ESTATE PLANNING

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Trust Owned Life Insurance (TOLI) Issues

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Foreword

The following remarks and comments were based in part on a review of a recent book, The Life Insurance Policy Crisis, *by E. Randolph Whitelaw and Henry Montag, published by the American Bar Association, and in part on an article that appeared in the appendix to the book. These comments also relate to a presentation about the book made on January 11, 2017, at the Heckerling Institute on Estate Planning, and include some additional thoughts and comments as to how the changing estate planning environment may have a significant impact on all of this. An earlier version of these remarks was published by Leimberg Information Services, Estate Planning Newsletter, #2503. For more information on the Whitelaw and Montag book, go to* www.shopABA.org.

INSIDE THIS ISSUE

7 IRS Provides Guidance on QTIP and Portability Elections

Monitoring Insurance Coverage

Some startling statistics from the book emphasize the importance of practitioners encouraging all clients to monitor their insurance coverage. This can be especially important for trustees of irrevocable life insurance trusts (ILITs). For example:

- 90 percent of ILITs are managed by trustees that have no particular background or skill in managing life insurance.

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EDITOR'S COMMENTS

February 2017

Gary L. Flotron, MBA, CLU, ChFC, AEP

An amazing event occurred at a reception on Wednesday evening, January 11, 2017, at the Heckerling Institute on Estate Planning. And I was lucky enough to be there. The ostensive purpose of the reception was to launch, promote, and celebrate the recent publication by the American Bar Association of a well overdue and exceptional book titled *The Life Insurance Policy Crisis: The Advisors' and Trustees' Guide to Managing*

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- About 39 percent of in-force nonguaranteed universal life policies, and 34 percent of in-force variable universal life polices, are illustrated by the carriers to lapse during the insured's lifetime or within five years of life expectancy. While this sounds incredibly worrisome, it likely understates the problem. There is a significant correlation between wealth and longevity so that the clients that have significant life insurance inside life insurance trusts are likely to have greater than average life expectancies.
- Those over age 65 appear to lapse life insurance policies at a shocking rate. Based on 2008 data, 1.1 million policies with a face value of $112 billion were lapsed. It appears that few of these considered the possibility of a sale of the policies prior to lapse.
- In 2013 the insurance policy lapse rate was 5.7 percent. 82 percent of those were merely allowed to lapse with no value to the owner.

Common ILIT Issues

ILIT issues arise with common frequency in practice as demonstrated by the following examples:

EDITOR'S COMMENTS (cont'd.)

Risks and Avoiding a Client Crisis, by E. Randolph Whitelaw and Henry Montag. But what made this such an exceptional evening were the observations, comments, and discussions on the book shared by such life insurance and estate planning luminaries as Larry Brody, Marty Shenkman, Richard Harris, and others.

For several years, Martin Shenkman, one of the contributing authors of supplemental articles in the book, has been writing commentaries on the presentations for each separate day of Heckerling. These commentaries are published in LISI (Leimberg Information Services, Inc.), a web-based publication which I highly recommend for every practitioner.

I was extremely delighted to see that Marty devoted considerable space in his coverage of the January 11 Heckerling sessions to the salient and very important topics of discussion at the reception. One of these topics was the problems with accommodation trustees and the premature disposition of life insurance policies on the belief that the life insurance will no longer be needed because of anticipated changes and elimination of the estate tax system.

Marty has reproduced his comments about the Whitelaw and Montag book and the Heckerling reception (which were originally published in LISI) for the benefit, and I believe enjoyment, of *Estate Planning* readers. I am personally very grateful to Marty and Steve Leimberg for allowing us to make this portion of the LISI article available. Believe me, you will like this one.

As an added bonus for this issue, we also feature a very timely and important article by Adam Farnsworth of Williams Mullen on the recently released IRS Revenue Procedure 2016-49, titled "IRS Provides Guidance on QTIP and Portability Elections." The revenue procedure puts to rest the uncertainty that the IRS would not respect a QTIP election coupled with a portability election even if the QTIP election is unnecessary to reduce a decedent's estate tax liability to zero.

