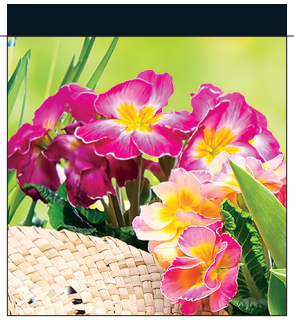

Troubling Trend for Trust-Owned Life Insurance Trustees

A life insurance trust may seem easy to administer, but prolonged low interest rates can upend policy assumptions, requiring trustees to be proactive.

AMIEL Z. WEINSTOCK

A growing concern for many estate planning professionals is that over the next ten to 15 years there will be an onslaught of litigation by trust beneficiaries against the trustees of irrevocable life insurance trusts[1] (ILITs) because the asset that the trustees were charged with safeguarding has imploded or become worthless.

The primary concern is for the trust beneficiaries themselves because of their financial loss, but there is also concern for the trustees. Many of these trustees will be the aunts and uncles of the beneficiaries, or the close family friend of the settlor, or perhaps the solo-practitioner attorney or accountant who agreed to serve as trustee because the grantor had nobody else to ask. Of course, "professional" trustees will not be immune from this either, whether the trustee is an individual corporate trustee, a bank, a trust company, or an attorney in a larger or more sophisticated law firm whose practice routinely includes serving as trustee (as is common in a city like Boston).

This article explores some of the basic parameters of the trustee's job description and highlights actions and considerations for those trustees as they do their best to serve the settlor and beneficiaries of their trust.

Why now?

Over the past several years, the global economy has experienced historically low interest rates and dividend returns. Many older policies have been adversely affected by these reduced interest rates. Whole life policies are dependent on the performance of dividends, which are determined by a company's mortality, expense, and interest experience. While expenses are controllable and mortality has improved over the past decade, interest rates have forced companies to reduce dividends consistently year after year. For many of these older policies, the impact of the lowered dividends may have been (1) an increase in the duration of required premiums, (2) the triggering of an automatic premium loan, or (3) for policies with non-guaranteed term blends, an increase in premium amounts or a decrease in death benefit amounts.

Universal life policies have had similar results, as the interest crediting rates have decreased to the point that they are now at the minimum guaranteed levels. For non-guaranteed universal life products, these rate decreases will decrease the duration of coverage that the specified premium will carry, or else increased premiums will be required to keep the policies on track in the future.

In addition, insurance companies have started to announce cost-

AMIEL Z. WEINSTOCK is an attorney in the Boston, Massachusetts, office of Morgan, Lewis & Bockius LLP. He prepares estate plans for high-net-worth families and is frequently asked to serve as a trustee for his clients.

of-insurance increases, which could have a negative impact on policy performance. These increases are due to underperforming blocks of business that threaten the long-term financial stability of the insurance company.

As a regulated industry, each insurance company is required to show good solvency; therefore, insurance companies tend to invest in safer asset classes, such as Treasuries and municipal bonds. Thus, in the current interest rate environment, they are investing a large portion of their premium revenue in vehicles that are yielding very low returns. The good news is that they tend to invest in long-term vehicles and are still benefiting from the blend of their older investments. The downside is that as the higher-yielding bonds mature, they are being reinvested in much lower-yielding options. Anyone who understands the law of averages will recognize that this issue is going to continue until a sustained period of high interest rates; i.e., just as it has taken many years to bring the crediting rates down, raising them will take many years too.

The result of this poorly performing blended portfolio is lowered dividends and interest crediting rates. These low rates have also affected new policy issues for many carriers. Actuaries are now concerned with their ability to earn reasonable returns, and these more conservative investment assumptions are now priced into newer products.

Trustees must take note of this process and learn to understand how their investment will be affected long-term by the interest rate trends, including the current increases to cost of insurance rates and financial ratings of the insurer. It is not as simple as saying, "Well, interest rates are at rock bottom so now they can only go up; therefore, as long as I have weathered the storm until now I should be fine." The policy a trustee is holding (or the policy that any individual is holding) will be affected for many years to come even if interest rates start going up. The key is knowing the assumption on which the policy has been built and asking the hard question of whether those assumptions are viable in both the short term and the long term.

