Irrevocable Life Insurance Trusts –

A Trustee's Perspective

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Life insurance is often acquired as a commodity, designed to provide a benefit upon the occurrence of a stated event – death of the insured – for the purpose of paying estate taxes, supporting a surviving spouse and/or descendants, funding other obligations of the insured (creditors, for example). However, with the exception of term insurance policies, life insurance is a complex investment. There is not readily available data on the percentage of life insurance policies owned by irrevocable trusts, but for individuals anticipating a taxable estate use of an irrevocable trust (commonly referred to as an "ILIT")[1] is a seemingly simple way to avoid estate taxation on the policy death benefit.[2] Annually, on average 30 million **new** life insurance policies are issued[3] and the average annual death benefit claims paid by all insurance carriers over the past 4 years in in excess of $90 billion[4]. As a result, there is likely a tremendous amount of value under the control of trustees (and not insureds). When life insurance is owned in an irrevocable trust, the trustee has legal ownership of the policy and significant fiduciary responsibility to ensure the investment is properly managed.

Over the past few decades, many corporate trustees have exited the business of serving for trusts owning life insurance policies due to a rise in risks, litigation and pressure from consumers (grantors) on fees charged to administer trusts that the consumer observes to be a routine and basic task. The result is more individuals being appointed, and agreeing, to serve as trustee for trusts owning life insurance policies – often with the blessing of estate planning attorneys who explain the role as simply ensuring that the policy stays in force by paying the annual premiums. When described this way, it does sound simple. But fiduciary duties, in any context, are anything but simple, and fiduciary duties and obligations are the same – and correspondingly, so are the risks – regardless of whether the trustee is a corporate trustee or an individual.

As a former practicing estate planning attorney and chief fiduciary officer for a regional bank providing trustee services, I am sharing my perspective on this topic, as well as guidance for estate planning attorneys and advisors as they counsel and advise both corporate and non-corporate trustees in serving for trusts owning life insurance.

I. ILIT Basics

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[1] An ILIT typically is used to describe an irrevocable trust the sole asset of which is a life insurance policy. As many irrevocable trusts own life insurance policies and other assets, I have chosen not to use the term ILIT in this outline, and instead use the term "trust" generally to describe or refer to an irrevocable trust owning at least one life insurance policy.

[2] This outline does not substantively address the estate tax provisions applicable to the taxation life insurance policies (notably the provisions of IRC Sections 2042 and 2035), and instead focuses on the administration issues specifically applicable to irrevocable trusts holding life insurance policies. The main outline for this session substantively addresses the provisions of IRC Sections 2042 and 2035.

[3] As reported by the NAIC.

[4] Sourced from AM Best News (www.news.ambest.com)

a. <u>Grantor vs. Non-Grantor Trust</u>

i. IRC Section 677(a)(3) classifies a trust as grantor for federal income tax purposes if the trustee of the trust has the power to use the income of the trust to pay premiums for insurance owned by the trust and insuring the life of the grantor or the grantor's spouse. Accordingly, almost all irrevocable trusts owning insurance on the life of the grantor are classified as grantor trusts.

ii. Exceptions to the application of IRC Section 677(a)(3) include:

1. If the insurance proceeds are irrevocably payable for charitable purposes;

2. If payment of premiums from income requires the consent of an adverse party.

iii. The advantages of grantor trust classification, include:

1. All income earned in the trust is taxed to the grantor, and payment of the income tax liability by the grantor is not classified as a gift. Rev. Ruling 2004-64 (2004-2 C.B. 7).

2. Tax free transactions between the trust and grantor, including related to the policy or any other policies insuring the life of the grantor.

a. This premise also includes IRC Section 101, such that a sale transaction of a policy insuring the life of the grantor to the trust is exempt from IRC Section 101. See Rev. Ruling 85-13 (1985-1 C.B. 184), holding that a transaction between a grantor and a trust classified as a grantor trust as to the "grantor" is disregarded for income tax purposes.

b. This holding also exempts the sale from the implications of IRC Section 101 and the sale being considered a transfer for value of the policy, which subjects at least a portion of the death benefit to income tax.

iv. If the trust agreement prevents the trustee from using the income of the trust to pay insurance premiums, and there are no other powers in the trust implicating IRC Sections 673 - 678, then the trust is not a grantor trust for income tax purposes. If this is the case, then:

1. If premiums are required for the policy, the trustee must ensure that only principal/corpus is used for the premium payments – this means no portion of the income (interest, dividends, etc.) earned by the trust during the calendar year is transferred to the insurance company for the premium payments. This is much more complex than it sounds and will require the trustee to keep accurate trust accounting records for income and principal and properly credit "principal" cash and not "income" cash for the insurance premium payments.

   Example: Trust is funded with $50,000, which is held in cash earning interest at a rate of 3% per annum ($1,500). Trust has no expenses other than payment of the annual premiums on the trust owned policy, in the amount of $2,500. If the trust agreement prohibits the payment of premiums from income, then the trustee must record the payment of the premium ***from principal***, as follows:

	Principal Cash	Income Cash
Beginning year balance	$50,000	
Interest		$1,500
Premium payment	($2,500)	
End of year balance	$47,500	$1,500

   The cash flow and net cash balance in the trust account will be the same, regardless of whether the premium is paid from principal or income, and further should not impact the interest earned on the cash held in the account. But, from a fiduciary accounting perspective, this tracking is important for both the interests of the beneficiaries, as well as to ensure proper tax classification of the trust.

2. Any transactions involving the life insurance policy will be taxable ***to the trust***, including a sale of the policy or surrender. If a sale or surrender transaction occurs, the trustee must ensure that sufficient funds are retained to pay the corresponding tax liability (federal and state, if applicable).

3. Purchase of a policy insuring the life of the grantor is not exempt from IRC Section 101(a)(1), meaning that if an insured sells a policy insuring his/her life to the trust (in order to exclude the death benefit proceeds of the policy from his/her estate and also avoid the implications of IRC Section 2035), then a portion of the death benefit (the amount equal to the consideration paid for the policy and the amount of the premiums paid for the policy after purchase) received from the policy will be subject to income tax. See IRC Section 101(a)(2) (as a transfer for value transaction).

