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Topic: Washington Report 13-08 : Best Practices in Insurance Trust Administration are Critical to Preserve Planning Benefits.

MARKET TREND: The IRS continues to review and audit the administration of irrevocable life insurance trusts ("ILITs"), including whether gifts to ILITs qualify for the federal gift tax annual exclusion.

SYNOPSIS: Clients and ILIT trustees, in collaboration with their advisors, must implement and follow procedures in the administration of ILITs that will leave them in the best position to defend against IRS scrutiny. Failure to implement and follow best practices can result in unintended taxable gifts to the ILIT by the client or an ILIT beneficiary and possible income and/or estate taxation of the insurance death benefits.

TAKE AWAYS: Insurance professionals can add value by offering post-transaction administrative support to their clients and ILIT trustees. Even relatively small efforts could offer significant benefits, such as sending early reminders of premium due dates so that ILIT contributions and the delivery of beneficiary notices can occur well before premiums are due. These services not only help clients and trustees follow best practices in ILIT administration, but also allow advisors to maintain contact and remain current on plan maintenance and performance. Given that many clients and their chosen trustees will lack familiarity with the administrative nuances that are crucial to preserving an ILIT's tax-planning benefits, this type of back-office support service could be in high demand.

PRIOR REPORTS: 11-84; 05-88.

Ownership of life insurance through an ILIT can remove the death benefits from an individual's taxable estate[1] and leverage the use of an individual's federal gift tax annual exclusions (when insurance premiums are funded with annual gifts). The IRS, however, continues to review ILIT implementation and administration procedures, and questionable practices result in expensive litigation, as well as significant adverse gift, estate, and income tax consequences for the client. The potential for ILITs to buy larger policies, due to the combined effects of higher estate tax rates and the availability of both exclusion gifts and larger exemptions to fund higher premiums, may bring even more scrutiny. Accordingly, it is crucial for clients and ILIT trustees to follow best practices in connection with the administration of their ILITs.

ILITS, ANNUAL EXCLUSION GIFTS, & ADMINISTRATION

Clients often fund premiums on policies owned by ILITs by making annual exclusion gifts. Generally, the first $14,000 of an individual's annual gift to a donee is excluded from federal gift tax.[2] A gift qualifies for the gift tax annual exclusion only if the donee has a "present interest" in the gift (such as a direct gift to the donee). Gifts to trusts, including ILITs, however, do not meet this requirement unless the trust gives the beneficiaries the power to withdraw the gift (frequently referred to a "Crummey withdrawal power").[3] The trust beneficiaries typically receive notice of gifts to the trust and their power to withdraw all or a portion of the gifts, up to the gift tax annual exclusion amount. If the power to withdraw is not exercised within the specified period of time (typically 30 or 45 days), the withdrawal power lapses and the gift remains in the trust to be invested

or used by the trustee as provided in the trust instrument.

Unfortunately, clients and ILIT trustees do not always follow recommended administrative procedures to ensure gifts to an ILIT qualify for the gift tax annual exclusion. Without proper administration, otherwise tax-free gifts to an ILIT can easily become taxable. Further, annual exclusion gifts to typical ILITs will not simultaneously qualify for the annual exclusion from the federal generation skipping transfer ("**GST**") tax.[4] Thus, unless proper allocations of GST tax exemption are made, the ILIT may not be fully GST tax exempt.[5] Finally, the failure to follow appropriate implementation procedures, including properly transferring a policy to or having a policy acquired by an ILIT[6] could result in income or estate taxation of the policy death benefits paid to the ILIT, thus forfeiting the ILIT's tax-planning benefits.[7]

BEST PRACTICES FOR ILIT FUNDING & ADMINISTRATION

As evidenced in recent case law,[8] the IRS continues to scrutinize ILITs, including the administration of gifts to ILITs, the source of funds used to make gifts, and whether such gifts qualify for the gift tax annual exclusion. Clients and ILIT trustees who, with the support of their advisors, implement and adhere to a set of best practices in the administration of their ILITs generally will place themselves in the best position to defend against IRS challenges.

1. **Taxpayer Identification Number ("TIN").** After execution of the ILIT agreement by the client and trustee, the trustee will need to obtain a TIN for the ILIT, which will be used to (i) apply for new life insurance policies in the name of the ILIT or to transfer existing policies to the ILIT, (ii) open accounts in the name of the ILIT, and (iii) file fiduciary income tax returns for the ILIT if it generates sufficient income. The client's estate planning attorney or accountant can generally arrange for the assignment of a TIN to the ILIT.