What is a trustee to do in these turbulent times?

The policy a trustee is holding will be affected for many years to come even if interest rates start going up.

Read the trust

Unfortunately, many trustees do not actually read the trust, especially when the trustee is a family member or friend. They might have a basic sense of what the trust is for (i.e., for estate planning purposes or to hold a life insurance policy), but they likely do not have a real understanding of the particular terms of the trust, what their obligations are, or what the grantor's stated (or unstated) objectives are.

The professional trustee's obligations extend even farther than the "family trustee." In many jurisdictions, a professional trustee is held to a higher standard of care than a family member or non-professional trustee. The professional trustee will be expected to understand the purpose of the trust and to know what the fiduciary obligations are and to whom those obligations are owed. In some cases, such as when the drafting lawyer is also serving as the trustee, he or she might have "conflicting" obligations: On the one hand the individual has an obligation to the client who is the grantor, and on the other hand he or she has an obligation to the beneficiaries of the trust.

Furthermore, a professional trustee's clients might have an expectation that the trust has been reviewed to check for issues with the drafting. For example, does the grantor have any incidents of ownership with respect to one or more of the policies under Section 2042(2) which might cause the full death benefit value of the policy to be included in the grantor's estate at the grantor's death (defeating what is likely the primary purpose of the ILIT)?

The bottom line is that no matter what the trustee's background, if someone is serving as a trustee of an ILIT (or any trust), the individual must read the trust and understand what it says. If he or she cannot understand the trust, then the individual must hire a qualified attorney to help out. A trustee must know what his or her responsibilities are and know the potential liabilities. Remember, no good deed goes unpunished.

ILIT facts and factors

An ILIT is an interesting trust vehicle. Like most trusts, it is designed to create a structure whereby a trustee is charged with holding title

1 For purposes of this article, references to "ILITs" include all irrevocable trusts that own one or more life insurance policies, even if the trust was established for other purposes and even if the trust holds others assets in addition to life insurance.

2 This is not to say that a trustee of any trust should ignore the assets inside a trust, but most assets held in trust do not require capital contributions from outside the trust in order to sustain them.

3 The unified credit is the amount that an individual may transfer from his or her estate without the imposition of gift or estate tax and is set forth in Section 2010(c). The unified credit amount is $5 million per person and is indexed for inflation. For calendar-year 2016, the inflation-adjusted unified credit amount is $5.45 million.

4 Section 2503(b).

5 Reg. 25.2503-3(b).

6 397 F.2d 82, 22 AFTR2d 6023 (CA-9, 1968).

to an asset on behalf of the beneficiaries of the trust. But unlike many other trusts, the asset inside the ILIT will not survive on its own if left unattended.[2] In most instances, the insurance policy inside the ILIT will require an annual premium payment to carry on from year to year. Most ILITs, however, are funded only with the insurance policy; they are not funded with cash and therefore cannot make those premium payments without help. That help usually comes in the form of gifts made to the ILIT by the grantors of the trust to cover the obligatory premium payments.

When the annual contribution is made to an ILIT to pay the premiums, the contribution is treated as a taxable gift to the trust beneficiaries. In most cases, the grantors intend to have those gifts qualify for the gift tax annual exclusion so that they do not deplete their unified credit[3] or pay a current gift tax. The gift tax annual exclusion is a statutory rule which states that any person may make a gift to any other person in an amount up to $10,000 per year without incurring a gift tax.[4] The $10,000 annual exclusion amount is indexed for inflation, and the inflation-adjusted amount for calendar-year 2016 is $14,000.

For the gift to the ILIT to qualify for the gift tax annual exclusion it must be a "present interest" gift. This means that the beneficiaries of the trust must have an immediate right to the use, possession, or enjoyment of the contributed property.[5] If they do not have access to the contributed funds, the gift will be of a "future interest" and will not qualify for the gift tax annual exclusion; this means that the gift will deplete the donor's unified credit (to the extent he or she has any credit remaining) or else will trigger the payment of a gift tax.