   Example: Insured sells policy with death benefit in the amount of $2,000,000 to a non-grantor trust for $400,000. After purchase, the trust pays aggregate premiums in the amount of $300,000 to maintain the policy. At the insured's death, $700,000 ($400,000 initial payment plus $300,000 of additional premiums) of the $2 million death benefit received will be taxable as ordinary income pursuant to IRC Section 101(a)(2), and the balance of the proceeds, $1.3 million will be received free of income tax.

v. From the trustee's perspective:

1. Who is determining tax status of the trust? The trustee is responsible for the tax filing (and payment) obligations of the trust and therefore must receive reliable guidance on the tax classification of the trust in order to properly execute on his or her responsibilities.

2. Based on whether the trust is a grantor trust (as to the grantor, or a beneficiary (see discussion below in Section I.c.)) or non-grantor trust, the trustee must ensure that tax returns and/or reports are delivered and filed with the taxing authorities (IRS and state department of revenue), as well as ensuring that any tax liability owed is paid.[5]

[5] Note that for a trust owning solely a life insurance policy, generally there is not taxable income (or if some income it is nominal in the form of interest earned on any cash balance of the trust and does not exceed the standard deduction for a trust ($600)). However, it is not uncommon for a trust that owns a life insurance policy to own other assets that generate taxable income and thus create a filing requirement for the trust.

3. Ensuring that transactions between the grantor and trust are handled at arm's length, including that adequate value is paid for assets sold to or purchased from the grantor.

    a. In the context of (1) a purchase of a policy from a grantor/insured, in order to ensure that the trust pays fair market value for the policy (to avoid a potential gift from the grantor to the trust), or (2) a sale of a policy (to ensure that the trust receives full and adequate consideration to protect the interests of the trust beneficiaries), the trustee should consider obtaining a valuation for the policy and not necessarily rely solely on the cash value of the policy (for a universal or whole life policy) or the pro rata premiums paid (for a term policy).

    b. As discussed below and in the main outline for this Session, there are external factors that can affect the value of a policy so that reliance on either cash surrender value and/or the insurer's issuance of a Form 712 may not constitute fair market value.

b. <u>Insurable Interest</u>

i. A basic requirement for the enforceability of an insurance policy is the existence of insurable interest by the policy owner in the life of the insured.

ii. Insurable interest is measured ***at the time a policy is issued***, and generally a familial or economic interest in the life of the insured is sufficient to meet the insurable interest requirement. The U.S. Supreme Court has held that assignment of a policy to one without an insurable interest in the insured does not invalidate a policy initially issued to one with insurable interest. See *Grigsby v. Russell*, 222 U.S. 149 (1911).

iii. Essentially, the insurable interest requirement exists to prevent individuals from acquiring insurance on the life of someone to whom the owner has no relationship or interest in the value of the insured's life. The premise is that the person owning the policy should have an interest (either economic or otherwise) in the continuance of the life of the insured, otherwise the policy "is a mere wager, by which the party taking the policy is directly interested

in the early death" of the insured. *Warnock v. Davis*, 104 U.S. 775, 779 (1881).

1. Economic interest (separate and apart from a familial interest) – generally this includes partners or associates in a business, employers in their employees, creditors (including former spouses), as well as charitable institutions in their donors.

2. Familial interest – Generally, close family members, including spouses, children and parents.

iv. Every state has either statutory or case law in support of insurable interest, although only a minority of states have insurable interest statutes addressing trust owned life insurance.

1. Consent Statutes – Several states have statutes providing that consent of the insured to the acquisition of the policy is sufficient to establish insurable interest. Note that participation in the insurance underwriting process generally is not sufficient to establish consent in these jurisdictions and requires a separate and preferably written indication of the consent by the insured.

2. One of the more recent and notable cases on the issue of insurable interest and trusts is *Chawla v. Transamerica Occidental Life Insurance Co.*, 440 F.3d 639 (4th Cir., 2006), where the insurance company successfully rescinded a policy issued to a trust as a result of material misrepresentations in the policy application and on the basis of a lack of insurable interest.

   a. Notably the lower Court found that material misrepresentations regarding the insured's health rendered the policy void, but the Court went on to rule on a lack of insurable interest by the trust owning the policy on the basis that the trustee of the trust had neither an economic nor familial relationship to the insured.

   b. On appeal, the Fourth Circuit noted that the misrepresentations in the policy application were sufficient to allow the insurer to rescind the policy and that the District Court's ruing on insurable interest "appears to have

unnecessarily addressed an important and novel question of Maryland law. And, as a general proposition, courts should avoid deciding more than is necessary to resolve a specific case."[6] The result being that the Court of Appeals' ruling vacated the District Court's decision on insurable interest. Regardless, the case sent waves through the insurance and estate planning community.

3. The following states have enacted statutes addressing insurable interest of a trust (or trustee) owning a life insurance policy: Colorado, Delaware, Florida, Georgia, Kansas, Maine, Maryland, Minnesota, Nevada, New Mexico, North Dakota, Oklahoma, South Dakota, Utah, Virginia and Washington.

4. States without statutes may have addressed the issue through case law that adopts either the entity or aggregate view. The entity view takes the position that the trust, through its trustee, must independently establish a basis for having an insurable interest in the insured. Notably, the District Court in *Chawla* adopted the entity view. The aggregate view evaluates the beneficiaries of the trust and whether their relationship to the insured is sufficient to create an insurable interest in the insured. See *Butterworth v. Miss. Valley Trust Co.*, 240 SW2d 676 (Mo., 1951) for an example of the aggregate view.

v. It is the life insurance company that has the right to enforce the insurable interest laws, but also issued the policy (and arguably should have made the determination of the sufficiency of insurable interest at such time). If an insurance company determines that insurable interest did not exist, they may decline to pay the death benefit but may be required to repay the aggregate premiums (potentially with an interest component, depending on state law). But see, *Penn Mutual Life Ins. Co. v. Greatbanc Trust Co.,* 2012 U.S. Dist. LEXIS 115015 (N.D. Ill., 2012) involving a STOLI policy declared issued void ab initio and Court denied the trustee's claim for recission and return of premiums paid (on basis that recission is not a valid claim when the policy is void ab initio).

