Ticking Time Bombs in Irrevocable Life Insurance Trusts

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The ubiquitous irrevocable life insurance trust, or ILIT as it often is called, is the first foray into lifetime estate tax reduction planning for many clients. If properly created and administered, the trust will remove life insurance proceeds from the insured's estate. The trust will receive the insurance proceeds income tax free, creating significant immediate liquidity for the family. The use of an ILIT does require the insured to give up control over the insurance policy during life, but this is a small matter for most insureds. After all, the real value of life insurance is not to the insured but to the beneficiaries. It is a relatively easy asset to give away. Hence, ILITs are quite common.

Because the ILIT is a basic component of many estate plans, it is perceived as easy to create and administer. There are, however, a number of common mistakes made in creating and administering ILITs. This article reviews several of these common mistakes. Fortunately, as discussed herein, most of the mistakes can be remedied, or, for better or worse, pass undetected by everyone, including the IRS. There is one area, however, that can lead to significant problems. If the trust ends up benefiting multiple generations of the insured's descendants, the trustee must know whether the trust has been properly exempted from generation-skipping transfer (GST) tax. If the question first comes up several years after the insured died, determining the answer may not be easy. The consequences of being wrong can be costly to the trust and possibly the trustee personally.

Problems With Crummey Powers

After life insurance is purchased by, or transferred to, an ILIT, the settlor typically funds the ongoing premium payments through annual exclusion gifts to the trust. To qualify gifts to the trust for the annual exclusion, the trust agreement grants some or all of the beneficiaries short duration rights of withdrawal over gifts to the trust ("Crummey powers"). These withdrawal rights convert each gift to the trust to a gift of a present interest. IRC § 2503(b)(1); *Crummey v. Comm'r*., 397 F.2nd 82 (9th Cir. 1968).

Poorly Drafted Powers. The Crummey powers in some ILITs may be too narrowly drafted to serve the current goals of the settlor and the trustee. For example, it is common in many form agreements for ILITs to limit the Crummey power in amount to $5,000, or to the greater of $5,000 or 5% of the trust property out of which the withdrawal right could be satisfied. The limits are tied to the "5 and 5" exception under Section 2514(e) of the Code. A beneficiary's failure to exercise a Crummey power is a lapse of a power of appointment and is considered a taxable transfer by the beneficiary back to the trust. However, to the extent of the greater of $5,000 or 5% of the trust property, the lapse will not be taxable. A simple ILIT form agreement will use this more restricted type of Crummey power in part because drafting for and administering more flexible Crummey powers can be complicated. In many cases, it also is more than adequate to cover premium payments on the policy acquired by the ILIT. Five $5,000 gifts to a trust with five Crummey beneficiaries will pay a $25,000 annual premium. The settlor of an ILIT drafted in this way may later decide, though, that he or she wants to make full annual exclusion gifts to the trust on behalf of each beneficiary. This would not be possible with the limited form of Crummey power. However, if the ILIT had been drafted with a different form of Crummey power, a hanging power (a discussion of which is beyond the scope of this Article), it would be possible.

Two other common problems are that the ILIT may designate only certain family members as potential Crummey power holders or will not allow the settlor to exclude a family member as a Crummey beneficiary. The settlor later may want to make additional gifts to the trust, such as to grandchildren who have no Crummey powers under the trust agreement. Or the settlor may want to exclude a child or grandchild from the right of withdrawal because he or she has become irresponsible or is experiencing creditor or divorce problems.

There are two possible solutions for these problems. First, the settlor could create a new trust with the desired Crummey powers. If the only difference between the old trust and the new trust are in the Crummey powers, it often is possible to treat the trusts as substantially similar and merge the old trust into the new trust under state law. If this is not possible, the settlor could create the new trust, fund it, and the trustee of the new trust could purchase the insurance policy from the original trust. The old trust can distribute the funds and terminate. The new ILIT can continue on with the insurance and all future gifts will be made to this trust. This purchase almost always can be accomplished without income tax consequences. Any trust in which trust income or principal may be distributed to the grantor's spouse or is used to pay life insurance premiums on the life of the grantor or grantor's spouse is a grantor trust. IRC § 677(a)(2),(3). If both trusts are grantor trusts, the new trust's purchase of the life insurance policy is not a transfer for value under Code Section 101. *See* Rev. Rul. 2007-13, 2007-11 I.R.B. 684.