Crummey Powers—a brief history

To ensure that the gift will qualify as a "present interest," most ILITs contain withdrawal provisions for the trust beneficiaries. These withdrawal provisions, which are now commonly referred to as "*Crummey* Powers," are the result of the development in the case law stemming from a 1968 Ninth Circuit case called *Crummey*.[6] In short, *Crummey* Powers confer to the trust beneficiaries the right to demand immediate distributions of trust property.

In *Crummey*, the taxpayers created an irrevocable trust for the benefit of their four children, some of whom were minors. The trust included a "demand" provision which gave each child the right to make a demand for a disbursement from the trust at any time prior to December 31 of the year of any contribution to the trust. Critical to the analysis was the fact that the trust included the following clause: "if a child is a minor at the time of such gift of that donor for that year, or fails in legal capacity for any reason, the child's guardian may make such demand on behalf of the child."

The IRS argued that no annual exclusions should be allowed with respect to the gifts made to the minor children because they were deemed to be "future interests." Notwithstanding that position, and despite the fact that (1) a minor might have difficulty making demand on the trustees to make the payment, and (2) it was likely that none of the beneficiaries (let alone the minors) had notice of the contributions to the trust and their respective withdrawal rights, the court allowed the gifts to qualify for annual exclusion treatment. The court reasoned that the beneficiaries had the "right to enjoy" the property. The trustees had no legal basis upon which they could have

refused a demand from a minor to make a distribution.

A few years later, Rev. Rul. 73-405[7] was issued, confirming that "if there is no impediment under the trust or local law to the appointment of a guardian and the minor donee has a right to demand distribution, the transfer is a gift of a present interest that qualifies for the annual exclusion allowable under § 2503(b) of the Code." Subsequent to that, Rev. Rul. 81-7[8] narrowed the holding from the *Crummey* decision to provide generally that to qualify as a present interest, the beneficiary must have knowledge of the power to withdraw and also a reasonable opportunity to exercise the power before it lapses.

Send a "*Crummey* Letter" to each of the beneficiaries giving them notice of the gift to the trust and the details of their withdrawal rights.

Relevant implications. What does this all mean for trustees as they administer their ILITs?

As was mentioned above, the trustee must read the trust carefully. The *Crummey* withdrawal rights can be written in many different ways (and some complex tax provisions might be included, like "hanging powers"[9]). Most trusts specify a window of time during which the beneficiaries can exercise the right of withdrawal:

- Some trusts offer 30 days; other trusts might offer 45 or 60 days.
- Some trusts require that the beneficiaries acknowledge receipt of the notice, and some trusts allow the grantor to limit or modify who gets notice of the gifts to the trust.
- Some trusts stipulate that a one-time notice of ongoing anticipated gifts to the trust will suffice while others will require a notice every year that a gift is made to the trust.

Best practices. Once the trustee understands the parameters established by the trust, he or she must determine his or her own set of best practices for administering the trust in accordance with the trust provisions. The trustee should develop a consistent approach and might consider the following guidelines:

1. Establish a separate bank account for the trust.
2. Have the donor make the gift to the trust at least 30 days prior to the due date for the premium payment. (If the withdrawal rights in the trust are longer than 30 days, making the gift even earlier might be helpful to match up the time periods.)
3. Send a "*Crummey* Letter" to each of the beneficiaries giving them notice of the gift to the trust and the details of their withdrawal rights (consider *leaving out* any request for acknowledgment by a beneficiary).
4. Keep good records of the *Crummey* Letters. While an audit on this issue is rare, it would be nice to have copies if the audit does occur.
5. Hold the contributed funds in the trust account until the expiration of the withdrawal period
6. Pay the premiums in a timely fashion from the trust account.

The steps enumerated above are only one option for "best practices." They are by no means the only way to satisfy a trustee's administrative and fiduciary responsibilities. In addition, as any estate planner can attest, donors do not always comply with these best practices themselves. Donors very commonly make gifts to the trusts within a few days of when the premium payments are due, or even make the premium payments directly to the insurance company.[10] As such, the trustee must keep his or her focus on the most important aspect of his or her fiduciary responsibilities, which is making sure that the asset being held is taken care of. This means two things:

1. Pay the premiums when they are due so that the policy does not lapse.
2. Conduct a periodic review of the policies to ensure they are in good shape.