[6] *Chawla* at 648.

vi. From the trustee's perspective:

1. If the trust is the initial acquirer of the policy, is there a risk of a lack of insurable interest that could render the policy voidable by the insurance company?

    a. If so, can it be countered by use of the consent statute, including applying the law of a state with a consent statute and drafting language in the trust agreement to enable the consent statute?

    b. If not, can the trust acquire the policy from one with an insurable interest (preferably the insured)?

    c. If so, the trust should be classified as a grantor trust for tax purposes to ensure avoidance of the transfer for value rules of IRC Section 101(a) and the exception to IRC Section 101(a) is only available if the transferor is the insured (and grantor of the trust).

2. If the trust acquires the policy from the insured (or another person with an insurable interest in the policy), ensure that there is appropriate time between the policy issuance and subsequent transfer to avoid application of the step transaction. See *Principal Life Ins. Co. v. Lawrence Rucker, 2007 Insurance Trust,* 2012 U.S. Dist. LEXIS 88313 (DE, 2012); *Wells Fargo Bank, N.A. v. American National Ins. Co.*, 2012 U.S. App. LEXIS 16725 (9TH Cir, 2012), and *Penn Mutual Life Ins. Co. v. Greatbanc Trust Co.*

c. Crummey Withdrawal Rights

i. The vast majority of irrevocable trusts, and in particular those owning life insurance policies, contain withdrawal rights that allow the stated beneficiaries the right to withdraw (a portion) of the funds gifted to the trust. As a result of the decision in *D. Clifford Crummey v. Commissioner,* 397 F2d 82 (9th Cir, 1968) a withdrawal right over contributions creates a present interest in the property gifted to the trust, and therefore makes the gift eligible for the annual gift tax exclusion.

1. Many grantors do not want to use their gift tax exemption to fund payments for insurance policies, so use of the annual gift tax exclusion is a more efficient way to fund the trust, and can leverage multiple annual exclusion gifts depending on the number of beneficiaries with a withdrawal right (and the potential to gift split with the grantor's spouse).[7]

    a. There are varying opinions on whether notice of the withdrawal right is required to be given for it to be effective and therefore for the annual gift tax exclusion to apply.

    b. Some practitioners rely on cases and rulings that provide actual knowledge of a gift and corresponding withdrawal right from a trust are sufficient to meet the present interest requirement, and that written notice of the withdrawal requirement is not required.

    c. However, a trustee does have an obligation to follow the express terms of the trust agreement, and if the trust agreement directs the trustee to provide beneficiaries of notice of their withdrawal right (and most do), then the trustee is obligated to provide the notice.

2. The withdrawal right is considered a general power of appointment (See Treas. Reg. Section 20.2041-1(c)(1) and 25.2514-1(c)(1)). The income tax result of this is that the beneficiary with the withdrawal right is considered the owner of the portion of the trust over which the beneficiary has the right to vest the trust property in him/herself. See IRC Section 678(a).

    a. As most ILITs are grantor trusts (as to the grantor of the trust) for income tax purposes, this issue may send trustees into a tailspin trying to determine how any taxable income of the trust is to be taxed and allocated as between the grantor and beneficiary(ies).

[7] Some ILITs are funded with insurance policies subject to a split dollar arrangement, in which case actual cash contributions are not made to the trust, but rather deemed gifts are made to the trust. There are nuances to the application of the Crummey withdrawal right in these structures that are not addressed in this outline.

b. However, IRC Section 678(b) and Treas. Regulation Section 1.678(b)-1 appear to clarify that in a situation where a grantor has retained any powers resulting in the trust being classified as a grantor trust from allowing another person from being classified as the grantor of any portion of the ***income*** of the trust.

c. Because the language in the statute and regulations is limited to income, and the withdrawal right is generally over principal, some have cautioned reliance on Section 678(b) to resolve this issue. However, many practitioners believe that the intent of these provisions were to extend to both income ***and principal*** and generally take the position that a beneficiary's withdrawal right over the principal of a trust classified as grantor (as to the grantor) does not impact that classification. In other words, a grantor trust remains a grantor trust for both income and principal transactions, even if a beneficiary has a withdrawal right over principal.

d. If the trust is not a grantor trust for income tax purposes, then this withdrawal right will cause the trust to be classified as a grantor trust as to the beneficiaries with a withdrawal right (that is not lapsed – see discussion below).

3. As noted above, most withdrawal rights have a limited period during which the beneficiary can exercise the withdrawal right, after which (if unexercised) the right lapses.

a. To the extent that the individual with the withdrawal right and the remainder beneficiary of the trust (meaning the person in whom the trust property ultimately will vest) are different, then the lapse of the withdrawal right (as a general power of appointment) is considered a taxable gift by the holder of the withdrawal right, ***to the extent that the lapse exceeds the greater of (1) $5,000 or (2) 5% of the aggregate value of the trust property***. IRC Section 2514(e) (referred to as the 5 x 5 rule).

b. If the withdrawal rights are limited (either by application of the formula for the withdrawal right or by drafting) then

lapse of the right will not result in a gift. This generally is why the withdrawal right of the grantor's spouse, if given a withdrawal right, is limited to the greater of $5,000 and 5% of the value of the trust property (to avoid the spouse making a deemed gift to the trust of which the spouse is a beneficiary and the potential estate tax implications to the grantor's spouse).

c. To mitigate or combat the issue of the gift resulting from the lapse of the withdrawal right, many trust agreements containing withdrawal rights contain hanging withdrawal rights. See Section I.c.ii. below for more detailed discussion hanging withdrawal rights.

d. A beneficiary of a withdrawal right who affirmatively waives his or her right to withdraw the amount is deemed to have made a gift of the entire amount of the withdrawal right, as such action is **<u>not a lapse</u>**.

e. Because the lapse of the withdrawal right is a further gift to the remainder beneficiaries of the trust, it is not a gift of a present interest in property and will not qualify for the annual gift tax exclusion.

ii. It is generally anticipated that the beneficiaries will not exercise their withdrawal right, resulting in the lapse of the withdrawal right.

