BUILDING FLEXIBILITY INTO THE TYPICAL IRREVOCABLE LIFE INSURANCE TRUST

Presented to the Kentucky Society of Certified Public Accountants, 48th Annual Kentucky Institute on Federal Taxation, November 18, 2005, Louisville, KY.

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1. *If life insurance proceeds are received tax-free, why is an irrevocable life insurance trust needed to own the insurance policy(ies)?*

   It is true that life insurance proceeds are received income tax-free (unless transferred "for value") under Code Section 101. But, if the insured has a taxable estate (generally over $1.5 million in 2005 and $2.0 million in 2006), the proceeds will be taxed in the estate of the insured, at rates beginning at 37% of the proceeds and going quickly as high as 47% in 2005 and 46% in 2006. In order to avoid estate tax on the insurance, the insured must not have "incidents of ownership" over the insurance policy. This will be discussed below but suffice to say, the insured must not own the policy at his death and must not have given up ownership of the policy (with some exceptions) within three years of death. Also, if the insurance policy is included in the estate of the insured, a person who does not have a taxable estate might have an estate that becomes taxable because of the value of the policy included in the estate. It is imperative in most cases to get the insurance policy proceeds out of the estate.

2. *Is there a way to keep the insurance outside of the insured's estate without using an irrevocable trust?*

   Yes, the insured could give the policy to his children or grandchildren or he could have them buy the policy on his life from the beginning. When premiums are paid, he could make gifts to them to make the payments. While this is easier than administering an irrevocable insurance trust, it has several problems. The first is that sometimes the beneficiary/owner predeceases the insured. When that happens, the portion of the policy owned by that child

may go to the spouse of the child or to very young grandchildren. This may not be what is desired. If instead the policy is transferred to the other co-owners for value, this could cause the proceeds to be taxable to the other owners. Finally, if there is a desire to provide a vehicle to hold the proceeds for use by multiple generations, without attachment by creditors or loss in divorce and to protect the money for incapacitated beneficiaries, then a trust is the best way to do it.

3. *If a trust is used, must it be irrevocable?*

   Yes. If the trust owns the policy and the insured is the grantor of the trust, then the trust must be irrevocable in order to keep the insurance policy outside of the estate. It is possible to have another individual be the grantor of the trust and be able to revoke or amend that trust, but this is tantamount to the other person owning the policy and will not likely accomplish what the client wants.

4. *If the trust is irrevocable, then does this mean it cannot be changed?*

   No. It means that the grantor may not change the trust but it does not mean that significant control cannot be maintained by the grantor and it does not mean that someone other than the grantor may not change the trust. But as will be discussed below, the "control" of the grantor must be drawn carefully and the changes allowed by others must be carefully considered as well. This will be the subject of most of this outline and speech.

5. *What is the process of setting up and administering an irrevocable life insurance trust?*

   First: determine how much insurance coverage is needed.

   Second: determine if the coverage will be on a single life or the joint lives of a husband and wife.

   Third: draft and sign the trust. The trust will be different for single life and second to die life insurance and generally it is not a good idea to put both types of policies in the same trust unless you carefully consider the terms of the trust.

   Fourth: the trustee applies for the insurance with the insurance company in the case of newly acquired insurance. If the insurance is already in force and owned by the grantor, then either a gift of the policy will need to be made to the trustee or another method of transferring policy ownership will need to be considered.

Fifth: when the premium notice is received by the trustee, he/she will inform the grantor that money is needed to pay the premium. The grantor will make a gift of the money to the trustee which is deposited to the trust account.

Sixth: the trustee will send letters, known as Crummey Notices, to the beneficiaries to inform them that money has been gifted to the trust and that they have a period of time, usually 30 days, to request that the money be given to them by the trustee.

Seventh: with the money left in the trust, the trustee pays the premium.

Eighth: on an ongoing basis, the trustee will monitor the insurance policy and assess it's viability from time to time. Sometimes this is done in conjunction with an insurance trust advisor.

Ninth: upon death of the insured, the trustee collects the proceeds and administers the trust in accordance with its terms.