Periodic policy review

An insurance policy is an asset. There is no other way to look at it. Money is invested in a product with an

[7] 1973-2 CB 321.

[8] 1981-1 CB 474.

[9] A discussion of hanging powers is beyond the scope of this article, but the general concept relates to the tax implications associated with the beneficiary allowing his or her power of withdrawal to lapse. When a beneficiary's right of withdrawal exceeds the greater of $5,000 or 5% of the value of the trust, and that right of withdrawal lapses (i.e., it is not exercised by the beneficiary—which is the most common situation), then the amount in excess of that figure is considered a release of a general power of appointment and might trigger adverse tax consequences for the trust and the beneficiary. The use of hanging powers avoids that release by allowing the beneficiary to have a cumulative right to withdraw that excess amount in future years.

[10] One note of caution about payments that are made directly to the insurance company: These "indirect" gifts can qualify as a present interest, even though it is hard to reconcile the fact that there would be no chance for a beneficiary to access those funds from the trust—they were never there to begin with. If a trust permits the policy itself to be withdrawn in satisfaction of the withdrawal rights, such an indirect gift might not be problematic from a tax perspective. See Estate of Turner, TCM 2011-209. But be aware that in Turner, the trust agreement actually provided that the withdrawal rights applied to each direct and indirect transfer to the trust. Query whether the same treatment would be available if the trust did not mention that indirect gifts were subject to the withdrawal rights.

[11] See Section 1035, which permits the exchange of one policy for another without triggering any gain.

expected return. With respect to term policies, the expected return is peace of mind (as most people hope to outlive their term policies and never receive the death benefit). With respect to permanent policies, like universal life or whole life, the expected return is a death benefit (or, in some cases, access to cash value).

A periodic review of the insurance policy held inside an ILIT may be the best way for a fiduciary to satisfy ongoing fiduciary responsibilities associated with managing an ILIT. A sound and comprehensive policy review educates the trustee on the current health and performance of that asset so that the trustee can take the necessary steps to ensure its ongoing viability.

In addition to summarizing the current basic facts of the policy (like cash surrender value, current annual premium, and the overall quality of the insurance company), a good policy review should raise the following questions:

1. What was the purpose for the policy when it was originally purchased, and does that same purpose still apply today?
2. Is the policy performing the way it was designed to perform?
3. What are the tax implications of surrendering the policy?
4. If a tax-free exchange of the policy is contemplated, what are the "give ups"?[11]
5. Does the policy in the ILIT continue to be a prudent investment?
6. Does the trustee have an obligation to diversify?
7. How does the ILIT fit in with the rest of the insured's estate plan?

Purpose of the policy. Everyone's estate planning needs and goals change over time. The concerns people plan for when their children are minors are very different than the concerns they plan for when they have grandchildren. In that same vein, the utility of life insurance also changes over that period. In the most typical scenario, young families look to life insurance as doomsday protection: It is income replacement to ensure that one's family will be taken care of under a worst-case scenario.

A decline in the crediting rate could affect the policy premium or the death benefit.

As the clients get older, their children grow up and move out. The clients have fewer "obligations," like college tuition, their mortgage is closer to being paid off, and they have saved for retirement. That insurance policy that was once so vital for that family's sustenance is no longer as important.

Notwithstanding the decline in importance of the policy in the context of a doomsday scenario, that policy might be a significant asset in a family's portfolio and should not be ignored. Instead, new questions should be asked about the planning goals. What is most important today? Are the premiums still affordable? What will cash flow look like after retirement? Can this policy be used in some other fashion as part of the estate plan?

Policy performance. In light of the current low interest rate environment, the issue of policy performance centers on whether market conditions have changed significantly from the time that the policy was issued, and what assumptions were made when the policy was purchased in terms of expected crediting rate and dividend yield.

Trustees of ILITs need to be aware that older policies likely assumed fairly high crediting rates because at the time the policies were written, the prevailing market interest rates were much higher than they are today. The crediting rate is the interest rate that is offered on an investment-type insurance policy. Depending on the variable the agent was trying to solve for when the policy was constructed, a decline in the crediting rate could affect the policy premium or the death benefit.