1. As discussed above, the lapse of a withdrawal right is considered a gift to the remainder beneficiaries of the trust (assuming the remainder beneficiaries are different from the beneficiaries holding the withdrawal rights (meaning that the trust property does not vest in the beneficiaries with the withdrawal rights)).

2. To avoid the additional gift and estate tax implications of a lapse, typically the trust agreement is drafted to provide that the withdrawal right lapses only to the extent of the greater of $5,000 and 5% of the value of the trust property; Meaning that the beneficiary has a continuing withdrawal right of an amount by which withdrawal right exceeds $5,000 and 5% of the fair market value of the trust property (the "hanging withdrawal right").

a. Example: Grantor contributes $50,000 to a trust owning a term insurance policy. Grantor's 4 children have the right to withdraw an equal amount of the contribution to the trust and 30 days after receiving notice of the gift/contribution to the trust, the withdrawal right lapses. Each child has the right to withdraw $12,500 ($50,000/4). The trust contains hanging withdrawal rights and the result is that each child's withdrawal right lapses as to $5,000 and "hangs" as to $7,500. The hanging withdrawal right will lapse in the following year, as to the greater of $5,000 and 5% of the value of the trust property, and further assuming no gift in the next year, which will only "compound" the amount of the "hang".

b. What this means is the trustee must track the amount of the hanging withdrawal right and note that the beneficiary has a continuing right to withdraw the amount of the "hang".

c. And, if the trust is not a grantor trust as to the grantor, the amount of the hanging right results in that portion of the trust (and any income earned on such portion) being taxable to the beneficiary with the hanging withdrawal right.

iii. From the trustee's perspective:

If at this point you are still considering accepting appointment as trustee of an ILIT, you might want to re-read the above and seriously consider the following:

1. The trustee must determine who has the right to receive notice of the withdrawal right based on how the withdrawal right in the trust is drafted.

a. Strict reading of the trust agreement is critical to ensure that the amount of the withdrawal right is properly determined.

i. Some older trust agreements were drafted with a set (or stagnant) withdrawal right amount (set at the then annual gift tax exclusion amount) and not tied to the

statutory section (IRC Section 2503), therefore the trustee should not assume that the withdrawal right is the current amount of the annual gift tax exclusion.

ii. Some trust agreements include a provision that automatically doubles the withdrawal right amount if the grantor is married, so knowing that information and applying it to the formula is important.

iii. Many withdrawal rights are drafted to apply to all of the grantor's children and descendants, so having a current and accurate family tree is necessary to determine who has a withdrawal right and the amount of the withdrawal right.

b. This includes contemplating additional gifts made by the grantor (and grantor's spouse) to the persons with withdrawal rights and if such additional gifts impact the withdrawal rights.

i. The withdrawal right is usually drafted in such a way as to apply only if it will result in an effective annual exclusion gift. Therefore, the trustee must determine if the grantor has already made gifts that would be considered annual exclusion gifts to those with a withdrawal right. If so, then the withdrawal right may not apply.

ii. Again, if the grantor is married and the trust agreement includes language doubling the withdrawal right if the grantor is married, the trustee should also determine if the grantor's spouse has made separate annual exclusion gifts that would impact the amount of the withdrawal right.

iii. In conclusion - a trustee should not necessarily automatically give a beneficiary a notice of withdrawal right with every contribution to the trust.

c. Calculating the withdrawal right, which is generally based on a formula.

   i. The formulas that drafting attorneys use are different and some contain a limit based on a dollar amount or percentage of the value of the trust property (usually 5% to avoid the lapse rule noted above).

   ii. Some withdrawal rights formulas are complex and include references to the annual exclusion amount (which is adjusted for inflation and therefore changes, although typically not annually (the last 4 years being an exception)), and are doubled if the grantor is married. Accordingly, the trustee will have to gather information and apply the formula to calculate the exact amount of the withdrawal right. It is generally not as simple as printing out the same notice letter as the year before.

   iii. If the withdrawal right is based on a percentage of the value of the trust property, and the trust includes assets other than the life insurance policy that may not be readily available, then the trustee may have an obligation to obtain an annual valuation of those assets to determine the amount of the withdrawal right.

   iv. Additionally, most insurance policies (other than term, although some may argue that term insurance has a value) have a value and the determination of that value could be difficult to ascertain. At a minimum a Form 712 could be obtained from the insurance carrier to provide a valuation for the policy to be used in calculating the amount of the withdrawal right.

      1. Trustee's may want to consider whether (based on external factors) the policy's value (meaning, what a willing buyer under no compulsion to purchase the policy may offer)

may be in excess of the cash surrender or reportable value on a Form 712.

2. For example, an insured with chronic health issues, newly diagnosed disease or condition affecting life expectancy, may make the policy marketable on the life settlement market.

3. Generally, a policy with a relatively low cash surrender value relative to death benefit will be more marketable on the life settlement market.

4. These issues are discussed further below and in the main outline for this session. The general takeaway from the trustee's perspective is that sole reliance on cash surrender value of the policy may not be reliable and therefore could result in a miscalculation of the withdrawal right amount.

2. Calculating and tracking the hanging withdrawal right.

   a. As discussed above, assuming that the trust agreement includes a hanging withdrawal right over the lapsed amount of the right of withdrawal, the trustee will have to calculate that amount and track it – for continuing withdrawal right purposes and to determine the amount that lapses in subsequent years.

   b. This is not as simple as it may sound, as the lapse is based on the 5 x 5 rule. See above discussion regarding valuation of trust property issues.

   c. And, in many cases the grantor is making annual gifts to the trust, so that the amount of the hang often compounds, and does not lapse. Using the above <u>example</u>, and assuming that the grantor makes annual contributions to the trust of

$50,000 over the course of 5 years (such amount being used fully to pay premiums on the term insurance policy and trust holding no other assets), there will be no lapse of the hanging power during the 5 year term and at the end of such term the amount of each beneficiary's hanging withdrawal right is $37,500 (5 x $7,500).

d. It is the trustee's responsibility to track the hanging withdrawal rights of the beneficiaries, to determine (1) how much each has the right to validly withdraw, (2) the amount that lapses in years when the beneficiary's withdrawal right for contributions made during the year do not exceed the 5 x 5 amount, (3) what portion, if any, of the trust is taxable to the beneficiary, and (4) what portion of the trust is includable in the beneficiary's estate if the beneficiary dies while holding a hanging withdrawal right.