Hope you enjoy this issue of *Estate Planning.* Please tell us what you think on the Estate Planning Section eGroup. ■

- Policies about to lapse or that have lapsed because no one had looked at the performance of the policy or the carrier since the policy was purchased decades earlier.

Example: In one case the client retained counsel to pursue the matter. When presented with two separate retainer agreements that expressly excluded life insurance selection, the law firm opted only to pursue the insurance broker.

- Policies cashed in instead of being sold or retained because a client with no input from any adviser decides he/she no longer needs the policy because the estate tax has become less relevant or irrelevant.

Example: Before contacting an experienced professional for an initial consultation, a surgeon had cancelled a number of Guardian Life policies that had been in force for nearly two decades and which were all owned by a well-crafted ILIT. His reaction was that he did not need the policies because of the increase in the estate tax exemption in 2013. His decision was made without any consideration of the income tax and significant asset protection benefits the well-done plan had afforded.

- A policy and trust that may be adequate but for which there are no records. Often there are changes in trustees that have never been reported to the insurance company and no documentation of those changes.

Example: A new client presented an existing ILIT. The ILIT was so old that the only copies of the trust anyone could find were missing several pages. There were two changes in trustees neither of which had been reported to the carrier which continued to list the initial trustee. The documentation appointing the successor trustees was also lost. Advisors should consider preparing a compilation of the trust instrument and all consents, actions, or documentation from inception to the current date anytime there is a significant change.

- The policy is found to be adequate but the trust instrument no longer serves the client's purposes so a combination of trust protector actions, decanting, disclaimers, etc., may correct the problems.

Example: The initial ILIT held funds in trust from a survivorship policy until each child was 35. At the time of evaluation each child was over 50. The old ILIT was decanted into a new ILIT with similar timers but lifetime trusts for the children.

The initial ILIT held funds in trust from a survivorship policy. The trust funds were supposed to be distributed when each child beneficiary turned 35 years of age. However, by the time the trust document was finally examined and evaluated each child was over age 50. The old ILIT was decanted into a new ILIT with similar terms and beneficiaries, but instead of distributing the funds outright to the beneficiaries at a stated age, the funds were held in trust for the lifetime of each child beneficiary to be used and distributed to each beneficiary as the independent trustee saw fit. This provided greater flexibility to the beneficiaries and protection of the trust funds from creditors, divorcing spouses and transfer taxes.

Shifting Policy Risk

Flexible premium nonguaranteed death benefit policies have become common and many clients and individual ILIT trustees do not understand that these policies shift the performance risk from the insurance company to the policyowner.

Life Insurance as an Asset Class

Life insurance can be viewed as an asset class. The death benefit does not correlate with other asset classes. Tax deferral, tax-free withdrawals, and loans are unique features that differentiate insurance from other assets.

Selection of Fiduciaries

Trusts, including ILITs, are the keystone of most

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estate plans. Whether a client has sought asset protection benefits, estate tax savings, probate avoidance, or most recently basis step-up techniques, trusts have often been part of the solution.

The incredible flexibility trusts bring to financial and estate planning has placed them in a position of prominence in the planner's toolkit. An essential component of every trust plan is the client's selection of fiduciaries. Most clients have, and continue to, shun institutional trustees. After all, institutional trustees charge fees and are rigid in their willingness to act. The solution for many clients appears simple—selecting an individual trustee who is typically a close family member or occasionally a friend. While theoretically that decision can provide as beneficial a result as naming a skilled institutional trustee, it is unlikely to be the case. The siren call of simplicity and low cost too often leads clients and their families down a dangerous path.

Duties of the ILIT Trustee

- The terms of the trust agreement create obligations on the trustee as do state laws. The Prudent Investor act may apply.
- Because IRC Section 2042 prohibits the grantor/insured from retaining incidents of ownership in the policy, the grantor/insured cannot exercise powers over the policy and the trustee must do so.

Other Considerations

Family and friends can serve effectively as trustees, but most will require professional guidance to do so.

The means of achieving this positive fiduciary experience, for the both the trustee serving and the beneficiaries involved, is rather simple and obvious to the professional adviser, but unfortunately not so for most individual trustees.

