

⁸ IRC §2522(a).

⁹ IRC §2503(e)(2)(A).

¹⁰ IRC §2503(e)(2)(B).

¹¹ IRC §2042.

¹² Treasury Regulation §20.2042-1(c).

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Although U.S. courts have ruled that it doesn't matter who applies for the policy, only who owns it when it's issued, having the grantor or their spouse apply for the policy, then step aside before the policy is issued, still carries some risk. One difficulty is that a life insurance policy may have different dates attaching to different times during its creation. A policy's issue date is usually the day that the life insurance company approves and accepts the application. Its effective date is the day the life insurance company's legal obligations under the policy are created. And a policy's policy date is the date the insurance company puts on the policy, often the same as the issue date, but sometimes later, to allow time for policy delivery. Adding to the potential confusion is the fact that the tax authorities may use the same terms as the industry, but may use different definitions for those terms. Having someone other than the grantor or their spouse apply for the policy avoids the potential difficulty and confusion.

Sometimes a grantor is uninsurable or so heavily rated as to make a new policy too expensive. If the grantor already owns a policy, they could transfer that policy to the ILIT. Three issues arise, though:

- **The three year rule.**¹³ Any property that a U.S. citizen transfers within three years of death will be included in their taxable estate at death. The rule discourages "deathbed" transfers by rendering them ineffective for estate tax planning purposes. The only way to avoid the rule is to live for another three years after the transfer.
- **Gift tax.** The transfer will be treated as a taxable gift to the trust beneficiaries. Unless the trust beneficiaries have the right to take the gift, the grantor won't be able to use the \$14,000 per trust beneficiary annual gift tax exclusion (see the discussion below regarding *Crummey* withdrawal powers, for more details). Even if the policy has been qualified for the annual gift tax exclusion, the grantor will still have to file a gift tax return and use some of their unified credit to avoid gift tax if the policy cash value exceeds \$14,000 per trust beneficiary.
- **Deemed disposition.** Under Canadian law the transfer will be treated as a disposition of the policy. The grantor will have to pay tax on the policy's taxable gain: cash surrender value (CSV) minus adjusted cost basis (ACB).¹⁴

The Canada-United States Tax Treaty (the Treaty) has no mechanism for avoiding the potential for double taxation resulting from Canadian tax on the taxable gain and U.S. gift tax on the policy cash value. Whenever possible, the trustee should be the owner of a new policy from the date it's issued.

Qualifying trust contributions for the annual gift tax exclusion

The trustee will have to pay premiums to keep the policy in force. The money will come from gifts the grantor makes to the trust each year. Any gift the grantor makes to the trust will be treated as a gift to the trust beneficiaries. The \$14,000 annual exclusion applies, but only to gifts of a present interest – gifts that the recipient can use immediately. Transfers to an ILIT are gifts of a future interest, because the beneficiaries receive nothing from the trust until after the grantor has died. Gifts of a future interest aren't eligible for the annual exclusion.¹⁵

But future interest gifts can be qualified for the annual exclusion. The leading case is *Crummey v. Commissioner of Internal Revenue*.¹⁶ In that case the grantor gave the premium money each year to the trustee, who then offered it to the trust beneficiaries. The trust beneficiaries had the legal right to take the

¹³ IRC §2035.

¹⁴ Income Tax Act (ITA) section 148.

¹⁵ Treas. Reg. §§2503-3(a) and (b) point out the distinction between future and present interest gifts.

¹⁶ 397 F.2d 82 (9th Cir. 1968).

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money. But if they did not, the trustee could use the money to pay premiums for the life insurance policy the trust owned.

When Dr. Crummey died, the IRS attacked the trust, saying that the gifts to the trust were gifts of a future, not present, interest. But the Court confirmed that the mere act of offering the money to the trust beneficiaries converted that money into a gift of a present interest that was eligible for the annual exclusion. After the trust beneficiaries had refused their gifts, the trustee could use the money to pay the life insurance policy premiums.

