Irrevocable Trusts and Life Insurance

What a Trustee should know

What a Trustee of an ILIT Should Know

For many years, estate planners have established irrevocable trusts to own life insurance and keep the death benefit free from estate tax. However, creating an Irrevocable Life Insurance Trust (ILIT) means that the insured(s) must relinquish control over the trust, and name one or more trustees to manage the trust assets.[1] In most cases, ILITs are just funded with one or more life insurance policies, although increasingly grantors are funding their ILITs with other assets. The trustee(s) of an ILIT are often family members or close friends of the insured(s), but they are also fiduciaries with respect to the trust beneficiaries. Trustees are placed in a position of great trust, confidence and legal responsibility. They are expected to manage the trust assets wisely and with the interests of all of the beneficiaries in mind.

After accepting appointment as the trustee of an ILIT, the trustee should try to find out how the life insurance proceeds are expected to be used, as well as the insured's expectation of how the policy and other trust assets should be managed. Although the trustee is not bound by the insured's expectations, he/she should also try to understand the general intentions of the insured/grantor regarding the distribution of assets for the benefit of his/her heirs and any other trust beneficiaries. As discussed below, the trustee should also be aware of the provisions of various laws, including applicable state laws on trusts and estates, investments and insurance.

RESPONSIBILITIES OF A TRUSTEE OF AN ILIT

Ultimately, the responsibility of the trustee is dictated by the provisions of the trust document. In general, the primary responsibilities of a trustee of an ILIT are as follows: 1.) Payment of Premiums; 2.) Providing notice to Crummey beneficiaries; 3.) Policy Review; 4.) Investment Management, and 5.) Income tax reporting (if applicable).

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

2. Providing Notice to Crummey Beneficiaries – Once the trustee receives the premium contribution from the insured/grantor, in most cases the trustee will need to notify the "Crummey" power holders that the contribution is available for withdrawal in the trust account for a specified period of time (usually 15-30 days) before the premium will be paid.[4] The trustee should review the trust document to determine how and when the notice should be provided to the Crummey beneficiaries. Typically, the trustee must provide written notice to the beneficiaries who have Crummey withdrawal rights and either the beneficiaries or their guardians (if they are minors) must sign the Crummey notice to acknowledge receipt. The Crummey withdrawal right, when administered properly, enables gifts to the trust to qualify for the gift tax annual exclusion.[5] However, if the Crummey notices are not administered properly, the IRS could challenge the use of the annual exclusion and the premium contributions may be subject to gift or estate tax.[6]

3. Policy Review – The trustee should periodically review the life insurance policy to determine if the policy is performing as expected, and should engage the services of an insurance specialist, if necessary. Particular attention should be paid to policies that are not performing as illustrated, policies that are not guaranteed until older ages, policies that are not cost-efficient (and may need to be replaced) and policies that may have a scheduled jump in premiums. In addition, the trustee should determine whether insurance coverage would be sufficient for the current needs of the trust beneficiaries.

4. Investment Management – The trust document generally places the duty of prudent investment on the trustee. The policy review will help the trustee determine if the life insurance policy owned by the trust is an appropriate investment. However, with trusts that own variable universal life insurance policies, the task of investment becomes more complicated. Variable universal life insurance policies have multiple investment options and the trustee, as the policyholder, has the responsibility of determining the type as well as the proportion of underlying investments for the policy. As with policy review, the trustee can delegate the responsibility for investment choices to an investment professional. However, the trustee still needs to monitor the investment performance of the policy funds and is ultimately responsible for explaining the investment choices to the trust beneficiaries.

Many states have adopted a form of the Uniform Prudent Investor Act, which requires that trustees must act prudently in making or retaining trust investments (other states have adopted the provisions of the Restatement of Trusts). The Prudent Investor Rule focuses on the overall investment strategy of a trust and requires trustees to balance the income beneficiary's right to income with the remainder beneficiary's right to the trust principal. State statutes, which vary among the different states, may also be expanded, restricted or eliminated by the provisions of the trust document. The trustee should become familiar with the statutes for the state in which the trust is domiciled (the trust document will indicate the domicile of the trust). The principles of prudent investment are particularly relevant for variable life insurance policies, but would apply generally to any ILIT, including a trust funded with a non-variable life insurance policy.

5. Income Tax Reporting – The trustee must work with a tax advisor and file any federal or state income tax returns for the trust and issue K-1's for the beneficiaries, if necessary. In many cases, ILITs will not have any taxable income, since the only asset owned by the trust is a life insurance policy, which has tax-deferred gains. However, increasingly grantors are funding their ILITs with income-producing assets, such as stock or real estate. If the ILIT is drafted as a "grantor trust" for income tax purposes, then the income and deductions from the trust assets should be reported on the grantor's individual income tax return. If the ILIT is not drafted as a grantor trust, then the income and deductions for the trust must be reported on a trust income tax return (Form 1041).

CONCLUSION

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

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1 IRC Section 2042. The insured must not have any "incidents of ownership" over the life insurance policy.

2 An irrevocable trust is a separate taxpaying entity, and the trust should have a separate bank account with its own taxpayer ID number.

3 Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2. Cash value available for loans and withdrawals may be more or less than originally invested.

4 See the case of Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

5 The annual exclusion in 2005 is $11,000 per person and is scheduled to increase to $12,000 in 2006.

6 See the recent case of Hattleberg v. Norwest Bank Wisconsin, 2005 WL 1574958 (2005), in which a trustee was held liable for estate tax incurred by a trust where the trustee knew that there were no Crummey provisions and still encouraged the settlor to make gifts to the trust.

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