3. Trust taxation.

a. Assuming that the trust is a grantor trust, as to the grantor, for income tax purposes, the tax reporting of the trust is fairly straight forward – even if the trust contains provisions for withdrawal right.

b. However, a trust that is a complex and non-grantor trust (at least as to the grantor of the trust) may be classified as a grantor trust as to beneficiaries (a beneficiary grantor trust) with hanging withdrawal rights. As noted above, the hanging withdrawal right is a general power of appointment and that is a grantor trust power under IRC Section 678. To the extent that the trust property does generate taxable income, that income would be reportable to the beneficiaries with hanging withdrawal rights over the principal generating that taxable income.

<u>Example</u>. Let's take the above example but instead of the trust holding only a term insurance policy, assume that it also owns an investment account generating interest and dividend income. Recall that there are 4 beneficiaries each having a hanging withdrawal right (in year 5) of $37,500 (for an

aggregate of $150,000). If the value of the trust on December 31st is $1.5 million, then 10% of the trust principal is subject to the hanging withdrawal right and 10% of the income earned on that investment account is taxable, in equal shares, to the 4 trust beneficiaries holding the withdrawal rights. The balance of the income is taxable to the trust.

c. A trustee is not necessarily expected to understand these complex income tax issues, but should hire competent tax advisors who can identify these issues and prepare accurate tax returns for the trust. As the hiring of an advisor is a delegation of responsibility that is generally permitted under the Uniform Trust Code (See Section 807). However, in delegating a trustee's duties, the trustee shall exercise reasonable case, skill and caution in (i) selecting the agent, and (ii) revieing the agents actions to monitor the agent's performance.

d. Generally, a trustee that complies with the requirements of a statute comparable to UTC Section 807 is relieved of liability for a function delegated to an agent. **However,** it is not uncommon for an agent to require the trustee to indemnify the agent for any liability related to the agent – in other words, agents often shift the liability back to the trustee through contract. As a result, through both the responsibility of the trustee in selection and monitoring of an agent, as well as through contract, it is not uncommon for the ultimate responsibility to continue to lie with the trustee - the buck still stops with the trustee.

II. Application of Fiduciary Duties to Trusts Owning Life Insurance

a. <u>Prudent Investor Rule</u>

i. Unless a trust is structured as a directed trust for investments, including specifically life insurance, the Trustee has full investment authority and responsibility.

ii. The vast majority of jurisdictions have statutorily enacted legislation adopting the Uniform Prudent Investor Act (UPIA), and those that have not have case law supporting the provisions of the UPIA, in particular related to the duty of diversification.

iii. The duty of diversification is not without exceptions, notably including where special circumstances exist or the trust agreement waives the duty of diversification.

1. Even if a trust agreement does not waive the duty of diversification, a trustee may retain a concentration that has a special relationship or value to the purpose of the trust. See UPIA Section 3.

2. Arguably, a trust established with the express intention to hold life insurance is a special circumstance. However, often an irrevocable trust does not include special language addressing the acquisition or ownership of a specific asset (including a life insurance policy).

iv. Outside of the duty of diversification, a trustee has general investment responsibilities that are applicable to all trust assets, including life insurance policies. Included in these responsibilities are, the duties to: (1) evaluate the strength of the insurance company issuing the policy; (2) select a policy type appropriate under the circumstances and given the terms of the trust and interests and rights of the beneficiaries; (3) monitor the policy, its performance and strength of the policy issuer; (4) evaluate policy options and the exercise or non-exercise of such options; (5) determine if diversification as to the type and issuers of the policies is appropriate; and (6) inquire into the health and financial condition of the insured as it impacts the value and status of the policy.

1. As noted in the main outline of this session, life insurance policies are complex and often have underlying investments as part of the asset structure. Further, the underlying investments of the policy can impact the premium requirements – meaning that underperformance can have the effect of raising the premium required to keep the policy in force.

2. Additionally, the underlying investment performance drives the policy's cash value for surrender and loan purposes.

3. Outside of a term insurance policy, a trustee has responsibility to review the policy performance, including evaluation of the insurance carrier (this aspect arguably also applies to review of term insurance policies).

4. While carriers offer products with no lapse guaranties, many policies do not contain such guaranties and are dependent on policy performance and premium payments that could increase significantly to maintain the policy's in force status.

5. Further, carriers are not without risk and that risk could jeopardize the status of the policy and/or the policy's value on the secondary market.

6. Policies that are leveraged, through either loans against the policy or premium financing pose additional risks and considerations.

    a. The loan on leveraged policies affect the policy's internal performance (where leverage is through the policy's return) and the trust's net return (where a third party lender is funding premiums).

    b. A trustee should evaluate the cost of funding (interest rate on the loan) vis-à-vis the policy's performance and death benefit.

    c. Additionally, where third party lending is utilized, most loans are structured to mature before the policy does, so refinancing and repayment become a consideration and if not available could result in forfeiture of the policy to satisfy the lender.

v. Exculpation Statutes.

1. Some states (a minority) have adopted statutes to exculpate a trustee's liability related to trust owned life insurance policies. The states that have adopted statutes are: Alabama, Arizona, Delaware, Florida, North Carolina, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia and Wyoming.

2. Generally, these statutes relieve a trustee from liability for compliance with prudent ***investment*** duties and responsibilities related to the acquisition and maintenance of life insurance as an asset of a trust. In other words, the trustee is not fully relieved from liability for all matters related to trust owned life insurance, including numerous of the duties outlined above.

3. Whether the statute applies to the trust owned insurance depends on how the policy was acquired, when the policy was acquired, who is the insured, and whether notice is provided to the trust beneficiaries.