2. **Acquisition of Life Insurance by the ILIT.** If new coverage is being acquired on the client, the ILIT trustee should submit the insurance application and designate the ILIT as the original owner and beneficiary. In this case, the insurance proceeds should immediately pass to the ILIT, estate tax-free, on the client's death

   If the client intends to transfer an existing policy to the ILIT, several issues will need to be evaluated prior to the transfer. First, who currently owns the policy? If the client and his/her spouse own the policy (as community property, for example) and the spouse will be a beneficiary of the ILIT, then the spouse must transfer all of his/her interest in the policy to the client. Second, even if the client is the only named owner, who has paid the premiums on the policy? If the premiums were paid from a joint account in the names of the client and his/her spouse or from community property earnings, the client's spouse may be deemed to own an interest in the policy, and, again, the spouse must transfer all of his/her interest in the policy to the client if the spouse will be a beneficiary of the ILIT. These transfers will require the preparation and filing of change of ownership and change of beneficiary forms, and may, particularly in community property states, necessitate equalizing separate property in the name of the spouse. Ideally, these issues should be analyzed and any required transfers completed well in advance of the ILIT's creation.

   After confirming that the client is the sole owner of the policy (or the client and his/her spouse are the sole owners if the spouse is joining in the creation and funding of the ILIT), the client and the ILIT trustee will need to complete change of ownership and change of beneficiary forms, naming the ILIT as the owner and beneficiary. These forms should be submitted to the insurance company as soon after the creation of the ILIT as possible. After the documents are submitted, and periodically thereafter, the ILIT trustee should obtain written verification of the trust's ownership and beneficiary designation and retain the verification with the trust's records.

   It should be noted that if the client dies within three years of making a gift of an existing policy to the ILIT, the proceeds will be included in his/her estate for estate tax purposes.[9]

3. **Retention of Original Insurance Contracts by ILIT Trustee.** The ILIT trustee should obtain and hold the original contract for each insurance policy owned by the ILIT in a safe place with the trust's records. This will add weight to the fact that the client has transferred all of his/her interest in the policy to the ILIT.

4. **Premium Notices.** Arrangements should be made for premium notices to be sent to both the client and the ILIT trustee.

5. **Establish Checking Account for the ILIT.** After execution of the ILIT and assignment of a TIN, the trustee

should open a checking account in the ILIT's name. The ILIT trustee should be the sole signatory on the account.

6. **Client Gifts to ILIT for Premium Payments.** When funding premiums on an ILIT policy using annual exclusion gifts, the client generally should not pay the insurance premium directly. Rather, the client should issue a check payable to the ILIT trustee, for deposit into the ILIT's account.

    - If the client and his/her spouse are both grantors of the ILIT (*i.e.*, it holds a survivorship policy), checks to the ILIT may be issued from an account jointly owned by the grantors. If the client is the sole grantor of the ILIT, checks to the ILIT should be issued from his/her individual account as opposed to a joint account, particularly if the other account holder is a beneficiary of the ILIT (a spousal lifetime access trust for instance).[10] Otherwise, the beneficiary may be deemed to have made a gift to the ILIT in which he/she has a beneficial interest, causing a portion of the ILIT assets to be included in his/her estate.

    - Gifts to the ILIT that are intended to be used for the payment of premiums should be made sufficiently in advance of the premium due date so that (i) the funds can remain in the ILIT during the withdrawal period specified in the ILIT, and (ii) the trustee will have enough time following the withdrawal period to send the premium payment to the carrier by the due date.

    - In the event the client makes a gift by wire transfer to the trust account, then the client should formally document the gift by executing a "deed of gift" or "gift letter" to the ILIT, which describes the value and type of gift. Receipt of the gift should be acknowledged by the ILIT trustee by countersigning the deed/letter. The original deed/letter should be retained by the trustee with the trust's records, with a copy returned to the client for his/her records. Clients making gifts by check should also consider using a deed of gift/gift letter to document the gift for the trust's records.

7. **Deposit Check into ILIT Checking Account.** Upon receipt of the check, the ILIT trustee should immediately deposit the check in the trust's checking account.[11]

8. **Notify Beneficiaries of Withdrawal Rights.** Immediately upon receipt of the check (or any other addition to the trust, including any existing policies transferred to the trust), the ILIT trustee must notify the trust beneficiaries of the gift and their withdrawal rights.[12] The trustee will need to review the trust instrument and well as any directions from the client accompanying the gift to determine which beneficiaries have withdrawal rights and will receive notices. For numerous reasons, clients may not want to provide notice to trust beneficiaries regarding trust contributions, and thus may direct that their gifts not be eligible for withdrawal (or for treatment as an annual exclusion gift).