For example, a 65-year-old male purchasing a $10 million universal life policy with a presumed crediting rate of 5% might expect to pay an annual premium of $185,000 to ensure that the death benefit would be available until age 100. If, however, the crediting rate were to drop to 4%, the policy would lapse about 14 years earlier than expected (assuming no increases to the premium payments).

The challenge for trustees of ILITs is that the insurance companies are not going to be proactive and tell the trustees that the crediting rate has dropped. If a trustee sits passively and simply holds the policy in the ILIT, he or she will not find out that a problem has developed until it is too late. A cursory review of the annual statement will not tell the trustee what he or she needs to know. While some older policies may have a footnote in fine print with a hint about the reduced rate, the statement will not have an "announcement" warning the trustee of any impact of that rate change. If a trustee does not inquire about the health of the policy on a routine basis, the trustee will not find out until a notice arrives indicating that the policy is about to lapse.

In addition to the crediting rate and dividend yield, other factors might help a trustee determine if the policy being held is the best policy available. For example, many older policies used mortality tables from 1980. The life expectancy assumptions in those older tables were a lot shorter than the assumptions in more recent tables. Longer life expectancies mean lower premium costs. If the policy a trustee is holding was based on those older mortality tables, it is possible that a newer policy will be more cost-effective.

Another factor worth reviewing is the underwriting class for the insured. The insurance industry has become more sophisticated over the years, and they are more knowledgeable about the impacts of certain conditions on life expectancies. They now have many more underwriting classes to choose from when pricing a policy. In addition, many maladies (like high blood pressure) are more easily treatable these days and no longer portend shorter life expectancy. Therefore, a person who was rated as a "standard" 20 years ago could quite possibly be rated "preferred" today.

Also, several companies now distinguish between cigarette smokers and cigar smokers. In the past, a cigar smoker was lumped in with all "smokers" and took a serious hit on the underwriting status. Now, a few carriers treat cigar smokers more liberally.

The UPIA requires diversification, but leaves it to the trustee to determine if special circumstances exist indicating that diversification is not required.

Surrendering the policy. Sometimes surrendering the policy for its cash value will be the best available option for managing the ILIT. Perhaps because of some of the financial factors explained above, the policy requires a significant infusion of cash in order to sustain the death benefit long term. In such a situation, if the insured does not have the available cash or is unwilling to invest more money in the policy, or even worse, if the insured needs the existing cash value to cover ongoing expenses, the best option will be to surrender the policy and take the cash.[12]

If the policy is surrendered, taxable gain will result if the cash surrender value is greater than the insured's tax basis in the policy. Tax basis is typically calculated as premiums paid less tax-free distributions. The worst part of this, however, is that any gain is taxed as ordinary income even though the policy is a capital asset.[13]

Tax-free exchange of the policy. A tax-free exchange of an existing policy for a new policy under Section 1035 can be a great way to modify the existing coverage to more appropriately conform to the current needs of the insured and the ILIT.

Section 1035 provides that a life insurance policy can be exchanged, tax-free, for another life insurance policy or an annuity. An annuity, on the other hand, can be exchanged tax-free for only another annuity; an annuity cannot be exchanged tax-free for a life insurance policy. When doing the exchange, the insured must be the same under both the original policy and the new policy. Exchanges can be between different insurance companies and for different types of insurance products (e.g., a whole life policy issued by MetLife can be exchanged for a universal life policy issued by John Hancock).

With respect to joint-and-survivor policies, if one spouse has died, the policy can be exchanged for a new policy on the life of the surviving spouse. Two single-life policies on spouses, however, cannot be exchanged for a joint-and-survivor policy on those spouses.

From an administrative perspective, the company issuing the new policy takes care of the exchange. The application completed by the insured and the trustee will indicate that a tax-free Section 1035 exchange is desired, and no further steps will be required by the

12 For policies held in ILITs, the insured is not a beneficiary of the trust. Getting those funds to the insured may require making distributions to the spouse (if she is a beneficiary) or else to children or grandchildren who might then have to make gifts back to the insured.

