By Kimberly E. Civins

Nursing the Sick ILIT

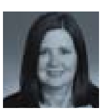
How a trustee can avoid liability when a trust lacks liquidity

Now more than ever, trustees, and in particular, corporate trustees, face administrative issues that arise in relation to an irrevocable life insurance trust (ILIT), in which the primary asset is one or more policies of life insurance on the grantor's life. These ILITs are sometimes referred to as "unfunded ILITs" although that name is a misnomer, as these ILITs are funded with life insurance policies and sometimes a small amount of cash. Recently, trustees have encountered various problems (for example, lack of liquidity to maintain the life insurance policy and failures in *Crummey*[1] notice timing) that make it difficult to administer these trusts. Failure to properly handle these problems could result in trustee liability.

To complicate matters, corporate trustees may no longer have regular contact with the grantor. Or, individual trustees may have contact with the grantor, but not wish to upset him—especially if the grantor is a friend, client or family member. But individual trustees also face liability. For all actions involving an ILIT, the trustee's duty and legal concern is to administer the trust for the benefit of the beneficiaries exclusively and not for the grantor, even when the trustee's primary or initial relationship is with the grantor.

Diagnosis: Lack of Liquidity

The symptoms: a $5 million life insurance policy, $150 in the trust bank account, a large annual premium due tomorrow, and a half-dozen unreturned email and phone messages to the grantor who is a potentially uninsurable insured. These may be the cards dealt to the trustee of an ILIT. What are the trustee's next moves?



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The greatest liability to the trustee exists when the insured is in poor health and no longer insurable, and the policy is in jeopardy because there's insufficient liquidity to pay premiums. However, there's also significant liability even with an insurable grantor.

First, there may be more time to deal with the problem than most trustees think. Typically, there's a 30-day grace period after the premium due date when the premium can still be paid with no lapse in the policy. The trustee's first call should be to the carrier to determine the length of the grace period.

Next, the trustee should send a letter[2] as soon as possible to the grantor and any co-trustee informing them that:

- nothing has been heard from them after the trustee made numerous attempts to reach them (the trustee should specify when those attempts were made);
- the policy will lapse on a certain date; and
- one or more options will be considered based on the trustee's evaluation of the situation. (See the discussion below and "Preventive Care for Sick ILITs," p. 20.)

The trustee should also evaluate the cash value or other self-financing arrangements of the policy to pay the premium. It's best if the governing trust document allows for this option. But if it doesn't, the trustee should consider this option anyway, unless the governing document expressly forbids it. The trustee should document for the file any demonstration of its efforts to evaluate other options, including notes of phone conversations, emails, memoranda or other correspondence, or even research that it has undertaken.

The trustee should also contact the attorney who drafted the ILIT regarding a possible lapse in the policy. If the attorney no longer represents the grantor, the trustee should find out if the attorney knows who does. If it's unclear which attorney currently represents the grantor, the trustee should find the name of the agent who sold the policy (and who should be servicing it) and communicate with that person regarding the situation. Document these communications for the file.

Assuming the trustee doesn't hear from the grantor after sending the letter discussed above, the trustee could also write the adult beneficiaries[3] about the situation. The trustee could suggest that they pay the premium to avoid a lapse in the policy, or, in the alternative, to sign a statement indicating that they understand that they had the opportunity to obtain advice from their own attorney and they understand the consequences of allowing the policy to lapse.

Some ILITs include language that expressly states that the trustee has no obligation to notify others of nonpayment or to attempt to secure payment from others. Best practice would dictate that the trustee proceed with this letter even if not obligated to do so, especially if the grantor is in bad health and possibly uninsurable. However, note that this language gives the trustee the option of not notifying others and depending on the relevant facts and the specific language, the trustee could decide not to notify others of nonpayment. However, if an ILIT includes language that the trustee can pay premiums using any funds made available to the trustee by any person, there's a strong argument that the trustee should contact the beneficiaries, as the ILIT contemplates payment of premiums from funds from sources other than the grantor.

Note, however, that although the law is unclear, there's an argument that under Internal Revenue Code Section 2036(a)(1), accepting contributions to the ILIT from the insured's spouse who's also a beneficiary of the ILIT could cause the assets of the ILIT to be includible in the spouse's estate. Therefore, if the spouse of the insured indicates a desire to provide a gift to the ILIT to pay premiums, the trustee should consider, instead, having the spouse loan the money to the ILIT. (The spouse and trustee should first consult with the spouse's legal and tax advisors.) If the grantor advises that he doesn't want the trustee to contact the adult beneficiaries, then the trustee can ask for an indemnification from the grantor. If the grantor won't give the indemnification or the trustee believes the grantor's indemnification would be ineffective, then the trustee should consider contacting the adult beneficiaries anyway, unless there's language in the ILIT relieving the trustee of any obligation to notify others of nonpayment or to attempt to secure payment from others.