6. *What are the gift tax return filing requirements for the setup of and funding of the irrevocable insurance trust?*

A gift of money or property to an irrevocable life insurance trust is a gift that may be required to be reported on a gift tax return. The gift tax return is due at the same time as the income tax return of the person transferring property to the trust. Because of the *Crummey Notices* outlined in item Sixth of question number 5 above, the gift is considered a gift of a present interest up to the amount of the power granted. Gifts of present interests under $11,000 ($12,000 in 2006) are not required to be reported if there are no other gifts during the year but if a gift tax return is filed for other gifts, then the gifts to the insurance trust should be shown. Amounts gifted in excess of the present interest amount will use up part or all of the donor's unified credit exemption equivalent (during lifetime, that amount is $1.0 million. At death, $1.5 million in 2005, $2.0 million in 2006). It is important to note that while the gifts that are present interest gifts are shielded from gift tax, the Crummey powers do not shield the gift from generation skipping tax and so the entire amount of the gift allocable to the grandchildren or younger will use GST exemption unless you elect out (see below).

In addition to the gift tax considerations, the gifts may use up part or all of the donor's generation skipping transfer tax exemption ($1.5 million in 2005, $2.0 million in 2006). Any gift to a generation skipping trust will be automatically allocated to the transferor's generation skipping tax exemption unless you elect otherwise. The question of what is a generation skipping trust is very difficult but the typical irrevocable life insurance trust is a generation skipping trust unless it provides that on death of a beneficiary, the property in the trust will be included in the beneficiary's estate (not a typical provision). The

client may not want to allocate GST exemption to the trust because of the unlikelihood that a child will die before the parent/transferor. If nothing is done, the exemption will be "wasted" on this trust. The new regulations allow considerable flexibility to elect out of the allocation of GST to the trust and professional advisors should consider whether to file a gift tax return merely to elect out of allocation of the exemption. If the client is unlikely to need to elect out, or if the client does not desire to elect out, it still may be a good idea to file the return in order to track the remaining exemption. If you don't, on death it may be difficult to determine what GST exemption is left and how much is available to be allocated to transfers at death. If exemption is specifically allocated to the trust, the preparer should consider using a formula allocation. The new regulations also do not directly discuss late allocation of the exemption but through a two step process, a late allocation can be made that can reduce the amount of exemption used by the taxpayer. This discussion is beyond the scope of this outline.

7. *When the client grants "Crummey" powers to a beneficiary, do they really have the power to take the money and if they do, can I stop them?*

   Yes, the Crummey Power is a very real power and the notice that the beneficiaries get sets out their rights with regard to the money placed in the trust. Even though the power to draw down the gift has only a short window, usually 30 days, it has happened before. In most cases, the persons who have the power recognize that if they do so, they may be disinherited by the grantor, usually their parent. In cases where the power holder does not listen, it is permissible, if you draft correctly, for the grant of Crummey Powers to be changed from year to year. This is a *flexible Crummey power.* A flexible Crummey power allows the grantor to specify from year to year which persons are given the power to draw down the money contributed to the trust. Usually, such powers state that if nothing is stated by the grantor, the power is given to all the individuals in the class equally. The grantor can use this mechanism to be sure that if anyone attempts to spoil the planning, they can only do so once.

8. *Crummey Powers seem like a great way to get money out of my estate without estate tax. How many persons may I give such powers to?*

   This is a hot issue for the Internal Revenue Service. The IRS says that the Crummey power holders should be limited to those persons benefiting under the trust. But IRS lost a significant case on this point (*Cristofani, 97 TC 74, 1991).* However, that case involved granting Crummey powers to relatives, not all of whom would ever benefit under the trust. This seems appropriate under the law as it stands today. But, if you attempt to benefit others who are not family members who also do not benefit under the trust, IRS is likely to challenge the validity of the Crummey powers and thus the present interest exclusions.

9. *Is it permissible for the grantor/insured to be the trustee of the irrevocable insurance trust?*

If the goal is to keep the insurance outside of the estate of the grantor, then he/she should not be the trustee. Life insurance is included in the estate of any person who has incidents of ownership over the policy. Incidents of ownership includes not only the typical ownership rights such as the right to terminate the policy or change the beneficiaries, but also the right to borrow against the policy. The trustee as owner of the policy typically has some of these rights and although the typical trustee has no estate inclusion if he dies while trustee of the trust, the insured would have estate inclusion by virtue of being both the insured and the owner, even as trustee.