4. See Trent S, Kiziah's survey on "Trustee Exculpation With Respect To Life Insurance" available on the ACTEC Website, and article entitled "Statutory Exculpation of Trustees Holding Life Insurance Policies" in the ABA Real Property, Trust and Estate Law Journal, V. 47 No.2 at page 327.

vi. From the trustee's perspective:

1. Most trustees, including corporate trustees, are not experts in life insurance products, and generally do not possess the skills necessary to adequately evaluate a policy owned by a trust to meet the trustee's fiduciary duties and obligations.

    a. A trustee is expected to exercise prudent administration and has authority to hire third parties and delegate to such parties those aspects of fiduciary administration necessary to meet the standards.

    b. There are third party service providers who provide independent evaluations of a policy's performance, including the internal rate of return on the policy, carrier ratings and risk of lapse. Many corporate trustees use these services, but independent and individual trustees may also consider engaging for this service. The largest provider in this arena is: Insurance Trust Monitor (ITM – www.trustitm.com).

    c. Trustees who are not familiar with or hold the expertise necessary to prudently manage policies owned by a trust

should consider utilizing a third party and delegating the management of the policy review.

d. Engaging a third party to evaluate a policy's performance, render a report and advise the trustee likely is a prudent course of action and can provide some protections to a trustee. However, as noted above in Section I.c.iii.3.c. and d., ultimately a trustee is responsible for prudent administration of the trust, including oversight of agents hired to provide services to the trust – meaning that the buck stops with the trustee.

2. Alternatively, if the applicable law allows, investment authority may be vested in a third party, which may limit the trustee's responsibility and liability over the policy.

   a. Under the Directed Trust Acts of many states that have enacted such legislation a trustee is relieved of liability (except for willful misconduct) for following the direction of a power holder/advisor.

   b. In a directed trust arrangement, a trust advisor or power holder would be appointed to direct the trustee on all matters concerning the trust's ownership of the life insurance policies.

      i. The power holder/advisor is a fiduciary (under the statute) and has the obligations set out pursuant to the statute and trust agreement.

      ii. The trust agreement should specifically articulate what authority the power holder/advisor has over the life insurance policies (including, to surrender or exchange the policy, take loans against the policy, sell or distribute the policy, exercise options, etc.).

      iii. Under most statutes adopting the Uniform Directed Trust Act, the trustee is relieved from liability for following the direction of the power holder/advisor

unless doing so constitutes (generally) willful misconduct.

1. The following states statutes provide the trustee has no liability for following the direction of the power holder/advisor: Alaska, Idaho, Kentucky, Nevada, New Hampshire, Ohio, South Dakota, Tennessee, and Wyoming.

2. The following state statutes provide the trustee does have liability for deciding to follow the direction of the power holder/advisor: Alabama, District of Columbia, Iowa, Kansas, Maryland, Massachusetts, Mississippi, Montana, Oregon, Pennsylvania, South Carolina, Vermont and West Virginia.

3. Waiver of the prudent investor rule and/or duty of diversification – more a caution for drafting counsel than trustees.

   a. In the context of a trust designed to solely own a life insurance policy, it may seem appropriate for the trust agreement to waive the prudent investor rule and/or duty of diversification.

   b. However, as discussed below, while initially the sole asset of the trust is a life insurance policy, once the policy matures the trust will hold the death benefit proceeds and the trustee will be obligated to invest the proceeds. It may not be prudent for the trust agreement to ***broadly*** waive the prudent investor rule or duty of diversification.

      i. Consider limiting the rule and duty solely to the trust's ownership of a life insurance policy, with potential extension to other assets anticipated that the trust may purchase from the grantor's estate (such as closely held business interests or stock concentrations) or a promissory note if it is

anticipated that the trust will loan funds to the estate for estate tax liquidity.

c. A trustee should carefully review the trust agreement to determine the extent to which either the prudent investor rule and/or duty of diversification are waived, and further any applicable state laws or case law guidance that may impede the effectiveness of these waivers.

4. Review state statutes that may provide exculpation to trustee.

   a. If the trust agreement is governed by the laws of a jurisdiction that has a statute providing exculpation to the trustee for trust owned life insurance, review the statutory provisions to determine how broad the exculpation is and any limitations.

   b. If the statute requires notice to the beneficiaries of the application of the statute, ensure notice is provided and retain appropriate records of providing notice.

b. Reporting to Beneficiaries

   i. A Trustee has an obligation to communicate with and provide reports (often referred to as an account or accounting) to the trust beneficiaries.

      1. Providing a report/accounting to trust beneficiaries, which adequately discloses information to the trust beneficiaries to allow the beneficiaries to protect their interest in the trust, also benefits the trustee by starting the statute of limitations on the filing of a claim against the trustee for breach of fiduciary duty.

         a. The applicable statute of limitations for bringing a claim for breach of fiduciary duty varies by state, and generally ranges from 1 – 6 years.

         b. In order to start the running of the statute of limitations, a beneficiary must receive a statement or account that adequately discloses the information necessary for the beneficiary to be able to identify the existence of the claim.

c. Some states provide for a truncated statute of limitations if the report or account is sent to the beneficiaries with notice of the truncated statute.

d. See attached survey of statutes of limitations provided by Banker Donelson, and noting the following states (**<u>a majority</u>**) with a truncated statute of limitations: Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, D.C., Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, Wyoming.

2. When a trust's primary, if not, sole, asset is a life insurance policy, a trustee may not be inclined to provide an annual statement or report to the trust beneficiaries – as there may be little activity to report, as the trustee may only be accounting for the receipt of contributions/gifts from the trust grantor and payment of premiums.

3. However, with regard to trust owning an insurance policy that is the primary asset of the trust, a trustee may only maintain statements regarding the cash activity of the trust.

    a. Reporting solely the cash activity of the trust to the beneficiaries leaves the trustee open to liability on the performance of the policy as an asset of the trust.

    b. Trustee's may consider providing an annual in-force illustration for the policy to the beneficiaries, in order to provide adequate disclosure to the beneficiaries regarding the primary trust asset – and therefore start the statute of limitations regarding this asset.