5 and 5 powers

Including *Crummey* withdrawal powers in the trust document helps deal with the grantor's gift tax issues. But those withdrawal rights create gift tax issues for any trust beneficiaries who are also U.S. citizens. The trust beneficiaries will likely include the grantor's children and grandchildren, who may derive U.S. citizenship from the grantor, and who may be subject to the same transfer tax regime as the grantor.

The problem is that each trust beneficiary must have a legal and actual right to take the money the grantor has transferred into trust for them. Otherwise, the ILIT will not deliver its tax benefits. But each trust beneficiary must also know, informally, that they must refuse their gift so that the trustee can use their money to pay the life insurance policy premiums. If they exercise their legal right to take their gift the life insurance policy may lapse, and the strategy could fail.

But if each trust beneficiary refuses their gift (or, more precisely, allows their withdrawal rights to lapse) each will have made a gift to the other trust beneficiaries. To the extent that the deemed gift is worth less than \$5,000 or 5% of the value of the trust's assets, there's no problem.¹⁷ But if the deemed gift exceeds that threshold, each beneficiary will have to file a gift tax return, and may have to pay tax or use some of their unified credit to avoid gift tax. Since no beneficiary will have a present right to receive any portion of their gift from their co-beneficiaries, the gifts won't qualify as gifts of a present interest, and the \$14,000 annual exclusion won't help.

The lawyer who drafts the ILIT can address this issue by including "hanging" withdrawal rights in the trust document for each beneficiary. With a hanging withdrawal right, the trust beneficiary's right to withdraw trust property lapses each year only to the extent of the greater of \$5,000 or 5% of the trust assets. The beneficiary retains the right to withdraw the rest of the gift. Because it's the lapsing of the right to take trust property that causes the gift tax problem among the beneficiaries, preserving that right deals with the gift tax problem.

Hanging withdrawal rights accumulate for each year they aren't used. In the trust's initial years, the policy's cash value will be low, so the annual lapse amount likely will be limited to \$5,000 per beneficiary. Once the policy cash value exceeds \$100,000 (\$5,000 / 5%) per beneficiary, each beneficiary's lapse amount will exceed \$5,000. And after the policy cash value exceeds \$280,000 (\$14,000 / 5%) per beneficiary, the lapse amount will exceed the current \$14,000 annual gift tax exclusion. At that time the size of the outstanding withdrawal right will shrink (assuming that the value of the annual gifts equals \$14,000 per beneficiary or less, and that the annual gift tax exemption remains at \$14,000).

Although the hanging withdrawal right addresses the trust beneficiaries' gift tax problems, it still carries some risks:

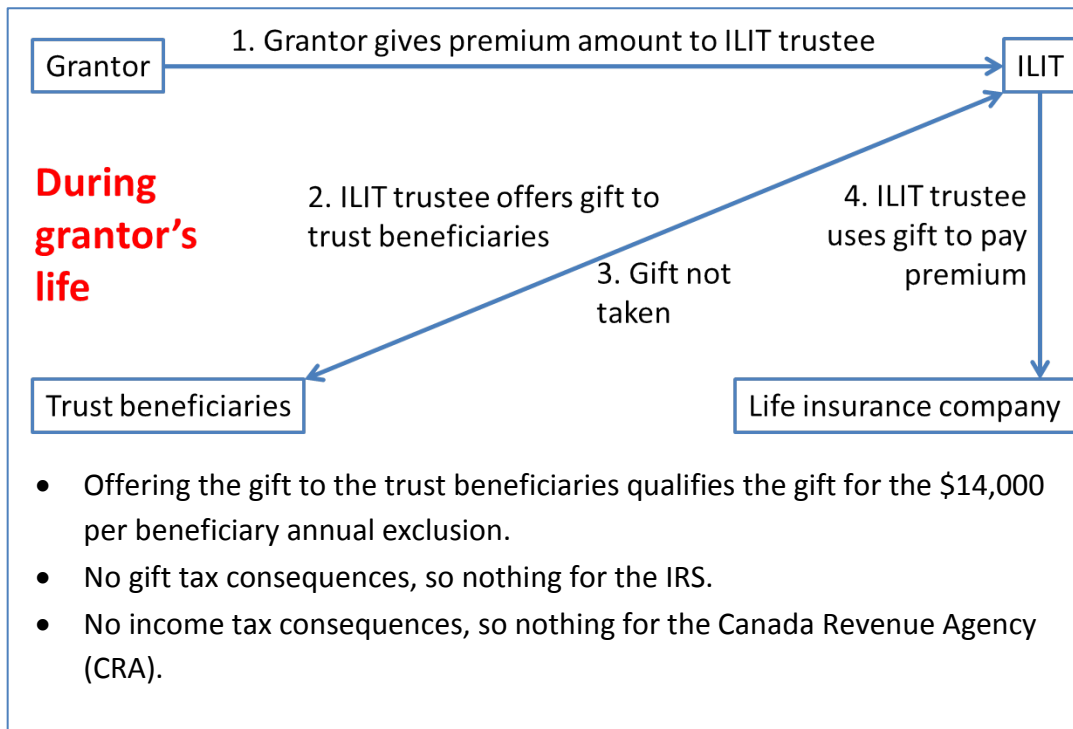
¹⁷ IRC §§2514(e)(1) and (2).