Additional Treatment Options

The trustee can consider other options for dealing with a situation in which there's a lack of liquidity to maintain the insurance policy. These options include:

Distribution of policy to beneficiaries: Some ILITs provide a way to distribute the policy with an encroachment to beneficiaries. Ideally, this would include language allowing for unequal distributions so that the trustee can safely distribute the policy to the spouse to the exclusion of the children. Language in ILITs can vary widely on the appropriateness of this technique. For example, this type of distribution provision might take the form of a trust termination provision rather than a principal encroachment provision. This solution makes the most sense when the grantor doesn't want the trustee to contact the nonspouse beneficiaries but is satisfied when the spouse has knowledge and receives the policy. The trustee's preference, however, should be to notify all primary beneficiaries. Doing so has the potential to continue the policy and preserve the estate tax planning goal that was likely the initial rationale of the ILIT.

Life settlements: The trustee could look into the possibility of a life settlement. A life settlement is a transaction in which the owner of a life insurance policy (here, the ILIT) sells the ultimate death benefit to a life settlement buyer for cash and the life settlement buyer takes over ownership of the policy and pays all future premiums. These settlements are available for most types of life insurance. However, if the insured is younger than age 70, it's unlikely that a party will offer to purchase the policy because the insured's life expectancy is too long. A life settlement is usually a viable alternative if there's at least four months of lead time prior to the lapse of the policy, and if the insured is willing to cooperate by allowing the buyer to obtain information about his health. The ability to obtain a life settlement is becoming easier with better consumer protection as states gradually adopt regulations governing these settlements. A life settlement should be considered when the offer to buy is in excess of the cash surrender value or there's no cash in a policy that's being considered for surrender. In addition, the income tax consequences of a life settlement needs to be assessed on a case-by-case basis.

Funding from other family trusts: The trustee should evaluate whether there are other trusts for the family that may be eligible sources of funds. Where a gift to the ILIT may be appropriate, the trustee should consider the terms of the other trusts. If a distribution from such a trust isn't appropriate, a loan to the ILIT from the trust might be authorized by the terms of both the lending trust and the ILIT.

Private split-dollar agreements: The trustee should evaluate whether a third party source of funds exists and consider whether such a third party might enter into a private split-dollar agreement with the ILIT. That agreement would involve the third party agreeing to pay the life insurance premiums on behalf of the trust in exchange for receiving, upon the insured's death or termination of the coverage, repayment of all premiums paid on behalf of the ILIT plus an interest factor. Often, this is only a viable option with whole life policies.

Trust amendment: If the particular ILIT allows amendments by the trustee or someone else (not the grantor), the trustee should determine whether particular language in the ILIT can be amended so that one or more of these suggestions may be implemented.

Resigning as trustee: Finally, it may be appropriate for the trustee to resign. If so, the trustee should look for helpful language in the ILIT allowing resignation. If the ILIT has such language, hopefully it names a successor trustee. If not, the trustee should determine who can appoint successor trustees and check for limitations in the trust instrument as to who can serve as successor. For example, the trust instrument may require that a corporate trustee serve. If language in the trust document isn't helpful, the trustee should evaluate the relevant state statutes regarding trustee resignation.

Diagnosis: *Crummey* Letter Failures

Another concern is the proper administration of *Crummey* notices. *Crummey* notices are periodic letters to beneficiaries of an ILIT informing them that a gift has been made to the ILIT and the beneficiaries have a period of time to make a withdrawal of their pro rata portion of the gift. Such withdrawal rights are given to the beneficiaries under the terms of the ILIT so that the gifts might qualify for the "present interest" requirement for gift tax annual exclusion purposes. *Crummey* notice problems may risk loss of "present interest" status of the gift, in turn resulting in gift tax paid by the grantor or loss of a portion of the grantor's lifetime gift exemption.