    When a notice is required, it should provide each beneficiary with (i) the amount subject to the withdrawal right, (ii) the expiration date for the withdrawal right, and (iii) the manner in which the withdrawal right may be exercised. Duplicate copies should be sent to each designated beneficiary, who should then sign and date both copies to acknowledge receipt. The beneficiary should keep one copy and return the other copy to the trustee to be retained with the ILIT's records.

9. **Pay Policy Premium.** Upon expiration of the specified withdrawal period, the ILIT trustee should issue a check from the ILIT's checking account to pay the policy premium and send it to the carrier in time for payment to be received by the due date.

10. **Provide Information to Client's Accountant.** The client should provide his/her accountant with the following information at the end of each year:

    - Information regarding the ILIT's bank account, including bank statements, so that the accountant can determine whether the ILIT must file federal and/or state income tax returns (income tax returns generally are not required during the client's lifetime if the ILIT only owns life insurance policies); and

    - Details of the client's annual gifts, including gifts to the ILIT (both direct gifts and any indirect gifts due to premiums paid directly by another (*e.g.*, the client's employer). The accountant will use this information to determine whether the client must file federal gift tax returns to report taxable gifts (i.e., gifts that exceed the federal gift tax annual exclusion).

- Note that, ***for most ILITs, the proper allocation (or non-allocation) of federal GST tax exemption will require the filing of annual federal gift tax returns, even if all gifts to the ILIT qualify for the federal gift tax annual exclusion.*** Thus, the accountant will need the above information to determine whether to file a gift tax return that makes an election with respect to the allocation or non-allocation of the client's federal GST tax exemption for gifts to the ILIT.

11. **Review Policies.** The client and the ILIT trustee should review each insurance policy owned by the ILIT with the producer and investment advisor on a regular basis to monitor policy performance, and the impact of any current or potential changes in market and economic factors, product options, and the insured's health condition.

While the above steps may seem overly technical and laborious, ***the potential tax ramifications for overlooking minor details could be severe.*** In most cases, the issues will not arise until after the client's death, when beneficiaries who have never been involved in the administrative process will want to understand why ILIT assets that were expected to be estate tax-free may now incur estate tax at a maximum 40% federal rate. The details associated with ILIT administration recommend the appointment of a professional or institutional trustee with established administrative staff and protocols. Unfortunately, however, most institutions won't serve as ILIT trustees. This means the family members and friends who are often appointed as trustees need significant guidance and should closely follow these best practices.

CORRECTIVE ACTIONS

Lapses or oversights in administration can occur even with the best-managed ILITs. In such situations, clients and their advisors should consider taking appropriate corrective action.

- If it is discovered that title to a policy intended to be transferred to the ILIT is not yet owned by the trust, immediate action should be taken to transfer the policy, either by gift or possibly by sale (if the ILIT is a grantor trust) and to name the ILIT as the policy beneficiary (subject to confirmation of the potential gift and GST tax consequences).

- If the client forgets to make a gift to the ILIT and instead pays a premium directly to the insurance carrier, the gift may still qualify for the gift tax annual exclusion.[13] In order to bolster this position, however, upon being informed of such payment, the ILIT trustee should immediately send confirmatory notices to the beneficiaries to substantiate that the trust beneficiaries were aware of and did not intend to exercise their withdrawal rights over the transfer. Efforts should be made going forward to have future premium payments made by the trustee, following the steps set out in this article.

- If the ILIT trustee fails to send the required withdrawal notices to the beneficiaries, the trustee should, immediately upon discovering the oversight, send confirmatory notices similar to the above. Efforts should be made going forward to send the withdrawal notices to the beneficiaries on a timely basis.

- If the client has been making gifts to the ILIT from a joint account and the other account holder is a beneficiary of the ILIT, actions should be taken, if possible, to confirm funds originally came from the client and not the beneficiary. Going forward, gifts should be made only from an account in the client's name (or from the client's separate property if the client lives in a community property state like California or Texas).

- If prior gifts to the ILIT exceeded the annual gift tax exclusion or were taxable gifts, or if the client's GST tax exemption was not properly allocated, the client's accountant should be notified immediately and gift and GST tax returns filed as appropriate.

IMPLEMENT A COLLABORATIVE ILIT MAINTENANCE PLAN

Clients and trustees will likely have more success in implementing and following best practices when they work with a collaborative team of advisors who provide a clear maintenance plan and post-transactional support, including as follows:

- The producer, who advises the client on product options, pricing and selection, facilitates the purchase of the policy, and assists with the post-sale monitoring of the policy.

