Irrevocable trusts and life insurance: What a trustee should know

ADVANCED MARKETS

BECAUSE YOU ASKED

For years, estate planners have established Irrevocable Life Insurance Trusts (ILITs) to own life insurance. An ILIT, when drafted and administered properly, keeps the death benefit and other trust assets free from estate tax, offers increased creditor protection, and can be drafted to give the grantor enhanced control and discretion over how and when income and principal will be distributed to beneficiaries. However, creating an ILIT means that the insured(s) must relinquish control over the trust, and name one or more trustees to manage the trust assets.[1] Certain trust formalities must be adhered to and a trustee has many duties to carry out. This BYA will explore some of the fiduciary responsibilities of a trustee.

Who can serve as an ILIT trustee?

The trustee of an ILIT can generally be anyone other than the insured. Oftentimes the trustee(s) of an ILIT will be family members of the insured(s) because they generally have the most familiarity with the needs of the beneficiaries and often serve for little or no compensation. Note, however, if a trust beneficiary is also a trustee, distributions should generally be subject to an "ascertainable standard" such as health, education, maintenance, and support, especially when the beneficiary-trustee is likely to face federal or state estate taxes at death.

In many situations, it may also be advisable to name an independent party as trustee or co-trustee. An "independent trustee" is someone who is not a beneficiary of the trust and is unrelated to the beneficiaries, and can be a close friend or other trusted third-party. In some cases, an independent trustee may be a "professional trustee" such as a CPA, an attorney, or a professional trust company/financial institution. An independent/ professional trustee generally has experience administering a trust, understands the complexities and responsibilities of a fiduciary, and offers maximum impartiality which can help to maintain family harmony.

What is a "fiduciary duty?"

Trustees have a legally binding "fiduciary responsibility" to the trust beneficiaries, meaning they are expected to manage the trust assets wisely and with the best interests of all of the beneficiaries in mind. A trustee must maintain an objective standard of care in managing trust property and must remain impartial between classes of beneficiaries. A trustee may be held personally liable for a breach of his/her fiduciary duties - trustees should consult with local legal counsel to better understand all of their duties.

After accepting appointment as trustee of an ILIT, the trustee should try to find out how the life insurance proceeds are expected to be used, as well as the insured's expectation of how the policy and other trust assets should be managed. Although the trustee is not bound by the insured’s expectations, he/she should also try to understand the general intentions of the insured/grantor regarding the distribution of assets for the benefit of his/her heirs and any other trust beneficiaries.

What are some of the key responsibilities of an ILIT trustee?

The responsibilities of the trustee are dictated by the provisions of the trust document. In general, the primary responsibilities of a trustee of an ILIT include:

Payment of Life Insurance Premiums

Unless the life insurance policy is a single premium policy, the trustee will need to manage the ongoing payment of premiums. Because the trust is both the owner and beneficiary of the life insurance policy, the trustee will receive the premium notices and will usually receive gifts from the insured(s)/grantor(s) to fund the trust.[2] If there is insufficient cash in the trust to pay the premium that is due, the trustee will also have to review the policy information to determine what other options are available, i.e., if it is possible/feasible to borrow or withdraw against the cash value in the policy (if it is a term policy, non-payment of premiums can lead to a lapse of the policy).[3]

Providing Notice to Crummey Beneficiaries

For a gift to qualify as an annual exclusion gift ($15,000 in 2019), there must be a transfer of a "present interest" in the property. Contributions to an ILIT typically can qualify as a present interest gift if the beneficiaries possess a power to withdraw the contributions for a limited period of time, known as "Crummey Powers."[4] If Crummey notices are not administered properly, the IRS may challenge the use of the annual exclusion and the premium contributions may be subject to gift or estate tax.[5] Accordingly, a key duty of an ILIT trustee is to ensure the formalities of Crummey notices are followed.

Once the trustee receives the gift from the insured/grantor, in most cases the trustee will need to notify the "Crummey" power holders that the contribution is available for withdrawal in the trust account for a specified period of time (usually 15–30 days) before the premium will be paid. The trustee should review the trust document to determine how and when the notice should be provided to the Crummey beneficiaries. Typically, the trustee must provide written notice to the beneficiaries who have Crummey withdrawal rights and either the beneficiaries or their guardians (if they are minors) must sign the Crummey notice to acknowledge receipt.

