

Life Insurance Trusts

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A hot topic currently being flogged by life insurance practitioners, often joined by new business officers from corporate trustees, is a presumed duty of the trustee to evaluate and recommend changes in the policy form and carrier. The concern arises from the poor economy and the risk of carrier insolvency, together with policy cost and the missed opportunities arising from holding onto the old policies too long.

I will concede that there is an almost uniform absence of attention by nonprofessional trustees of irrevocable life insurance trusts to certain mandated duties: dealing with Crummy powers and gift tax returns. I am less certain about the existence of a duty to select and monitor carrier quality and product cost.

- The aim of the Crummy powers is to avoid encroaching on the insured's \$1 million lifetime gift tax exemption, and thereby part of the \$3.5 million applicable exclusion amount for federal estate tax. It does so by converting annual trust contributions for premium payments to "present interest" gifts covered by the \$13,000 gift tax *annual* exclusion.

The manner in which the conversion is effected is written notice from the trustee to remainder beneficiaries of the trust that the contribution was made and that the beneficiary has 30 days in which to withdraw it. If no withdrawal, the right lapses and the contribution is applied to the premium payment then due. Beneficiaries must, of course, be enlightened as to the insured's expectations. The problem is that nonprofessional trustees invariably fail to calendar and implement the notice requirements.

- When the trust may (intentionally or by unexpected circumstance) pay benefits to two or more generations, and the annual premiums exceed the annual gift tax annual exclusion amount, distributions may be subject to the generation-skipping transfer tax (45%) when distributed to "skip persons" (generally grandchildren and beyond). This is in addition to any gift or estate tax otherwise applicable. A \$3.5 million exemption is provided, separate from the exemption for gift tax and the exclusion for estate tax. In order to be certain that none of the exemption is wasted, however, it should be allocated by the trustee in an annually-filed gift tax return, *Form 709*.

Transfers are not subject to generation-skipping transfer tax if no gift tax was imposed on the transfer due to the annual gift tax exclusion (*IRS Publication 448*), and the property transferred was not part of the transferor's gross estate for federal estate tax purposes. (Treas. Reg. 26.2611-1) This points up the importance of adhering to the Crummy notice rules.

By allocating to the trust a portion of the exemption equal to the premiums paid,

important tax leverage is accomplished. That is, the full face value of the life insurance policy owned by and payable to the trust is excluded from both the estate tax and the generation-skipping transfer tax, even though the aggregate premiums are much less. If the reporting is left until the insured dies, the entire face value of the policy must be covered by the allocated exemption, losing the leverage.

For example, a \$1 million policy has a premium of \$30,000 annually. Crummy provisions for three beneficiaries avoids gift tax on the annual contributions to the trust, and the allocation of \$30,000 per year from the generation-skipping transfer tax exemption keeps the entire trust exempt from that tax. If the insured dies after 10 years, the \$300,000 aggregate exemption allocation excludes the entire death benefit, and \$700,000 of the exemption remains available for use in protecting some other part of the insured's estate.

While the transaction memorandum of the careful practitioner will cover these duties in detail, even offering language for the *Form 709* exemption allocation attachment, few nonprofessional trustees remember to prepare and file the gift tax returns. That leads to the big surprise after the death of the insured, and as noted, total loss of the tax leverage.

The two points noted above amount to trustee malfeasance. They are told what to do, but almost uniformly fail to perform. This is fiduciary liability in its starkest terms.

To go beyond that, however:

- to suggest that the trustee has a duty to check the quality rating of the carrier selected by the insured or recommended by the insured's insurance agent;
- to suggest that the trustee has a duty to actively monitor the fiscal health of each carrier from year to year; or
- to suggest that the trustee must monitor industry trends as to rates and benefits, and to inform and advise the trust clients on when to seek product comparisons by which to keep costs competitive, goes too far.

Admittedly, these assertions provide a great door-opener for the life insurance salesman: I wish I had known that much when I was one. But it appears to me that the proponent is leaning on a bent reed. Imposing such duties is comparable to imposing on a lawyer a duty to keep all estate planning clients informed as to changes in the law affecting their respective plans. With thousands of clients (many of whom may have died, moved away, or changed lawyers), such a duty would be arbitrary (based on the claimant's preference) and capricious (fanciful). There is a line to be drawn, and that's where I would draw it.