Steve Leimberg's Estate Planning Email Newsletter - Archive Message #625

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From: Steve Leimberg's Estate Planning Newsletter
Subject: **Funding an Irrevocable Life Insurance Trust: Doing It Right**

Timing (Yes, I've said it before) – is everything!

This special commentary has been set to go for over a week.

Just hours before its release, I received an e-mail from **Mike Weinberg**, a Denver life insurance consultant and expert witness, who edited both the Life Insurance Due Care and Split-Dollar Life Insurance books and is Editor Emeritus of The Irrevocable Life Insurance Trust text for the American Bar Association. Mike's e-mail was about a malpractice suit which involved the (im)proper execution of an ILIT, the (mis)arrangement of its life insurance, and the poor - and poorly orchestrated - timing of each step.

In a nutshell, Mike's e-mail said,

"Everyone imaginable was sued in this case, the insurance agent, the insurance company, the insurance broker, the trust officer, the trust company, and the lawyer. … The principal issue was whether the adviser-defendants had met the standard of care due the insured and his family were entitled to. After a thorough analysis of the facts (gleaned from over five linear feet of depositions and exhibits), it was our opinion that the defendants had been negligent and breached their duty of care. … The case was settled and the defendants paid the plaintiff the full amount of the estate tax deficiency, including penalties and interest."

I said that message was good timing because "doing an ILIT right" is the subject of this LISI report.

FUNDING AN IRREVOCABLE LIFE INSURANCE TRUST:
AN ACT IN THREE PARTS!

Jeffrey R. Lauterbach, JD is Chairman & CEO of **The Capital Trust Company of Delaware**. **Trisha W. Hall**, JD is AVP and Staff Attorney at Capital Trust. Jeffrey and Trisha have created for LISI members a very practical follow-up to their previous LISI contribution, **THE SEVEN DEADLY SINS OF TRUST DRAFTING** (Estate Planning Newsletter Archives # 571 at **http://www.leimbergservices.com**).

Here, they provide LISI members with a step by step guide for setting up irrevocable life insurance trusts and the life insurance that powers them. This is an ILIT checklist that every attorney, sophisticated insurance agent, trust officer, and every other member of the planning team will find highly useful!

GREAT ON PAPER NOT ENOUGH:

Judging solely by the amount of material on how properly to draft an irrevocable life insurance trust (ILIT), one would think that drafting is the most important piece of the ILIT puzzle.

But an ILIT document – no matter how perfect it appears on paper – won't be worth the paper it's written on if proper procedures aren't followed to implement the trust and buy the insurance policy it will hold.

THE SECTION 2035 PROBLEM:

The primary reason for proper funding is to leverage the client's wealth through life insurance and enhance the advantage of that leverage by keeping the policy proceeds out of the insured's estate. One problem with accomplishing that objective is Code Section 2035.

Code Section 2035 deems includible in a decedent's gross estate any property transferred within three years of the decedent's death that would have been included had it not been transferred. For instance, if John Smith, as owner of a life insurance policy on his life, transfers his policy to an irrevocable trust and dies two years later, the proceeds of that policy will be included in his gross estate for federal transfer tax purposes even though John did not own it at the time of his death.

THE SECTION 2503 PROBLEM:

One of the major concerns when purchasing life insurance through a trust is to reduce or if possible eliminate any gift tax cost. Obviously, a gift is being made from the client to the trust (technically, its beneficiaries) each time he/she makes a contribution to the trust to help it pay premiums.

So another technical and practical issue arises at the first exercise of Crummey rights when funding an ILIT. Crummey withdrawal rights are given to the primary beneficiaries of the trust to qualify any of the grantor-insured's contributions made to the trust as present interest gifts subject to the gift tax annual exclusion (2503(b)). Crummey beneficiaries are thus given a legal right to make a withdrawal – all or a formula amount of the contribution - from the trust during a specified period of time. The IRS requires that Crummey beneficiaries receive prompt notice of contributions from the trustee in order to give the holders of a withdrawal power a reasonable opportunity to exercise it.

But how long is reasonable? Documents usually specify a 30-day withdrawal period. A period as short as 15 days was deemed to be a reasonable period, but this isn't as commonly used and is rarely recommended.