Grantor pays premium directly (an "indirect" gift to the ILIT): Fortunately, an insured's direct payment of life insurance premiums doesn't cause an incident of ownership to be attributed to the grantor. Generally, the trustee should send *Crummey* letters immediately after the grantor's payment. However, the grantor's direct payment presents a problem if the ILIT has no liquidity to satisfy a beneficiary's exercise of his withdrawal right. So, it's important to check the ILIT's language to make sure that the *Crummey* right may be satisfied not only against the contribution, but also against other trust property, including any insurance policy or fractional interests therein. The Internal Revenue Service has sanctioned fractional interests in life insurance policies several times as sufficient to satisfy a *Crummey* withdrawal right.[4]

If the ILIT language doesn't trigger a *Crummey* withdrawal right upon an indirect gift to the ILIT, then a direct payment of the premium might be subject to gift tax on the part of the grantor, either causing the imposition of a gift tax or use of a portion of the grantor's lifetime gift tax exemption. The trustee should alert the grantor of this possibility and suggest that the grantor seek the advice of his accountant or attorney regarding the specific gift tax consequences of such a payment.

Gift made too late for complete *Crummey* withdrawal period: In this scenario, the grantor makes a last minute gift to the ILIT, but the premium is due during the period *Crummey* withdrawal rights would be outstanding.[5] It's similar to the above situation in which the grantor pays the premium directly in that there's a problem of liquidity in the ILIT to satisfy a *Crummey* beneficiary's exercise of his withdrawal right. The trustee should send the *Crummey* letters immediately after receiving the grantor's gift and pay the premium just prior to the lapse deadline, and not before, to maintain liquidity in the ILIT for as long as possible. Even if the beneficiary exercises the withdrawal right when there's no liquidity in the ILIT, it's likely that the trustee could use other assets to satisfy the withdrawal right, including the policy itself.

Unfortunately, there are instances of language in

Preventive Care for Sick ILITs

How to ward off problems from occurring in the first place

The trustee can take the following steps to help prevent problems from occurring:

Conduct proper screening. Generally, unfunded irrevocable life insurance trusts (ILITs) don't make sense for corporate trustees, considering the relatively low fees compared with the high potential for liability. Therefore, a corporate trustee generally shouldn't serve as a trustee of an unfunded ILIT unless the ILIT is a part of a larger client relationship. All trustees should examine the language in the ILIT regarding an exit strategy for the trustee, should the ILIT begin to show dysfunction.

Get liquidity. When possible, have the grantor make extra initial gifts to provide a cushion for *Crummey* withdrawals and possible future unpaid premiums. Encourage the grantor to couple other wealth transfer techniques, such as grantor retained annuity trusts and family limited partnerships with the ILIT to fully fund the ILIT over time.

Consolidate gifts. Have the grantor make annual gifts, even though premiums are paid monthly or quarterly to minimize the number of *Crummey* letters.

Look to state law (or lobby for it). A trend is emerging in which states are adopting some statutory relief for trustees of ILITs. For example, a Delaware statute relieves the trustee from liability for failure to (1) determine whether the policy is a proper investment, (2) investigate the health of the carrier, (3) determine whether to exercise a policy option, (4) determine whether to diversify the policies among each other or other trusts assets, or (5) inquire about changes in the insured's health or financial condition relative to the contract.[1]

Include special provisions. When an ILIT is still in the draft phase and there's an opportunity for the trustee to influence the ILIT provisions, the trust could include a special trustee who isn't the primary trustee. The special trustee would be given the continuing duty to monitor the policy for quality and appropriateness as an ILIT asset. Also, a trustee should ask for language specifically authorizing the retention of life insurance policies within the ILIT. This applies even if such retention represents an undiversified portfolio of trust assets and such retention could be viewed as a lack of diversification because all policies are issued by a single carrier or consist of a single life insurance product. Also, the trustee should consider including language incorporating the following principles:

- looking to other sources for premium payments, including other ILIT assets and beneficiaries of the ILIT, and notifying any person or beneficiary of the non-payment of a premium;
- selling, assigning or pledging any policy;
- relieving the trustee of accountability for the failure to make a premium payment if there are insufficient funds to pay premium;
- satisfying *Crummey* withdrawal rights with all or part of any insurance policy if liquid funds aren't available;
- cancelling or terminating an insurance policy;
- exchanging a policy, even for an amount less than the original face amount and collecting cash surrender value remaining after an exchange;
- accepting contributions to the ILIT from any person in an amount necessary to pay premiums in whole or in part;
- entering into arrangements with any party other than grantor with regard to payment of premiums, including an agreement in which the party pays all or a portion of premiums and the trustee repays the party by transferring all or a portion of the cash surrender value or death benefit of the policy to the party;
- converting a policy into any other form of insurance or annuity; and
- relieving the trustee of a duty to investigate or monitor regarding the performance of policies, policies being sufficient for client needs, cost efficiency of policies, availability of other products and riders with better options and premium increases.