10. *Is it permissible for the grantor to retain the right to remove and replace the trustee?*

Yes, so long as the grantor is not permitted to name himself as the trustee, he can retain the right to remove and replace the trustee. (see *Estate of Wall, 101 TC 300 (1991).* It is also prudent to not allow the grantor to be able to name a person who the grantor has a right to control, such as an employee of his company. While this is true, some practitioners suggest that the right to remove and replace the trustee be given to a friendly independent person including a trust protector or trust protection committee to be discussed later.

11. *Is it permissible for the spouse of the grantor to be the trustee?*

Yes. If the spouse is not a beneficiary of the trust then the only limitation on the spouse's powers should be that he/she does not have the right to make any distribution that would satisfy the spouse's obligation of support under state law. If the spouse is a beneficiary of the trust and if keeping the proceeds out of the estate of the spouse is also a goal, then he/she should be limited in making distributions or principal to an amount necessary to pay for the beneficiary's health, education, maintenance and support, including distributions to the spouse from him/herself.

12. *Is it permissible for any of the other family members who are beneficiaries of the trust to be trustee?*

Yes. In the case of other beneficiaries, if the trust is designed to pay out the property to a child/children after the death of the grantor or after the death of the grantor and the spouse, then the trust property will be included in the estate of the child/children. In this case, a child could be the trustee and have more control over the trust property, including the insurance policy without adverse tax effect. And in the case of a trust that holds the property in trust for the lifetime of a beneficiary, as discussed in question #23, where the

beneficiary becomes trustee after the death of the grantor, there is significant flexibility.

13. *Are there any special considerations if a financial institution is the trustee?*

Yes. The grantor typically has less control over an independent financial institution and the institutions are typically reluctant to take certain actions that are discretionary without some guidance. For that reason, both the institutional trustee and the grantor typically like to use a named Trust Advisor to give guidance to the trustee. This is particularly true when it comes to evaluating whether to change insurance policies and whether to make certain discretionary distributions after the proceeds are received. The trust advisor provision can be drafted giving the advisor only advisory powers with the trustee having ultimate authority, or the trust advisor can be given extensive powers including the power to stretch out the ages at which property is distributed to the beneficiaries, but be careful that the trust advisor does not become a fiduciary. Finally, the beneficiaries will likely be much more happy if they have the power to remove and replace the institution with another institution after the death of the grantor. Sometimes this power is limited to a certain number of times in a period of time, such as one removal every three years. This is because changing trustees is not as easy as it sounds and you don’t want to waste trust resources doing this often.

14. *What happens if the trust is irrevocable and the spouse is either a named beneficiary or the trustee or both and the grantor and the spouse get divorced?*

It depends on state law as to what will happen. In Ohio, a spouse’s marital rights terminate upon divorce. However, in the case of ERISA plans, federal law overrides state law and the participant should immediately change the beneficiary designations. In the case of an irrevocable trust, the spouse’s rights do not terminate unless the trust specifically says so. Therefore, the trust either should provide that if the spouse is not married to the grantor at the time of death, the spouse is no longer a beneficiary of the trust, or provide that the term “spouse” means the person married to the grantor at the time of death. In the latter case however, you need to be careful because it is not always desirable to provide for the second spouse in the insurance trust and so you may have to terminate the trust anyway, or you may not be paying attention and that which is not desired may occur in your later planning for the same client. I do not practice in Kentucky and cannot speak to what happens under Kentucky law.

15. *Is there any way to guard against the problems that may occur if something happens to include the insurance in the estate of the grantor/insured?*

Yes, two possibilities come to mind, there may be more. First of all, if there is a surviving spouse, qualifying for the marital deduction will eliminate tax on the death of the insured. There are two ways to do this. The first is to provide that if the spouse survives, the trust pays all income at least annually to the spouse and if desired, pays principal as needed for health, education, maintenance and support of the spouse. This qualifies for the marital deduction under Code Section 2056(b)(7). In the alternative, the proceeds can be paid out directly to the spouse or to the marital trust of the grantor.

If there is no spouse or if giving the assets to the spouse is not desirable, the trust could provide that the assets go to charity or a charitable trust and if the grantor has provided for charity in his/her revocable living trust, then this provision can adjust accordingly.