- The estate planning attorney, who drafts and coordinates the ILIT with the client's overall estate plan, works with the

producer to properly title the owner and beneficiary of the policy, assists with implementing the premium funding program, and works with the client, ILIT trustee, and other advisors with the day-to-day administration of the ILIT.

- The investment advisor, who advises the client on the best use of the insurance portfolio, reviews funding sources for the payment of premiums, and monitors exit strategy performance (side funds, GRATs, etc.) to ensure they are meeting hurdle rates.

- The accountant, who assists the client with gift and GST tax reporting, and prepares income tax returns for the ILIT, as required.

TAKE AWAY

In light of the administrative requirements associated with using the gift tax annual exclusion for gifts to trusts and the new, permanent $5,000,000[14] gift and GST tax exemptions, we may see a shift to clients making larger gifts to their ILITs or simply making annual gifts and using their gift tax exemptions, particularly those mid-market clients who may be less likely to use their full exemptions during life or at death.

Regardless of how premiums are funded, insurance advisors can add value by offering post-transaction administrative support to their clients and ILIT trustees. Even relatively small efforts could offer significant benefits, such as sending early reminders of premium due dates so that ILIT contributions and the delivery of beneficiary notices can occur well before premiums are due. These services not only help clients and trustees follow best practices in ILIT administration, but also allow advisors to maintain contact and remain current on plan maintenance and performance. Given that many clients and their chosen trustees will lack familiarity with the administrative nuances that are crucial to preserving an ILIT's tax-planning benefits, this type of back-office support service could be in high demand.

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NOTES

[1] If an existing policy is transferred by gift to an ILIT, the policy proceeds will be included in the insured's estate if the insured dies within three years of the transfer. IRC § 2035(a).
[2] IRC § 2503(b)(1). This amount is indexed for inflation. IRC § 2503(b)(2).
[3]This can be more complicated when dealing with corporate or business life insurance if the premiums are funded directly by the company.
[4]To qualify gifts to a trust for the annual GST exclusion, the trust must benefit only one individual during his or her life (who is a skip person for GST tax purposes (*e.g.*, a grandchild)), and the trust assets must be paid to that individual during life or be includible in his or her gross estate at death. Typical ILITs have multiple beneficiaries and are drafted to prevent inclusion of the trust assets in a beneficiary's estate.
[5] In these cases, the so-called "automatic allocation" rules may help, since they automatically allocate GST exemption to any contribution made to a qualified GST trust (see Treas. Reg. §26.2632-1). The rules are complex, however, and the taxpayer must confirm the trust's GST status and record the amount of GST exemption automatically allocated each year.
[6] This can be of particular concern when trying to preserve or "save" the client's age for purposes of issuance of the policy.
[7] Every estate tax return asks directly about life insurance and trusts for same.

[8] See e.g., *Turner Est. v. Comr.*, T.C. Memo 2011-209, discussed in more detail at note 13.
[9] IRC § 2035(a).
[10] In community property states, if the client's spouse is a beneficiary of the trust, it may be necessary to take the additional step of creating separate property for the client from which gifts can be made.
[11] If the ILIT holds a group life insurance policy for which the client's employer pays the premium directly, it will be unnecessary for the client to make transfers to the ILIT to pay the policy premiums. Note that holding such coverage in an ILIT is not common, as it is generally not seen as cost-effective to use annual exclusion gifts to fund the type of term coverage typically provided by group policies. For an ILIT holding a group policy, however, the trust beneficiaries must still be given notice of their withdrawal rights with respect to the premiums paid by the employer. In such instances, one annual notice stating when the premiums are expected to be paid, the amount of the premiums and when they can be withdrawn may be sufficient. Best practices would also suggest that the client make a "seed" gift to the ILIT as evidence that the beneficiaries' withdrawal rights are not illusory and that the ILIT has assets available to satisfy any exercised withdrawal right.
[12] If the beneficiary is a minor or incapacitated, the notice should be sent to his or her parent, guardian, conservator or other person specified in the ILIT.
[13] See, *Turner Est. v. Comr.,* T.C. Memo 2011-209 (decedent's direct payment of life insurance premiums on policies held in insurance trust were present interest gifts and subject to the §2503(b) exclusion, even though beneficiaries did not receive notice of the transfers, because beneficiaries had absolute legal right and power to demand withdrawal).
[14] The $5,000,000 exemption is adjusted annually for inflation. The gift and generation-skipping transfer tax exemption for 2013 is $5,250,000. See, IRC § 2010(c)(3)(B).