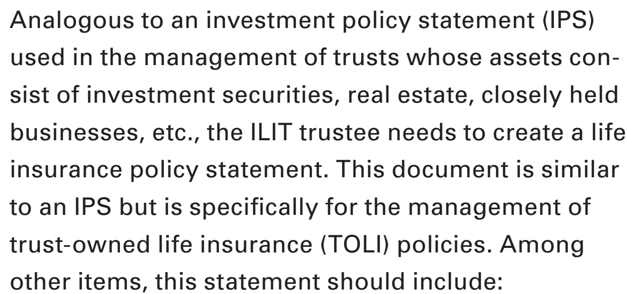
Individual trustees should meet with appropriate professional advisers before beginning to serve. A trust attorney can dissect the trust governing the trustee position so that the trustee can understand in specific terms his or her rights, duties, obligations, and so forth. This process will involve annotating and or summarizing the trust instrument to create a more accessible guide to the provisions of the governing trust. A checklist of operations can also be quite useful. Counsel should advise the client trustee about the importance of periodically reviewing the operations and status of the trust, communications with and distributions to beneficiaries, etc. Unless counsel has the expertise to address insurance specifics, consider expressly excluding insurance design and selection decisions in the retainer letter.

Trustees should meet with a CPA, who has specific expertise in trust income tax planning, to review general planning implications, year-end tax planning if the ILIT holds more assets, and trust recordkeeping. The CPA should arrange for the filing of Form 56 informing the IRS of the new trustee relationship and Form 1041, if applicable.

Trustees should meet annually with the professional advisers guiding the investment in trust assets if the client is not an expert in the field. This might be, depending on the nature of the trust, a wealth manager for marketable securities, an insurance consultant for life insurance, or other specialists. Certainly the key take home message of the Whitelaw/Montag book is that periodic reviews by an insurance expert to actively monitor insurance coverage are essential. The ILIT trustee should demonstrate a reasonable process of evaluation of steps taken. See the case *Cochran v. KeyBank* which deals with a claim of breach of fiduciary duty for ILIT trustees.

Managing Life Insurance as a Trust Asset

Nonprofessional ILIT trustees need to understand that life insurance is not a buy-and-hold proposition but rather an asset that must be actively managed.



Analogous to an investment policy statement (IPS) used in the management of trusts whose assets consist of investment securities, real estate, closely held businesses, etc., the ILIT trustee needs to create a life insurance policy statement. This document is similar to an IPS but is specifically for the management of trust-owned life insurance (TOLI) policies. Among other items, this statement should include:

1. Product suitability and product design determinations. This is complicated by the broad range of products and product enhancements offered by insurance companies.
2. Carrier selection and underwriting.
3. Annual performance monitoring and risk management.
   - Is the policy performing in a manner consistent with the illustrations?
   - What is the insured's age at the date the policy is projected to lapse?
   - Are policy charges competitive?
   - Has the insured's health changed? Consider an actual life expectancy analysis.
   - What riders exist?
4. Periodic remediation and restructure. The book cautions how replacement of policies, while sometimes warranted, can be detrimental to the policyowner.

A new policy may provide a more efficient premium and new benefits. If a policy is sold into the life settlement market consider the income tax implications. Rev. Rul. 2009-13 provides guidance on this topic. Agents may have an obligation to inform policyholders of the existence of the life settlement market. See *Larry Grill et al. v. Lincoln National Life Insurance Company,* 5:2014 CV 00051 U.S. District Court, California Central District.

While there are certainly more steps individual trustees can and should take, it is not that difficult or costly to hire the appropriate experts to guide the trustee in carrying out his or her fiduciary duties. Appropriate professional guidance, with a modicum of recordkeeping, diligence and follow up, may suffice for many individual trustees. The reality is that few individual trustees consult with professional advisers after the trust is formed other than to have an accountant (and not always one with particular trust expertise) prepare income tax filings, unless and until a problem arises.

Individual Trustees Do Trip Up

While it might be theoretically possible for an unskilled individual trustee to carry out his or her duties in a reasonable manner without consulting professional advisers regularly, unless that individual trustee has particular knowledge and training, or is one of those rare individuals who thoroughly researches and tackles the unfamiliar, that positive result may be unlikely.