Having the ILIT be the initial owner of a life insurance policy and giving Crummey beneficiaries prompt notice of and reasonable opportunity to exercise their rights sounds relatively simple. In reality, though, funding the trust with the policy and having the contributions to the trust qualify for gift tax exclusion treatment is an intricate production involving multiple actors entering the stage at various cues all dependent on one highly critical player: the grantor/insured. And all too often, lines are forgotten!

DIRECTING THE PLAY:

In researching this article, we talked with a cross-section of actors that would typically be involved in the creation of an ILIT: financial advisors, insurance agents, insurance carrier insiders, and attorneys.

We expected to hear conflicting opinions that we would then explore for this newsletter. But our expectations were dashed. While we did accumulate some fine variations in detail, our conclusion is that there is a right way -- a script, if you will, to properly fund an ILIT.

ACT ONE:

SCENE 1: Before the client agrees to an ILIT, the primary advisor should discuss with the client what the total package may cost. The advisor should obtain and present to the client ballpark estimates for drafting, administration, and purchasing the insurance.

SCENE 2: After the client has agreed to proceed, the primary advisor should initiate and conduct a meeting with the client and all of the client's advisors to discuss expectations and timing. The advisors at this meeting may include the attorney, the accountant, the financial advisor, the family office representative, and the insurance advisor.

SCENE 3: These parties should decide on what kind of trustee to use (individual or corporate or combination), how long the process may take, and the risk of underwriting re-classification if the client returns to his/her physician between the first physical and the first premium payment, among other topics. By putting time and effort in at the beginning, the overall process will likely be more streamlined throughout.

SCENE 4: Next, the primary advisor or insurance advisor should obtain and send to several insurance carriers the client's medical records, and in some cases, a medical questionnaire and physical.

In some cases, a carrier may provide a tentative offer based on this informal underwriting. For example, the carriers might be able to tell you based on the information provided what the client's underwriting classification (i.e., standard, preferred, or sub-standard) and premiums would likely be. Even when the intended carriers do not provide this service, an insurance advisor or agent should be able to provide a rough estimate.

When everyone has received the approximate cost information, the idea of an ILIT should be reaffirmed with the client. In addition, the advisors and the client should discuss and decide upon the carrier, the type of policy, and the funding configuration (i.e., over how many years will the premium be paid, how will the premium payments be designed.)

ACT TWO:

SCENE 1: Once the client has given the green light to move forward, the attorney (if he or she is not the primary advisor) should be notified to begin drafting. Concurrently, the insurance carrier should be notified to begin the formal underwriting process, usually consisting of an application to the carrier of choice and a physical.

We found a slight difference in opinion as to which should begin first: the drafting of the ILIT or the underwriting on the client. But no matter which actually comes first, both should be done as soon as possible after the informal medical is completed and the client gives the final go-ahead.

Completion of this step is especially critical, as the client's underwriting will typically expire within several months. If the attorney hasn't drafted the trust before the window closes, the client will have to go through another medical exam. This reflects poorly on all the advisors, and the delay may prove very costly as the client's health could have deteriorated during this time resulting in a less favorable underwriting classification and higher premiums, or worse, uninsurable status (or perhaps even the client's death). In fact, even if the client's health has not deteriorated, any additional physician's appointment will give reason to the carrier to review the file and possibly change the underwriting classification – which happens more often than people think.

Getting the draft done and executed well before the underwriting expires is especially important depending on how long the funds are held in Act Three. The rush of a check arriving and departing on the same day (or worse yet resorting to an oral declaration of trust when the document isn't done), all to beat the deadline, is an invitation to errors, client disappointment, and professional liability.

THE THIRD AND FINAL ACT:

SCENE 1: THE TIN SOLDIER:

The first scene of Act 3 begins with assigning the trust a tax identification number (TIN.) If the trust opens a trust bank account to hold the first contribution, some banks will not allow the trust to do so without a TIN.

If the ILIT is drafted as a grantor trust, the grantor's TIN (i.e., social security number) may be used.

However, many carriers won't accept anything but a TIN for the ILIT itself.