Get a preemptive blanket release and indemnification from the grantor and/or trust beneficiaries. While an onerous one-time task, a trustee could consider getting a release and indemnification from the grantor and all adult beneficiaries to gain some of the advantages of the language summarized above that might not be included in the ILIT agreement itself.

Endnote

1. 5.12 Del.C. Section 3302(d).

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ILITs mandating that the trustee maintain liquidity in the ILIT to satisfy *Crummey* withdrawal rights during the *Crummey* period. In this case, the trustee could potentially be in an impossible situation and consultation with an attorney would be prudent. Generally, given the choice between maintaining liquidity in the ILIT versus allowing an insurance policy to lapse, the likely path to the least liability for a trustee is to pay the premium, and assume that, if necessary, the trustee could satisfy the withdrawal right with fractional interests in the policy itself.

No returned letters from *Crummey* letter recipient acknowledging receipt: A written acknowledgement from the *Crummey* beneficiary as to receipt of a *Crummey* letter isn't critical, although it's helpful to document for the trustee's file. It's more important, however, for the trustee to be able to show that the *Crummey* beneficiary actually received the *Crummey* letter. Therefore, I recommend that the trustee send the letters so as to allow confirmation of receipt. Trustees should continue to ask for returned *Crummey* letters with the signed acknowledgement, as that's the best practice.

If a *Crummey* beneficiary doesn't return one or more *Crummey* letters with a signed acknowledgement of receipt, a trustee might consider including language in future *Crummey* letters identifying previous gifts to the ILIT and the beneficiary's previous *Crummey* rights. Also, in a current *Crummey* letter, the trustee should ask the beneficiary to acknowledge that he received notice of the prior gifts. If the beneficiary ever returns a signed acknowledgment, then the trustee would have the written acknowledgement for the prior *Crummey* rights as well.

Other ILIT Illnesses

Trustees may encounter other problems with the ILIT that they must deal with. These include:

Lack of quality and efficiency of insurance policies. Trustees should periodically perform a check-up on the health of the policies within the ILIT. Insurers may have been downgraded. It may be possible for the trustee to diversify insurance products and carriers. (Some well-drafted ILITs specifically waive the duty to diversify and authorize the holding of a single policy of life insurance.) The trustee may be able to replace policies with better or less expensive policies. For instance, for more recently issued policies, carriers were required to use updated mortality tables with longer life expectancies, which cause premiums to become less expensive.

Trustee fees. Trustees may have trouble collecting trustee fees from ILITs that hold primarily only one or more life insurance policies; the usual practice is to collect the fees annually from the ILIT's grantor directly. When attempts to collect from the grantor aren't fruitful, the trustee may want to collect such fees from the policy's cash value or from a loan on the policy. The trustee ideally should pursue this method in consultation with the grantor and the beneficiaries, as tapping into cash value can materially degrade the policy's performance over time.

Certainly, the trustee would have the right to collect all owed trustee fees at the time the ILIT has liquidity, usually upon the grantor's death. If the trustee is satisfied with this delayed result and wishes to collect interest as well, then corporate trustees could consider including such language in the fee schedule.

Documentation

To avoid liability for ILIT administration problems, the most important action for the trustee is to document for the file that the trustee took all reasonable steps to solve the problem. A "reasonable step" probably doesn't include the trustee paying the premium itself, lending cash to the ILIT to maintain such a policy or providing cash to fund a beneficiary's exercise of a *Crummey* withdrawal right. However, should the trustee be inclined to provide liquidity to the ILIT in the form of a loan (on commercially reasonable terms, if the trust allows borrowing from the trustee), this is a viable option to solve liquidity problems in the ILIT.

Endnotes

1. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).
2. For all instances in this article where we advise that trustees use correspondence, we suggest using an overnight service or other similar means to insure timeliness and a verification of delivery.
3. The doctrine of virtual representation or other means of binding minor and unborn beneficiaries should be a consideration in obtaining an acknowledgement, indemnification, consent or other document executed by trust beneficiaries or the grantor. A discussion of the means of obtaining approvals from minor and unborn beneficiaries is outside the scope of this article.
4. *See* Private Letter Rulings 7935091 (May 31, 1979) (term insurance) and 8044080 (Aug. 11, 1980) (whole life insurance).
5. The rule of thumb for practitioners is that the recipients of *Crummey* withdrawal rights should have at least 30 days to exercise those rights. *See* PLR 199912016 (March 26, 1999).