Consider the nearly ubiquitous ILIT trust administrative step of completing Crummey powers. How many individual trustees who do not work with their professional advisers actually complete this task reasonably well with any degree of consistency? If this task is not completed often or well, what can be expected regarding more complex tasks?

How many individual trustees have an investment policy statement governing the trust they serve? How many individual trustees are even familiar with what an IPS is?

Individual trustees should solicit trust beneficiaries to identify information relevant to the trustee decision making. How can a trustee identify beneficiaries to whom distributions may provide an overall tax benefit without knowing the current and likely future tax status of the beneficiaries? How can, in the context of an ILIT, the trustee assess the continued relevance of the original rationale for the insurance plan, policy design, etc.?

When is the last time individual trustees have

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reviewed life insurance held in a trust for which they serve as fiduciary? What is the likelihood of a trust insurance plan succeeding without regular professional involvement? For many ILITs, this is not particularly likely. This is a key point of the book and why it goes to lengths to stress the importance of advisers guiding unskilled (in terms of life insurance knowledge) ILIT trustees to retain appropriate experts to assist in monitoring coverage.

For ILITs, when is the last time that an individual trustee inquired with some specificity as to the health status of the insured? This might actually be a task that is more difficult for the family member or friend then an institutional trustee to perform. How can the appropriateness of an existing life insurance program be evaluated without the trustee having any current medical knowledge?

How many individual trustees have sought guidance as to the usefulness of a particular ILIT insurance plan in light of the dramatic changes in estate and income tax laws in the 2012 tax act? How many have simply cancelled existing policies and terminated ILITs (typically with no formal documentation) because "the policy isn't needed any longer to pay estate tax," with no analysis whatsoever of the performance of the policy, income tax benefits, possible legacy building, and other nonestate tax paying purposes? Few of these individual trustees could imagine the liability exposure they might face for inappropriately cancelling a policy with no supporting corroboration.

If the Trump administration eliminates the estate tax as proposed, there is likely to be a flurry of cancellations or surrender of ILIT policies for their cash value. Individual ILIT trustees should be warned not to act in haste. Before any modification of the coverage, consideration should be given to the original purpose for the policies and the relevance of those factors in the current environment. While a policy may have been purchased to pay a federal estate tax that no longer applies, it may still have relevance to pay a state estate tax or a capital gains tax on death—which is one of the proposals of the Trump administration.

Even if the individual trustees take the appropriate action, in many cases they fail to document that action as to reasonableness or to inform beneficiaries of their actions. Endeavoring to corroborate the rationale for an action after the fact is never easy and rarely as persuasive as contemporaneous records.

As the population continues to age and the myriad of existing trusts mature, the potential for problems with these informalities mounts, and the likelihood of lawsuits grows.

Worse Issues with Individual ILIT Trustees

While the problematic issues noted above that can be so common with individual trustees are substantial, a further concern is that individual trustees (because they often do not adhere to trust disclosure rules or other formalities), may also be tempted to engage in inappropriate self-dealing transactions, mismanagement, over-charging, and worse transgressions. Unless checks and balances are built into the trust, e.g., a trust protector, specified reporting, or a cotrustee, the ability to take advantage of the position of being a trustee, or even to defraud beneficiaries, may be too great. ■

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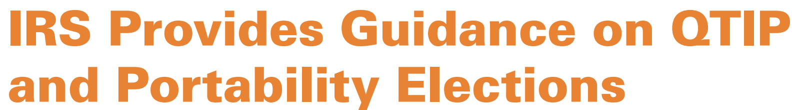

IRS Provides Guidance on QTIP and Portability Elections

Adam Farnsworth

The Treasury and the IRS can cross off another project from their joint priority guidance plan. IRS Revenue Procedure 2016-49, effective as of September 27, 2016, settles an issue arising when both QTIP and portability elections are made on a decedent's estate tax return. According to Rev. Proc. 2016-49, a QTIP election can be made on a portability-only return. Consequently, property passing from a deceased spouse's estate to a surviving spouse in trust may qualify for the marital deduction without using up the deceased spouse's unused applicable exclusion amount (more commonly referred to as the "DSUE amount"), even where the marital deduction is unnecessary to reduce the taxable estate to zero. To achieve this result, the executor of the deceased spouse's estate must make a proper portability election.