Poorly Administered Powers. For Crummey powers to be effective, the beneficiaries must have actual notice of the rights of withdrawal and adequate time to exercise them. The notice requirement is easy to comply with, but frequently not adhered to by clients. Because the only asset of the ILIT is a life insurance policy, the settlor decides using a corporate trustee during life is unnecessary and names instead a friend, relative or even the Settlor's spouse. The settlor and the individual trustee may not be disciplined about preparing written notices of withdrawal rights each year. Even when the attorney creates a form for the trustee, and provides instructions for completing it each year, the trustee often fails to follow up.

The gift to an ILIT will qualify for the annual exclusion if the beneficiary, or representative of a minor beneficiary, has <u>actual</u> notice of the right of withdrawal. <u>Written</u> notice to the beneficiaries is not a legal prerequisite to the effectiveness of a Crummey power. Written notice nevertheless is highly desirable so that contemporaneous written proof of notice can be provided to the IRS if it later challenges the annual exclusions claimed. If the attorney or trust professional discovers several years where there are no contemporaneous notices, it may be adequate to create a written confirmation that there was actual notice of the withdrawal rights, to be signed by the settlor, trustee and beneficiary. Although the written confirmation is not contemporaneous, it may be helpful evidence of notice, which should not be viewed by the IRS or a court as contrived or manufactured, if there was no challenge to the validity of the Crummey power at the time. Of course, the professional must be convinced that actual notice did exist. If, for example, the settlor's spouse is both trustee and representative of the minor trust beneficiaries, there can be little doubt that there was actual notice. In other cases, a factual inquiry may be necessary.

The settlor also might avoid any risk of challenge to the adequacy of notice of the Crummey powers if he or she was filing gift tax returns reporting the gifts and claiming the annual exclusion. Under applicable rules, if gifts are accurately reported and adequately disclosed on a gift tax return, in a manner sufficient to apprise the IRS of the nature of the gift, then the statute of limitations period (normally 3 years plus 1 year for transferee liability) will commence. Once that period has expired, the IRS no longer can challenge the gift for gift tax or estate tax purposes. These rules apply to any issue with respect to the gift, including both valuation issues and issues involving interpretation of the gift tax law; for example, whether the gift is a present interest that qualifies for the annual exclusion. *See* Treas. Reg. §§ 20.2001-1(b); 25.2504-2(b).

Generation-Skipping ILITs

The Real Annual Exclusion Rule. Many estate planning professionals believe that any gift that qualifies for the annual exclusion is also exempt from GST tax. That was true when the GST tax first was enacted, but Congress narrowed the exclusion in 1988. For transfers after March 31, 1988, a gift to an ILIT that qualifies for the gift tax annual exclusion does not necessarily qualify for the annual exclusion for GST tax purposes. For GST tax purposes, an annual exclusion gift is nontaxable only if made outright or to a trust with one beneficiary whose interest is vested. IRC § 2642(c). In a typical ILIT with multiple beneficiaries, the settlor must allocate GST exemption to the trust to make it GST exempt. As a result of the lack of understanding of this requirement, there are many ILITs that the settlor and trustee believe are GST exempt but which in reality have received multiple years of gifts after March 31, 1988, that were not exempt. With many of these trusts, no gift tax returns were ever filed because the gifts to the trust were under the annual exclusion and did not require gift splitting.