4. Additionally, providing solely a statement of the cash activity of the trust does not disclose the largest asset of the trust and ***its value***. As noted above, a policy's value may not be nominal, or set solely by

the cash surrender value. Providing a statement, report or "account" that uses an inaccurate value for the policy does not provide accurate notice to the trust beneficiaries and therefore could leave the trustee open to potential liability to the beneficiaries.

c. <u>Transactions between the Trust and the Grantor/Insured's Estate</u>

i. As discussed in the main outline for this session, an irrevocable trust is used to own a life insurance policy to exclude the death benefit of the policy from the insured's estate. To the extent that utilizing an irrevocable trust is necessary, because the insured anticipates having a taxable estate, then the death benefit proceeds of the life insurance policy will be needed by the grantor/insured's estate to pay the resulting estate taxes.

ii. This begs the question, how does the estate get access to the death benefit proceeds paid to an irrevocable trust, that is outside of the grantor/insured's taxable estate? The answer is that the trustee of the trust can either:

1. Purchase assets from the grantor's estate, effectively swapping illiquid assets or assets that the heirs do not want to sell, providing cash liquidity to the estate; or

2. Loan the cash to the grantor's estate for a promissory note, giving the estate time to liquidate assets to pay the ILIT back (given that the estate tax is due within 9 months of the grantor's death).

iii. From the trustee's perspective:

1. While these options seem reasonable and provide an eloquent solution, is the trustee obligated to either loan funds to the estate or purchase assets from the estate?

2. Generally, trust agreements do not explicitly address this issue or provide a directive to the trustee to either make the loan or purchase assets from the estate. In which case, the trustee must evaluate whether either transaction is prudent and in the best interests of the beneficiaries of the trust.

3. In evaluating the proposition of loaning funds to or purchasing assets from the insured, the trustee should evaluate:

a. The alignment of the interests of the beneficiaries of the trust to the beneficiaries of the estate (are they the same, or are they different);

b. The terms of the loan and whether the proposed terms are at a market rate that would provide an adequate return to the trust, secured by assets of the estate, etc.;

c. Whether the transaction would result in the trust holding a concentrated position and if the trust agreement waives the prudent investor rule and/or duty of diversification;

d. The needs of the beneficiaries of the trust and if there is an anticipation and need to make current distributions if the transaction would impede the trustee's ability to make distributions to support and provide for the trust beneficiaries.

4. Even if the trust agreement permits transactions between the trust and the grantor's estate, a revocable trust established by the grantor, etc., that does not mean that the trustee should transact without evaluating the above (non inclusive list) considerations. The trustee has an independent fiduciary duty and obligation to the beneficiaries of the trust owning the life insurance policy – not to the grantor's estate.

d. Trustee's Obligations to the Interests of the Beneficiaries (and not the grantor/insured)

i. The trust (and by extension the trustee) are often reliant on the grantor/insured to make annual contributions to the trust to fund ongoing insurance premiums. In these situations, the trustee may be at the mercy of the grantor to continue to fund the premiums, and there is no guarantee that the grantor will continue to make the contributions. For example, an insured may:

1. Face financial difficulties resulting in an inability to fund the contributions;

2. Become estranged from beneficiaries of the trust and no longer wish to fund an asset providing a benefit to the estranged individuals;

3. Believe that the policy is no longer necessary, that there are better uses for the funds contributed to the trust than investing in the policy; or

4. Want to change the terms of the trust and therefore no longer desire to fund an asset that will be disposed of in accordance with the trust's dispositive provisions.

ii. If the policy does not have a cash or surrender value, as either a term policy or one that has not yet accumulated a cash or surrender value, the trustee is not relieved of liability for managing the trust's assets in the interests of the beneficiaries and in order to protect itself from liability should evaluate:

1. Options for alternative funding for the policy premiums – premium finance, loans from trust beneficiaries (or others);

2. Potential sale of the policy (a life settlement);

3. Conversion to reduce death benefit for lower premiums that the grantor/insured may be willing to fund.

iii. Certain transactions involving a life insurance policy necessarily will require the participation of the insured.

1. Where life settlement is an appropriate consideration for the policy, engaging in a life settlement transaction will require that the insured provide detailed health insurance information, as well as be obligated to provide continuing information to the policy purchaser. Many insureds view this as an invasion or privacy and are not comfortable with participating in the process.

a. The insured has no obligations, fiduciary or otherwise, to the trust so the trustee cannot compel the insured's participation in the life settlement process.

b. A trustee should document the efforts to have the insured participate in a life settlement, in order to protect the trustee

that he/she made every effort to preserve the value of the trust's assets.

2. Where there is an opportunity to exchange the policy for a new policy product that could provide a better benefit, reduce premiums, etc., again, the insured's participation in the underwriting process is required.

    a. An insured may not want to participate in the underwriting process, which typically requires a physical exam, completion of questionnaires, etc.

    b. As noted above, if the insured refuses to participate in the process, the trustee should document the efforts to protect the trustee.

3. An alternative situation may be where the death benefit of the policy is no longer necessary for its initial purpose (liquidity for estate taxes) and the insured desires to have the trustee exchange the current policy for one that could provide additional benefits (such as long term care).

    a. In this situation, and where the policy requires ongoing premium payments to remain in force, the insured may withhold premium payments if the trustee does not convert the policy.

    b. Because the trust cannot benefit the grantor/insured (without estate tax inclusion of the insurance death benefit), conversion of the policy to one that provides a long term care benefit to the insured would be a moot transaction. However, the grantor may instead want to reacquire the policy from the trust in order to pursue the policy conversion or exchange.

    c. Some life insurance policies with long term care benefits can provide that benefit to the insured's spouse, so if the grantor/insured's spouse is a beneficiary of the trust, this conversion may be a viable option. However, the trustee

should consider the impact of that conversion to the interest of all of the beneficiaries of the trust.

iv. From the trustee's perspective:

1. As noted throughout this outline, the trustee has a duty and obligation to act in the best interest of the trust beneficiaries.