QTIP and Portability Elections

The QTIP election is a common way to qualify property passing in trust from a decedent to a surviving spouse for the estate tax marital deduction. Generally, the value of property given to a surviving spouse is not deductible for estate tax purposes if the decedent gives the surviving spouse a "terminable interest" in that property. Exception to this terminable interest rule is made for qualified terminable interest property, or QTIP. QTIP is generally property in which the surviving spouse has a qualifying income interest for life. For marital deduction purposes, QTIP is deemed to pass to the surviving spouse and not to any other person. As a result, the property's value can be deducted from the decedent's gross estate. To take advantage of this treatment, the executor must affirmatively make a QTIP election with respect to the qualifying property on the decedent's timely filed estate tax return.

Another important election available to the executor of a decedent's estate has come about more recently. In 2010, Congress changed the Internal Revenue Code to permit the executor of an estate to elect to transfer, or "port," the DSUE amount to the surviving spouse for his or her benefit. This so-called "portability election" permits the surviving spouse to apply the DSUE amount of a deceased spouse when making transfers during life and at death. In this way, a surviving spouse's applicable exclusion amount will equal his or her own applicable exclusion amount plus the remaining amount from his or her deceased spouse.

The Unnecessary QTIP Election and Revenue Procedure 2001-38

Many professionals have become concerned with the advent of portability that, in certain situations, making both elections might create an unnecessary QTIP election, thereby running afoul of prior IRS guidance in Rev. Proc. 2001-38. Under Rev. Proc. 2001-38, which was issued well before portability, the IRS stated that it would disregard and treat as a nullity for estate, gift, and GST tax purposes a QTIP election made in cases where the election was not necessary to reduce the estate tax liability to zero. This would be the case, for example, where the decedent's total estate was worth less than his or her remaining applicable exclusion amount. In that case, the decedent's remaining applicable exclusion amount would reduce any estate tax liability to zero. If the estate tax liability were zero, a QTIP election, used to qualify property for the marital deduction, would be unnecessary as it could not reduce the estate tax liability below zero.

Because Rev. Proc. 2001-38 was issued before, and clearly does not contemplate portability, the question many wrestled with was whether Rev. Proc. 2001-38 would block a QTIP election on a portability-only return. Rev. Proc. 2016-49 addresses this very question.

Applying Rev. Proc. 2016-49

In Rev. Proc. 2016-49, the Treasury and the IRS make clear that where the executor of a decedent's estate makes the portability election, a simultaneous QTIP election with respect to the decedent's property, including unnecessary QTIP elections, will not be treated as void, so long as such QTIP elections are properly made.

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IRS Provides Guidance

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This now clarifies that QTIP elections will not be ignored for gift, estate, and GST tax purposes where: (i) a partial QTIP election was required with respect to a trust to reduce the estate tax liability, and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero; (ii) the QTIP election was stated in terms of a formula designed to reduce the estate tax to zero; (iii) a protective QTIP election under Reg. § 20.2056(b)-7(c) was properly made; (iv) the executor of the estate made a proper portability election; or (v) certain procedural requirements to affirmatively treat a QTIP election as void are not met.

Conversely, Rev. Proc. 2016-49 provides that certain QTIP elections will still be considered void, so long as all of the following are met: (i) the estate's federal estate tax liability was zero, regardless of the QTIP election, making the QTIP election unnecessary; (ii) the executor of the estate neither made nor was considered as making the portability election; and (iii) certain procedural requirements set forth in Rev. Proc. 2016-49 to affirmatively treat a QTIP election as void are met.

Conclusion

Rev. Proc. 2016-49 puts to rest a fear that certain QTIP elections would not be respected by the IRS, even though properly made. Instead, Rev. Proc. 2016-49 provides that the IRS will respect a QTIP election even if such election is unnecessary to reduce a decedent's estate tax liability to zero. ■

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