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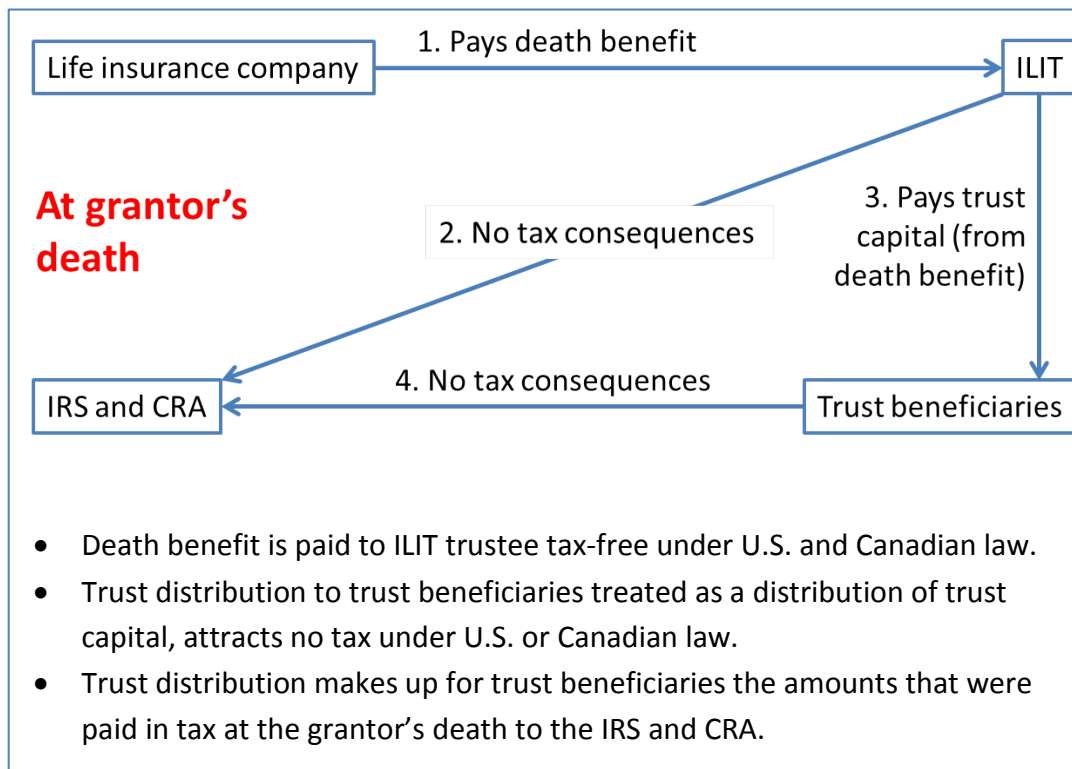
- A trust beneficiary could be tempted to exercise their accumulated withdrawal rights, since the property governed by those rights could grow to a substantial amount over time. If that happened, the trustee would probably have to borrow from, withdraw from, or even surrender the policy to get the money needed to pay the beneficiary. Depending on the policy's CSV and ACB, the beneficiary's demand could subject the trust to adverse tax consequences, and could cause the strategy to fail.
- If a trust beneficiary dies before the grantor, the right to withdraw money from the trust will be an asset that will be included in that trust beneficiary's estate.
- The withdrawal right is an asset that a beneficiary's creditors could seize during the beneficiary's life and at death.