Indirect Skips. The problem discussed above extends only to gifts made through the end of 2000. Starting in 2001, Congress provided for the automatic allocation of GST exemption to transfers to trusts that do not result in an immediate GST tax but may incur GST tax later. IRC § 2632(c). This automatic allocation to "indirect skip" transfers eliminated the problem of missed GST exemption allocations to ILITs designed to be generation-skipping trusts. Even if the settlor failed to allocate GST exemption, even failed to file a gift tax return, the settlor's GST exemption was automatically applied to the trust under the indirect skip rules. For these ILITs where gifts funding premium payments have been made both before and since January 1, 2001, the trust property is partially exempt from GST tax.

The indirect skip rules created another possible problem for other ILITs. The IRS definition of a trust to which the indirect skip rules apply is very broad. *See* Treas. Reg. § 26.2632-1(b)(2). In many cases, the settlor would not want GST exemption automatically allocated to the trust. If the settlor is not filing a gift tax return for gifts to the ILIT, or is not making the proper election on the gift tax return to elect out of the indirect skip rules, his or her GST exemption may be being depleted unintentionally. These trusts may be fully or partially exempt from GST tax and the settlor and trustee, again, are unaware of it.

Consequences for Trustees

It is clear from the foregoing discussion that competent professional advice and careful record-keeping during the life of the settlor are critical to ILITs. To properly administer the trust post-death, the trustee will need to know when gifts were made, what Crummey powers were granted, whether Crummey powers lapsed in a taxable way, whether gift tax returns were filed and what those returns reported. Of course, record-keeping is important with any irrevocable trust, but the nature of ILITs raises the stakes: ILITs usually are funded with smaller annual gifts over many years. The gifts are not always large enough to require gift tax returns, and, over many years, they cross over several different rules about their tax treatment.

For the trustee, the consequences of lack of information can be costly. If there is a taxable termination in the trust (for example, the last child of the settlor dies and the trust continues on for grandchildren or terminates in their favor), the GST tax is paid by the trustee out of the trust property. IRC § 2603. A trustee who does not pay the tax, operating on the incorrect assumption that the trust is GST exempt, may face interest and penalties that beneficiaries will assert should not be borne by the trust. If the trust indeed has terminated, the trustee will have to seek recovery of the tax from the beneficiaries, an effort that is often not completely successful. The fact that the beneficiaries are liable as transferees and the IRS could go directly after them does not help. The IRS will start with the trust because it is the easiest target. And more to the point, the trustee may have personal liability for the GST tax under federal law if the trustee distributed the trust assets when it should have known, with reasonable inquiry, that a GST tax was due. *See* 31 U.S.C. § 3713; *United States v. Ayer*, 12 F.2d 194 (1st Cir. 1926).

For a taxable distribution (for example, a discretionary distribution by the trustee to a grandchild), the beneficiary is liable for the GST tax unless the trust agreement provides otherwise. IRC § 2603(a)(1). If the trust is liable by its terms, the same issues discussed in the preceding paragraph exist. If the beneficiary is liable, the trustee has a duty to so advise him or her. Failure to do so may be actionable. At the very least, it is very bad for business.

It also is possible that the trustee of the ILIT may not be aware of automatic allocations of GST exemption that occurred during the settlor's life. In this situation, the trustee could refuse to make distributions to skip persons because of the perceived GST tax cost, or, worse, make distributions and pay a GST tax that is not due. If, in either case, it later is discovered that the trust is GST exempt or is partially exempt, the trustee will face potential liability.

Conclusion

The lesson to a bank or individual who assumes trusteeship of an ILIT is clear: do not assume the tax status of the trust; investigate it. If this can be done when the settlor is still alive, all the better. It will be easier to access and reconstruct records. A careful review of the facts concerning funding of the trust will help avoid liability for the trustee, and avoid or reduce taxes for the trust and beneficiaries.

About the Author

Thomas W. Abendroth concentrates his practice in the fields of estate planning, federal transfer taxation, and estate and trust administration. His practice encompasses all phases of wealth preservation and transmittal, ranging from the preparation of wills and trusts to the implementation of multi-faceted transactions that reorganize business holdings in order to minimize transfer taxes.

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