Policy Review

The trustee should periodically review the life insurance policy to determine if the policy is performing as expected, and is still sufficient to meet the goals of the trust for the beneficiaries. Particular attention should be paid to policies that are not performing as illustrated, policies that are not cost-efficient (and may need to be replaced) and policies that may have a scheduled jump in premiums. In addition, the trustee should determine whether insurance coverage would be sufficient for the current needs of the trust beneficiaries. When performing a policy review, the trustee should consider engaging the services of an insurance specialist.

Investment Management

The trust document generally places the duty of prudent investment on the trustee. The policy review will help the trustee determine if the life insurance policy owned by the trust is an appropriate investment. However, with trusts that own variable universal life insurance policies, the task of investing becomes more complicated. Variable universal life insurance policies have multiple investment options and the trustee, as the policyholder, has the responsibility of determining the type as well as the proportion of underlying investments for the policy. As with policy review, the trustee can delegate the responsibility for investment choices to an investment professional. However, the trustee still needs to monitor the investment performance of the policy funds and is ultimately responsible for explaining the investment choices to the trust beneficiaries. Many states have adopted a form of the Uniform Prudent Investor Act, which requires that trustees must act prudently in making or retaining trust investments (other states have adopted the provisions of the Restatement of Trusts). The Prudent Investor Rule focuses on the overall investment strategy of a trust and requires trustees to balance the income beneficiary's right to income with the remainder beneficiary's right to the trust principal. The trustee should become familiar with the statutes for the state in which the trust is domiciled and must establish a process for determining the suitability of the trust-owned life insurance on an ongoing basis.

Income Tax Reporting

The trustee must work with a tax advisor and file any federal or state income tax returns for the trust and issue K-1's for the beneficiaries, if necessary.[6] In many cases, ILITs will not have any taxable income if the only asset owned by the trust is a life insurance policy, which has tax-deferred growth, tax-free access to cash value, and a tax-free death benefit. If the policy is lapsed or surrendered then there may be taxable gains in the life insurance contract, which would have to be reported. However, ILITs may also be funded with income-producing assets, such as stock or real estate. If the trust has reportable income and the ILIT is drafted as a "grantor trust" for income tax purposes, then the income and deductions from the trust assets should be reported on the grantor's individual income tax return. If the ILIT is not drafted as a grantor trust, then the income and deductions for the trust must be reported on a trust income tax return (Form 1041).

Conclusion

Trustees of ILITs have increasingly complex responsibilities, as a result of the requirements of investment standards, state and federal law, the provisions of the trust document, and the needs and requests of the trust beneficiaries. In recent years, trustees have been sued for negligence in maintaining a life insurance policy, improper investment decisions, poor life insurance policy design and numerous other claims. Trustees should work closely with advisors on life insurance, tax and investment issues and follow the proper procedure required by the trust document and/or state statutes to manage the trust assets appropriately.

1. IRC Section 2042. The insured must not have any "incidents of ownership" over the life insurance policy.
2. An Irrevocable Trust is a separate taxpaying entity, and the trust should have a separate bank account with its own taxpayer ID number.
3. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested.
4. These powers are known as "Crummey Powers" after the taxpayer in the case *Crummey v. Commissioner*. See *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968) and IRC §2503(b). For a Spousal Access Trust, the beneficiary spouse should not be given "Crummey" rights of withdrawal. In addition, in a community property state, the grantor spouse should create a separate property agreement and the premium gifts to the ILIT should be funded from separate property. See Treas. Reg. §20.2042-1(b)(2).
5. See *Hattleberg v. Norwest Bank Wisconsin*, 2005 WL 1574958 (2005), in which amounts gifted to trust did not qualify for annual exclusion and a trustee was held liable for gift and estate taxes incurred by decedent's estate because trustee knew that there were no Crummey provisions and still encouraged the settlor to make "annual exclusion" gifts to the trust.
6. Schedule K-1 is used to report a beneficiary's share of all items of income from a trust or estate.

INSURANCE PRODUCTS		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	