The only solution to these risks is the passage of time. The risk declines as the cash value of the life insurance policy increases. And if the grantor dies, there should be enough money in the trust, in the form of a death benefit, to offset any accumulated withdrawal powers.

Here are two diagrams showing generally how an ILIT works:



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Minors as trust beneficiaries

ILITs with *Crummey* withdrawal powers work even when the trust beneficiaries are minors, and not able to legally accept or reject the grantor's gifts to the trust. Usually a minor's parents are their guardians, and make decisions for the minor. But what if the parents are also the grantors? If the grantor serves as guardian there would be a conflict of interest. The grantor would want the gift used to pay the insurance premiums, but the guardian would have to choose whether that was in the beneficiary's best interests. Exploiting this conflict, the IRS could assert that the beneficiary never had any intent to exercise the *Crummey* withdrawal powers, and could deny the \$14,000 annual exclusion.

In such cases, the grantor's (or grantor's spouse's) brother or sister could serve as guardian until the child or children reached the age of majority. Appointing a guardian for a minor may require a court application, and must be discussed with a lawyer.

Form 3520

A U.S. citizen files Form 3520 to report ownership of foreign trusts, transactions with foreign trusts, and the receipt of large gifts or bequests from foreign persons.

A Canadian ILIT will be a foreign trust from the IRS' perspective. The grantor will need to file a Form 3520 with the IRS to report the creation of the trust and their annual trust contributions.¹⁸

If the beneficiaries receive anything from the trust (probably not until after the grantor's death) they also will need to report the receipt of those distributions on their own Form 3520.

¹⁸ See instructions to Form 3520, at <http://www.irs.gov/pub/irs-pdf/i3520.pdf>.

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What happens when the grantor dies

When the grantor dies the ILIT trustee claims the death benefit. It's paid to the trust income tax-free. If the trust beneficiaries are of legal age the trustee pays the death benefit to them soon after the trustee receives it, according to the terms of the trust document. The trust is then terminated. Since both Canadian and U.S. law treat the death benefit as trust capital, there are no tax consequences to the beneficiaries when they get their shares of the death benefit.

If there is a delay between the trustee's receipt of the insurance proceeds and payment to the trust beneficiaries, the trustee may decide to invest the life insurance proceeds. Any income from those proceeds will be income to the trust. But if the trustee pays that income to the trust beneficiaries in the same year that it's earned, the trustee can deduct it from the trust's taxable income. The income will then be taxed to the trust beneficiaries at their marginal tax rates. If any of the beneficiaries are also U.S. citizens they will need to also report the receipt of trust property on Form 3520, as noted above.

If the trust beneficiaries are minors (like the grantor's children), the trust must include terms that will allow the trustee to retain the trust funds until the trust beneficiaries reach the age of majority, or attain a responsible age. If it doesn't, a guardian or trustee will have to be appointed to manage money that the minor receives from the ILIT. If the guardian is not appointed in the ILIT or grantor's will, a court application will be needed.

The trust will need to pay tax on any income the trust generates at the top marginal tax rates applicable to the trust's province of residence. In most cases that will be the trustee's province of residence, since the trustee will control the trust. Under recent changes to the Income Tax Act (ITA) income earned by *inter vivos* and testamentary trusts is taxed at the top marginal rate applicable to the trust's province of residence. An exception, the graduated rate estate (GRE), allows certain trusts to use marginal rates for up to 36 months after death. However, this exception applies only to testamentary trusts. An ILIT is an *inter vivos* trust because it is created during the grantor's lifetime.

Generally, trusts created for minors also allow distributions for items like education, a first house, or a new car when the beneficiary takes their first job. If the trustee pays the tax on any trust income earned, these distributions will be tax-free to the trust beneficiaries. However, any beneficiaries who are also U.S. citizens will need to report their distributions on Form 3520, as noted above. A client should discuss with their lawyer whether and to what extent they want to include powers to distribute trust money early.

