



# ADVANCED MARKETS INSIGHT

## Trust-Owned Linked-Benefit Long Term Care Insurance

### What Is Long Term Care (LTC)?

Long Term Care (LTC) is a specialized set of services required when an individual suffers from a chronic illness, or an accident renders them physically or mentally unable to care for themselves. These services can be very costly, and many people choose to protect themselves against this risk by purchasing LTC Insurance.

### Life Insurance with an LTC Rider

Recently, insurers began combining two different forms of insurance coverage by offering Life Insurance policies with an LTC rider. If LTC is required, the policy pays benefits to help offset costs. The death benefit of the insurance policy is typically reduced dollar-for-dollar by the amounts paid out as LTC benefits. However, if the insured never requires LTC, or only uses a portion of the LTC benefit, any remaining life insurance death benefit will be available for heirs upon the death of the insured.

### Possible Estate Tax Consequences

Although this “hybrid” type of insurance policy efficiently combines two important forms of insurance, it also creates a challenge for estate tax planning purposes.

In general, if a life insurance policy is owned by an individual, the policy’s proceeds are subject to estate tax at death. Often, an Irrevocable Life Insurance Trust (“ILIT”) is created to own the insurance policy, thereby removing the proceeds from the taxable estate.

However, if an ILIT owns a hybrid policy, the trust becomes the potential recipient of any LTC benefits. If the trustee makes monetary distributions to the insured, or benefits are reimbursed to an LTC service or facility for the benefit of the Grantor, the entire trust could be included in the insured’s taxable estate.

Therefore, the question is: How can an ILIT own a hybrid policy to ensure the life insurance is outside of the estate, but still make funds available to provide for LTC needs?

Fortunately, there is a solution. While the trust cannot directly pay the LTC expenses of an insured, it can contain a provision to allow it to lend the insured money. Such a trust may be called an Ultimate Life Insurance Trust (“ULIT”).

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## How Does the Strategy Work?

- The Grantor transfers funds to the ULIT, which are subject to gift tax. However, annual exclusions and the Lifetime Gift Tax Exemption can be used to shelter some or all of the transfers from gift tax.
- The trustee purchases a life insurance policy with an indemnity LTC rider, insuring the Grantor's life.
- Should the Grantor require LTC, benefits would be paid to the ULIT. Life insurance death benefits are reduced accordingly.
- As an unrelated transaction, the trust may make collateralized loans to the Grantor. Loan interest must be charged and would be due annually on the loan.<sup>1</sup>
- At death, any remaining death benefit of the policy will be paid to the ILIT. Before estate taxes are determined, the Grantor's estate repays the loan to the ULIT.
- The trust assets are distributed estate tax free to the trust's beneficiaries, inclusive of the insurance proceeds and the repaid loan and interest.
- The results:
  - The Grantor has funds to pay LTC expenses.
  - The trust is made whole again with the remaining death benefit and the repaid principal.
  - Additional funds have been added to the trust through the interest payments.
  - The estate has been reduced, resulting in lower estate taxes.

## Considerations

- The Grantor should not direct the trust to use LTC insurance benefits to cover his/her LTC expenses. Doing so may be regarded as a retained interest in the trust, causing the trust assets to be included in the estate for estate tax purposes.
- The insurance policy must pay LTC benefits on an indemnity basis. The trust itself must file the claim for benefits independent of the insured/grantor.
- The trustee must be unrelated to the Grantor.
- There is no direct IRS authority concerning the use of an ULIT, and its suitability must be determined by legal and tax advisers on a case-by-case basis.

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<sup>1</sup> Revenue Ruling 85-13 provides that no income tax is due on interest payments between a Grantor and a Grantor Trust.

## Trust-Owned Long Term Care Insurance

1. A Grantor establishes an Irrevocable Life Insurance Trust that will allow for collateralized loans and funds it with taxable gifts. Annual exclusions and the Lifetime Gift Exemption can be used to shelter some or all of the gifts from gift tax.



2. The Trust uses funds to purchase life insurance policy with an indemnity-style Long Term Care Rider from an insurance company.



## When Long Term Care is Needed

3. The insurance company pays Long Term Care Benefits to the Trust.



4. The Trust makes collateralized loans to the Grantor at a reasonable interest rate. The Grantor will pay interest annually to the Trust.



## At Death

5. The estate of the Grantor repays the loan to the Trust.



6. Any remaining life insurance benefits are paid to the Trust.



7. Proceeds are distributed to the beneficiaries per trust's provisions free of estate tax.



## For More Information

To learn more,  
please contact:

Jeffrey D. Dattolo  
CFP, CLU, ChFC  
Partner  
908.603.1256  
jdattolo@AtlasAdvisory  
Group.com

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Atlas Advisory Group, LLC  
21 Commerce Drive, Suite 301  
Cranford, NJ 07016  
908.276.0096  
908.276.0038 Fax  
www.atlasadvisorygroup.com