16. *The insurance agent has proposed the client buy an investment grade insurance policy and significant investment values are expected inside the policy in the future. Can the grantor access those policy values even though the trust is irrevocable and designed to keep the policy out of his/her estate?*

Yes, but care must be taken. It is possible to allow the grantor to borrow money from the insurance trust. Since the only asset of the irrevocable insurance trust is typically the insurance policy, the trustee will need to borrow from the insurance policy to provide the funds to allow the grantor to borrow from the trust. Since incidents of ownership will cause the policy to be included in the grantor's estate, care must be taken to structure the loan so that it is not seen as a direct borrowing from the policy.

This concept has become commonly known as the Wealth, Retirement and Asset Protection Trust (WRAP Trust). This name is trademarked but not by me. The proper way to structure this is to provide in the trust document that the grantor has the right to borrow money from the trust, up to an amount that is less than an amount that would lapse an insurance policy if one is owned by the trust, evidenced by a note with interest at a market rate (not determined with reference to the borrowing rate from the insurance company), providing adequate security. If the grantor borrows from the trust, the trustee will lend the money to the grantor and if necessary, take the money from the insurance policy in the trust. The interest paid to the trust by the grantor will not be deductible by the grantor and will not be income to the trust. This is because the trust is a grantor trust. In addition, the WRAP trust can provide asset protection value since the loan is secured and the grantor does not have a claim against any of the assets inside the trust.

17. *Are there any other ways to allow access to the investment values in the trust and are they less risky?*

Yes and maybe. There is another concept known as the Spousal Lifetime Access Trust (SLAT) also a trademarked name, also not trademarked by me. Under the SLAT, the insured is married and the spouse is a beneficiary of the trust. If the spouse is the trustee, she should be limited in making distributions to an amount necessary for the health, education, maintenance and support of the spouse plus up to the greater of 5% of the trust corpus or $5,000, each year. In this case, the spouse will have a limited but significant ability to take distributions from the trust, and the money to make those distributions will come from withdrawals or loans from the insurance policy.

In the alternative, a friendly independent trustee may be given the power to make distributions to the spouse on an unlimited basis. This would allow the trustee to access the cash value of the policy and make distributions in an unlimited fashion, ostensibly giving the spouse unlimited access to the cash value of the policy.

While this has appeal, there are several issues that need to be addressed. First of all, if the spouse dies first, access to the cash value will end. Similarly, if the marriage ends in divorce, access to the cash value will end. Finally, the ability to access the funds is dependent on the discretion of a trustee that neither the grantor nor the spouse controls. And the trustee does owe a fiduciary duty to all beneficiaries and may at some point be reluctant to dip deeply into the insurance policy cash values.

18. *Can the SLAT and WRAP concepts be combined into one trust?*

Potentially Yes. Neither the WRAP nor the SLAT concept is dependent upon one or the other not being present. Obviously the drafter must be careful so as to avoid estate inclusion but it does seem possible to have both concepts in the same trust.

19. *How flexible can the trust be in allowing changes to that which is supposed to be irrevocable?*

It is clear that the grantor cannot be allowed to change the trust. The grantor is allowed to remove and replace the trustee within limits as specified above. The grantor is allowed to borrow from the trust if the borrowing is commercially reasonable, as set out above. The grantor may not change the beneficiaries or the date beneficiaries may enjoy the property and may not exercise incidents of ownership over the insurance policy.

However, any of these powers may be given to someone other than the grantor. But some of these powers have estate tax implications to the person(s) who have them so they must be carefully drafted.

First: it is not unusual to give the power to push the ages at which distribution is made to beneficiaries, to an independent person or even a family member who is not the beneficiary to which it applies. This is very comforting to many grantors. Sometimes the Trust Advisors are given this power or a Trustee or a Trust Protection Committee can be formed for this and other purposes.

Second: While some grantors will be reluctant to give the power to amend the trust to anyone, it is comforting to know that it can be done. Usually, the power to amend the trust is given to a Trust Protection Committee whose power to amend is usually limited so that the lineal descendants of the grantor remain the only permissible beneficiaries. If the power is unlimited and the protectors have the power to appoint the trust property to themselves, they will have estate tax inclusion in their own estates of the amount of property over which they may amend or appoint to themselves.