Obtaining a TIN is much simpler when using a corporate trustee as they have numbers on hand to assign.

SCENE 2: BANK ACCOUNT DECISION:

Before executing the trust, the actors involved should decide whether the trust will open a bank account and, if so, what kind.

If a bank account is not opened, the grantor may cut checks to the trustee and the trustee will endorse the check over to the carrier – an approach usually reserved for individual trustees.

If the trustee will open a bank account, the ideal account for this situation would be one that does not require a minimum balance, one that does not charge a fee, and one that, if it does accrue interest, is federal and state tax free.

TIME - AND TIMING - IS OF THE ESSENCE:

In short order:

1. the trustee and grantor execute the trust,

2. the trustee opens the trust's bank account (where applicable,)

3. the grantor makes the first contribution to the trust, and

4. the trustee notifies the Crummey beneficiaries of their withdrawal rights.

5. As soon as possible, the trust must apply in its name to the insurance carrier for the policy.

If this is not done, the trust will not be listed as the owner on the policy when issued, thus bringing Code Section 2035 back into play.

If you recall from Act Two, the grantor submitted a preliminary application for the insurance. To keep the underwriting file open, avoid the need for re-examination, and preserve the terms of any offer from the carrier, we suggest the parties employ one of two methods depending on the carrier.

1. The trust submits a substitute application or

2. The grantor withdraws the preliminary application and the trust submits a new one.

HOW LONG SHOULD FUNDS REMAIN IN THE TRUST?

Then there is the debated issue about how long funds should remain in the trust account before the trustee pays the first premium. On the one hand, if a change in the client's health occurs before the premium is paid, there is the realistic possibility that the carrier will change the underwriting classification. So some practitioners have the trustee pay the premium weeks, days, even hours after the grantor has made the first contribution.

On the other hand, some practitioners strongly believe that the trust funds should remain in trust for the entire Crummey period to avoid the risk that the IRS will determine that everyone was acting pursuant to an understanding that the Crummey beneficiaries would not exercise their rights to withdraw and therefore disallow the gift tax exclusion, causing the grantor to have to eat into his/her lifetime gift tax exemption or pay a gift tax.

Theoretically only, if the cash is not held in trust for the entire Crummey period and somehow the Service were to make a rapid determination as above, the trustee could exercise its right to return the policy for full money back during the free look period, thus arguably making moot the Service's determination.

Incidentally, the free look period varies by state, type of policy and carrier and may not offer protection for the full Crummey period.

THE ENCORE:

An ILIT can be a great strategy for a client who needs liquidity at death to pay potential estate taxes or who wants to benefit his/her family with tax free wealth at death. But if all the actors aren't reading the same script, and the director isn't co-ordinating the cast's efforts, your client may be staging much sound and fury but signifying worse than nothing.

Hopefully, we have provided a "best practices" approach to creating and funding an ILIT.

If expectations are set in advance, the intricate timing involved with an ILIT production should be executed correctly and smoothly. If you are acting as the primary advisor and the production is a success – everyone will applaud your efforts.

HOPE THIS HELPS YOU HELP OTHERS!

Jeffrey Lauterbach   *Trisha W. Hall*

LISI extends its appreciation to the following planners for their helpful comments and contributions to this commentary: **Kim Ciccarelli Kantor**, CFP, Ciccarelli Advisory Services, Inc.; and **Robert Strauss**, J.D., Weinstock, Manion, Reisman, Shore & Newman.

CITE AS:

Steve Leimberg's Estate Planning Newsletter # 625 at **http://www.leimbergservices.com**

REFERENCES:

Zaritsky and Leimberg, **Tax Planning With Life Insurance** (800 950 1216); Grassi, **A Practical Guide to Drafting Irrevocable Life Insurance Trusts** (800 253 6397); Mezzullo, **An Estate Planner's Guide to Life Insurance** (800 – 285-2221). Leimberg, Plotnick, Evans **The New New Book of Trusts** (610 924 0515); Brody, **The Irrevocable Life Insurance Trust: Forms With Drafting Notes** (800 285 2221). Wealth Transfer Planning is an excellent drafting tool (888 315 0872) which we'll be reviewing in an upcoming LISI commentary.