The ILIT must not direct the trustee to pay the grantor's estate settlement costs. Such a direction could result in the death benefit being included in the grantor's estate. But an ILIT can be written to let the trustee provide some liquidity for the estate. If the estate owes money, or has expenses, but its assets are not liquid, an ILIT can allow (but not require) the trustee to lend money to the estate or buy assets from the estate, as long as the trustee decides that it's appropriate to do so.

What if the grantor changes their mind?

If the grantor decides to abandon this strategy, for example if a rift develops between the grantor and the trust beneficiaries, the grantor cannot get the policy out of the trust or retrieve any contributions they made to the trust. Although the grantor could stop making contributions to the trust, the trustee would have a fiduciary duty to the trust beneficiaries to maintain coverage in some form for as long as possible. As such, anyone considering an ILIT must regard it as permanent.

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The grantor may become dissatisfied with the ILIT trustee, and want to replace them. However, any power to replace a trustee must be carefully worded. The IRS is concerned that an ILIT grantor could exercise *de facto* control over the trust through their choice of trustee, particularly if the trustee is related to or subordinate to the grantor, or if the grantor can arbitrarily exercise the power to replace a trustee.¹⁹ In those cases, the IRS could rule that the grantor had incidents of ownership in the trust property, and include the death benefit in the grantor's estate.

Prohibited uses for life insurance

Because the grantor can't have any incidents of ownership in the trust property, some uses for life insurance aren't allowed when an ILIT owns the policy. For example, any strategy that contemplates the grantor using the policy's cash values to supplement retirement income won't be allowed. Nor will taking policy loans or using the policy as security for a loan (for example, to invest and take advantage of deductions for interest and the lesser of premiums paid and net cost of pure insurance). Taking money from the policy, directly or indirectly, is a financial benefit that would allow the IRS to ignore the trust and treat the death benefit as an estate asset.

Canadian life insurance policy tax implications

As noted above, the ILIT trustee should be a Canadian citizen and resident, and not a U.S. citizen or resident. That's because the policy will be a Canadian policy, issued by a Canadian life insurance company, and will conform to Canadian rules governing the income tax treatment of life insurance policies. If an American citizen or resident owned the policy, even as trustee, it could be argued that the policy would also have to conform to U.S. tax rules. That would require an actuary to determine each year whether the policy conformed to those rules. Naming a Canadian citizen and resident as trustee avoids that issue.

Having the ILIT own a Canadian life insurance policy will not affect the U.S. estate tax outcome. There is no rule that specifies that ILITs may own only American life insurance policies.

Premium excise tax

Internal Revenue Code (IRC) §§4371 – 4374 and Treasury Regulations 46.4371 and 46.4374 impose an excise tax on the premiums paid for any life insurance policy issued on the life of a U.S. person, but purchased from a foreign insurer.²⁰ The tax is 1% of the gross premiums paid, and applies to all U.S. citizens wherever they live.

Even though a trustee will own the policy, the IRS also holds the insured person jointly liable to pay the tax (if different from the policy owner). As a result, a U.S. person living in Canada won't be able to avoid the premium excise tax just by placing a Canadian life insurance policy in an ILIT.

FBAR and FATCA

The Bank Secrecy Act, passed in 1970, requires U.S. citizens to report certain foreign assets with a cumulative value exceeding \$10,000 at any point in the year to the U.S. Treasury Department. A U.S. person uses FinCen Form 114 (formerly Form TD F 90-22.1). "FinCen" stands for "Financial Crimes Enforcement Network", part of the U.S. Treasury Department. Under another law, the Foreign Accounts Tax Compliance Act (FATCA), a U.S.

¹⁹ See Technical Advice Memorandum 8922003, Revenue Ruling 95-58, 1955-2 CB 191 and Private Letter Ruling 9832039.

²⁰ Casualty and indemnity bonds, and reinsurance are also subject to the tax, but a discussion of them is beyond the scope of this article.