13 See Rev. Rul. 2009-13, 2009-21 IRB 1029.

14 UPIA section 2(a).

15 UPIA section 4.

16 Comments to UPIA Section 4.

17 UPIA section 3.

18 Use of an IPS shows that the trustee has developed an investment strategy, has been thoughtful about the risks and rewards of the investments, and that the trust is being administered with care, skill, and caution. The IPS also memorializes the prudence of the trustee in making financial decisions.

trustee to effectuate the tax-free exchange.

Is the policy a prudent investment? The Uniform Prudent Investor Act (UPIA), which as of this writing has been adopted in one form or another by 44 states and the District of Columbia, provides generally that a trustee must invest and manage trust assets "as a prudent investor would," and must consider the purposes, terms, and circumstances of the trust.[14] In addition, upon acceptance of the trust, a fiduciary must take stock of the trust assets and decide what assets to hold or dispose of.[15] This obligation applies to both new trustees as well as to successor trustees, and requires action even if the assets were prudent at the time they were acquired.[16]

A detailed discussion about the UPIA is beyond the scope of this article. Two components of the UPIA, however, require a bit of attention as they are important concerns for ILITs: (1) the duty to diversify, and (2) the consideration of the investments in light of the overall estate plan. Furthermore, if a trust is governed by a state that is subject to the UPIA, the trustee must make sure to read the text of the UPIA applicable to that state, as many states have adopted the UPIA in slightly different forms.

Diversification. The UPIA requires diversification, but leaves it to the trustee to determine if special circumstances exist indicating that diversification is not required.[17]

Notwithstanding the discretion that a trustee might have, two layers of diversification must be reviewed every now and again. The first is whether it is acceptable for the trust to invest only in life insurance. In other words, should an ILIT hold other assets besides insurance policies (which are typically illiquid)? The second layer is whether the trust must have diversification within the insurance portfolio itself:

- Is it better to have two $5 million policies instead of one $10 million policy?
- Should the policies be with different carriers?
- Should the policies be of different types?

Because specific guidelines for the above questions are hard to find, the best bet is for the trustee to act with prudence and to document his or her analysis and conclusions, whether in an "investment policy statement" (IPS)[18] or in a memorandum to the file.

Every insurance trust situation is different, and what might be appropriate or prudent in one case may not be so in another. In all cases, the trustee should explore the available alternatives in the market, understand the costs of each available product, and consider the overall administrative requirements of managing a larger portfolio of insurance policies.

Sometimes diversification is not possible. For example, if the insured is a cigar smoker, only a handful of insurance carriers will issue nonsmoker ratings to that insured. Forcing the trust to diversify might significantly increase the cost of the coverage. Similarly, a trustee must take note of the surrender charges associated with a policy. This can come up when purchasing new policies as well as when the trustee is considering a diversification or exchange of a policy. Excessive charges negatively affect a trustee's ability to properly manage the risk in the trust.

ILIT as an estate plan component. Closely related to the issue of diversification is the examination of the ILIT in the context of the overall estate plan. When viewed in a vacuum, an ILIT with a large insurance policy might appear to be a very risky undiversified investment. But what if the ILIT were part of an overall estate plan involving assets in excess of $100 million—including real estate, an investment portfolio, and significant retirement assets? Would the ILIT still look risky? Would the trustee still feel the need to diversify the policy into several smaller policies?

A large estate does not obviate the need for prudence or ongoing review of the assets in an ILIT, but it does change the analysis of some of the diversification questions. Risk can be managed and hedged through other assets in the overall estate, potentially giving the trustee greater flexibility with the policies inside the ILIT.

Conclusion

A fiduciary's responsibility to administer an ILIT is complex and requires prudence and ongoing attention. A fiduciary must be familiar with the details of the trust instrument, must understand the original purpose of the ILIT, and must constantly ask whether the ILIT is still satisfying the planning objectives. Periodic reviews of the underlying assets of the ILIT are critical to assessing the cost/benefit of the investment and will help the trustee avoid an unexpected disaster. Reviews may also create opportunities for the trustee to add greater value to the trust and perhaps his or her relationship with the client.

The UPIA is designed to measure a fiduciary's conduct, not the fiduciary's performance. While a fiduciary will not always be right, the fiduciary can always be prudent. ■