2. In circumstances where the grantor/insured is no longer willing (or able) to fund premium requirements for the trust owned insurance policy, the trustee should evaluate all other options to preserve the value of the trust's asset – including, loans/financing, surrender and life settlement. Documentation of these efforts will provide the trustee with a defense that all options were evaluated in the exercise of the trustee's fiduciary duties and obligations.

3. A trustee should not fall to the pressures of the insured/grantor with regard to the life insurance policy. The trustee does not owe any fiduciary duties to the grantor.

    a. A grantor may believe that it is a better financial decision for the trustee to surrender a policy and invest the proceeds for a higher return than the policy can produce.

    b. However, a trustee must independently evaluate this proposition, taking into consideration the income tax consequences to the trust from the surrender, the tax drag on the trust's investments/return and that the assets of the trust do not receive a step up in tax basis (as IRC Section 1014 does not apply to the trust's assets).

    c. Further, a grantor may desire to reacquire the policy, in order to convert it into a product that provides a LTC benefit to the insured. Again, the trustee must evaluation this transaction in light of the interests of the trust beneficiaries, and not the grantor.

III. Other Considerations and Conclusion

a. <u>Issues when a trust acquires a policy from an insured (other than the issues addressed above)</u>

   i. Confirm that the insurance company has updated the ownership of the policy to the trust and has correct contact information for the trustee;

   ii. Confirm that the insurance company also has updated the beneficiary designation of the policy to the trust;

   iii. Obtain a current in-force illustration of the policy for the trust's records;

   iv. Obtain the insurance contract from the insured to maintain with the trust's records

b. <u>Administration after the policy matures</u>

   i. As discussed above, once a policy matures it is anticipated that the trust (through the trustee) will engage in transactions with the grantor/insured's revocable trust and/or estate to provide liquidity to the estate for estate taxes.

   ii. Even if the trust does not purchase assets from the grantor/insured's estate, the trustee will have the responsibility to invest the proceeds received from the death benefit and for a trust that held solely a life insurance policy prior to the grantor's death, the trust is no longer a single purpose trust. The result is a much larger obligation on the trustee to invest and manage the trust's assets.

      1. The exculpation statutes, if applicable, are no longer applicable to the investment of the death benefit proceeds.

      2. The trustee should evaluate the trust agreement's provisions addressing investments, retention of certain types of assets, waiver of a diversification requirement, etc.

      3. Drafting attorneys should also consider incorporating investment provisions also found in the grantor/insured's revocable trust agreement – understanding that the assets of the grantor/insured's trust may ultimately become assets of the irrevocable trust.

iii. Prior to the grantor/insured's death, the trust may not have had any assets from which distributions could have been made to the trust beneficiaries. However, once the policy matures, the trustee must consider the needs of the beneficiaries for distributions and evaluate distribution standards set forth in the trust agreement.

1. The trustee must determine if at the grantor's death separate trust or share are to be established for the grantor's spouse, children, etc.

2. The trustee has an obligation to communicate with the trust beneficiaries and determine their financial needs in light of the trust terms, including the distribution standard and whether the trust agreement requires the trustee to consider the other assets or resources of the trust beneficiaries.

3. Review the trust agreement's trust administration and distribution provision to determine if a beneficiary has an annual withdrawal right or other power of appointment that could be exercised and whether notice is required to be provided for such rights.

iv. The trustee should also determine all potential current and remainder beneficiaries and ensure that annual statements and reports are sent in order to provide notice and start the applicable statute of limitations to run.

v. In other words, administration of the trust has gotten even more complex.

c. Generation Skipping Transfer Tax (GST)

i. While generally GST is an issue that the grantor addresses through the filing of gift tax returns and the allocation (or potential automatic allocation) of the exemption to the trust, the trustee should also be sure to communicate with the grantor on this issue in order to:

1. Obtain documentation (typically filed gift tax returns) to confirm the GST exempt status of the trust.

2. Be cognizant of the GST rules and whether a distribution to a beneficiary is subject to the tax (because the beneficiary is a skip person as to the grantor)

3. Be prepared to file and pay the applicable tax for any GST event.

ii. The trustee is responsible for the payment of GST tax due on a distribution from a trust, and also obligated to file the applicable tax return (either Form 706- GS(T) (for trust terminations), or 706- GS(D-1) (for trust distributions)).

1. A trustee is obligated to file Form 706- GS(T) for any termination event resulting in a distribution to a skip person, even if no tax is due because the trust is exempt.

2. A trustee is obligated to file form 706-GS (D-1) for any distribution from a trust to a skip, even if the inclusion ratio is zero.

3. Simply relying on a trust being exempt does not relieve the trustee from these reporting obligations.

d. Conclusion

Trust administration is a complex process. While the number of issues that any trustee will encounter in the administration are uncertain, what is certain is that there will be many. While I was in private practice, I would have clients ask if I would be willing to serve as trustee for an irrevocable trust they were establishing, or as trustee of their revocable trust (at their death or incapacity). My answer was always the same – no, because you could not pay me enough to be a trustee. I knew how challenging and risky being a trustee is, and that was before having to actually do it and deal with all of the issues (as I did when I was CFO for a regional bank).

I would encourage every advisor to have these discussions with their clients when selecting a trustee, and with their clients who are considering serving as a trustee. This outline focuses primarily on the issues attendant to trusts owning life insurance policies, and many of these issues apply to other trust arrangements. But, this outline does not specifically address the other duties and responsibilities of trustees, in general, that also apply to the administration of a trust owning a life insurance policy. I would also suggest that education of consumers of trustee services may be critical to the future of professional fiduciary services – which I believe is a necessary service to the public. Consumers are not willing to pay for the services of a professional trustee for what they perceive to be "tasks," but what they are paying for are services being executed by an institution or an individual under the fiduciary standard and carrying with it a tremendous amount of risk and potential

liability. Ultimately, the consumer should evaluate the situation in terms of what they would pay to protect the significant asset placed in trust and to ensure that the interests of their family members are taken care of in a fair, independent and unbiased manner. Couched this way – the trustee rates should be viewed more fairly and palatable to the consumer.