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person must also report certain foreign assets to the IRS. Both laws include cash value life insurance policies as foreign assets.²¹

The reporting obligation extends to foreign assets that the insured owns or has signing authority over. But when an ILIT owns a life insurance policy, the insured U.S. person neither owns the policy nor has signing authority over it, so neither the FBAR nor FATCA reporting obligations apply. Further, as long as the trustee is a Canadian citizen and resident, the trustee won't have an FBAR or FATCA reporting obligation, either. Having said that, the grantor and trustee must obtain tax advice on any reporting obligations they may have. There are severe penalties for failing to file an FBAR or FATCA report if you're obliged to file.

Canada and the United States signed an Intergovernmental Agreement (IGA) on February 4, 2014 to implement certain reporting provisions under FATCA. Canada has since amended the ITA to incorporate the IGA into Canadian law. In general terms, Canadian financial institutions must now report information about their U.S. person customers to the CRA, and the CRA must share this information with the IRS. These reporting obligations do not exempt U.S. persons from their FBAR and FATCA obligations discussed in this section.

Canadian tax considerations

The trust will need to conform to Canadian law. One requirement is the 21-year deemed disposition rule. A life insurance policy is not an asset that has to be disposed of every 21 years, but the proceeds of insurance, if retained in the trust, will be deemed disposed of every 21 years, and half of any capital gains earned on those proceeds will be brought into trust income unless paid to the trust beneficiaries. Even if there are minor beneficiaries, this should not pose much of a problem. In most cases, money from an ILIT is flowed out soon after death, provided the trust beneficiaries are of age and have capacity to receive the funds. If money is held for a minor beneficiary, they should reach legal age before the 21-year rule applies.

The attribution rules are also worth mentioning. Generally speaking, any income arising from money that the grantor transfers to a spouse or child, even in trust, is attributed to the grantor. An ILIT is not exempt from these rules. However, as long as the gifts to the trust pay only the life insurance policy premiums and the trustee's reasonable expenses, there should be little or no trust income to attribute or tax. Since the death benefit is paid tax-free, and can be transferred to the trust beneficiaries tax-free, there should be no attribution on the death benefit. Any income earned on a death benefit held in trust for a beneficiary will not be attributed to the grantor because the grantor will have died by this point.

ILITs for Canadians owning U.S. property

If a Canadian owns property in the United States, that property could be subject to estate tax at death. Life insurance owned in an ILIT can help reduce or eliminate the resulting loss to a Canadian's estate from that tax.

Generally, the IRC denies use of the \$5.45 million unified credit to the estates of non-U.S. persons. But a pro rata credit is available for Canadians under the Treaty.

²¹ Regarding the FBAR obligation, the IRS has said, "An insurance or annuity policy that is purchased outside of the United States, as defined in 31 CFR §103.11(nn), from a non-United States issuer is a foreign financial account." http://www.irs.gov/pub/irs-utl/draft_fbar_instructions.pdf. Regarding FATCA, the IRS has said in its instructions to Form 8938: "A financial account is ... any cash value life insurance or annuity contract maintained by an insurance company or other foreign financial institution." <https://www.irs.gov/pub/irs-pdf/i8938.pdf>.

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The size of the pro rata credit depends on the proportion that the deceased's assets located in the U.S bear to their world-wide assets. For example, if 10% of a Canadian's world-wide assets are located in the United States, 10% of the unified credit, or \$545,000, would be available to shelter those assets from estate tax.

The Treaty makes you calculate the pro-rata credit according to U.S. estate tax rules. Items like life insurance policy death benefits and the present values of payout annuities and pensions are included in an individual's world-wide estate. Accordingly, a Canadian resident may reduce the size of their world-wide estate (and increase the size of their pro rata unified credit) by having an ILIT own their life insurance policies, and thereby remove the death benefit from their estates.

It's important to remember that the three year rule discussed above applies to this strategy, as do the Canadian rules that may tax the life insurance policy gain on transfer to an ILIT.

Conclusion

Creating and administering an ILIT is complicated. But the potential tax benefits can be substantial, and therefore worth the effort and expense. Make sure that the client receives appropriate tax and legal advice in creating an ILIT, and that the trustee receives the same quality of advice for administering it.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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