Third: If giving the power to remove the trustee to the grantor is deemed too risky, this power can be given to another person, even a family member or a trusted advisor like the financial planner, attorney or CPA.

Fourth: An independent trustee can be given any of these powers although the trustee has a fiduciary duty to the beneficiaries that a trust protector ordinarily does not. It may be better to use the trust protector concept.

20. *If the trustee is a family member or otherwise not independent and if an independent trustee is needed to perform certain acts, can one be appointed?*

Yes. If the trust so provides, an independent trustee can be appointed to do any act that a trustee that is related may not do. This allows a trusted person to be trustee to perform the usual and customary acts of a trustee but if something like a distribution in excess of the standard for health, maintenance, education and support, or a distribution that would satisfy a legal obligation of support of the family member, or exercising any incidents of ownership over an insurance policy is needed, an independent trustee could be appointed to perform these specific acts.

21. *How is a Trust Protection Committee usually formed and utilitzed?*

A Trust Protection Committee, or if only one person is named, a Trust Protector, may have any powers that the grantor gives them. If they are independent of the grantor, they can amend the trust, change the beneficiaries (usually within a class of persons or charities) and do other acts that the grantor may not. This may include removal of trustees, naming of trustees and changing the situs of the trust and the laws that govern the construction of the trust document. While it is possible for a family member to be a trust protector, this should not be done without an independent person also serving

as trust protector in conjunction with them and the powers given the trust protectors should not be too broad if a family member is serving.

The provision structuring such a committee should specify the duties and responsibilities of the Trust Protection Committee, the limitations on their power and when they may be called upon to perform such duties. The Trust Protectors should acknowledge their roles in writing by signing the document or a document that is ancillary, to that effect.

22. *Can I put a special power of appointment in the trust, who can I give it to and would it be useful?*

Similar to the provisions of the typical family trust in most standard estate planning, it is very usual to give a special power of appointment to a family member, usually the surviving spouse. This allows the spouse who survives the insured spouse to use hindsight and decide if the money in the trust that is available to distribute to the beneficiaries should benefit one or more lineal descendants of the insured. This is similar to allowing the spouse to make out her own will and say where her own money goes as well as the money in this trust. Because the power to appoint is limited to the lineal descendants, it does not include the trust property in the surviving spouse's estate. It also protects against the premature death of a child, to keep the money in the trust from getting into the hands of a spouse of a child who has remarried or a grandchild who is too young. The power to appoint can be given to appoint either outright or further in trust. This may be particularly helpful if a beneficiary is incapacitated or a spendthrift or otherwise unable to handle their affairs.

23. *Are there any trends in the naming of beneficiaries that could help build further flexibility into the irrevocable insurance trust?*

It is usually prudent to align the beneficiary payout provisions of the client's revocable trust and will with that of the insurance trust. This is not always possible because the revocable trust and will can and will be changed from time to time. But there is one structure that is becoming increasingly popular that may not ever require changing.

It used to be popular to have the trust property go to the lineal descendants at certain ages. These ages are often rethought by the grantors. But with divorce and creditor problems becoming prevalent, many clients are opting to have the trust property stay in trust for the entire life of the beneficiary allowing the beneficiary to become the trustee of his or her own trust share at certain ages, like age 35. In addition, the beneficiary is granted a limited power of appointment over that portion of the trust that is not subject to generation

skipping tax and a general power of appointment over the rest. For the limited power of appointment, the power usually extends to the lineal descendants of the grantor. For the general power, it usually extends to the same lineal descendants plus the creditors of the estate of the child. This latter portion will be included in the estate of the child but because their spouse may not be a beneficiary, it may not be shielded from estate tax by the marital deduction.

The limited and general powers of appointment can allow the child to appoint the property to lineal descendants either outright or further in trust and allow the child to decide what the trust provisions should be at that time.

In states that have a rule against perpetuities, the limited power of appointment will be limited to a period of time not exceeding 21 years after the last life in being is deceased, usually about 80-120 years at normal life expectancies.

While the property is in trust and the child is his own trustee, the trust may purchase personal and real property for the use of the child or his family without the need for the child or family members to pay rent. This is tantamount to the child and family having full control over the property while protecting it from divorce and creditors. Special provisions should be put in the trust for when the child is serving as trustee so that if creditor issues become evident, appropriate action can be taken to protect the trust property for the family.