



(/news/publications/the-cpa-journal)

Welcome to the new – and evolving – online home of The CPA Journal.

About (/news/publications/the-cpa-journal/about-the-journal)

Editorial Team (/news/publications/the-cpa-journal/editorial-team)

Browse Subjects

Archives (/news/publications/the-cpa-journal/archives)

Submission Guidelines (/news/publications/the-cpa-journal/submission-guidelines)

Classifieds (/news/publications/the-cpa-journal/classifieds)

September 2016 (issue?IssueID=235) » CPAs' Growing Role in Trust-Owned...

CPAs' Growing Role in Trust-Owned Life Insurance Planning

Chad L. Reyes and Robert J. Adler, JD

In Brief

CPAs have a tremendous responsibility to provide individuals with timely and accurate information, especially in the realm of life insurance and estate planning. The authors examine issues related to proper management of irrevocable life insurance trusts, the legal standards of care for such management, and the pitfalls surrounding the taxation of such trusts. They also share the checklist they have developed to help trustees understand and fulfill their responsibilities.

Many individuals who own life insurance for estate planning purposes keep it in an irrevocable life insurance trust (ILIT) so that the death benefit proceeds are excluded from the individual's estate. It is incumbent upon CPAs advising such individuals to ask when, if ever, these policies have been reviewed. Will the policy lapse due to poor policy performance or lack of appropriate premium funding, or are there better policy options available that are in the best interest of the beneficiaries? Studies have found that 85% of trust-owned policies could be restructured to provide more value. In addition, 71% of ILIT trustees say they have not reviewed their trust's life insurance policies in the last five years, and 84% do not have stated guidelines and procedures in place for handling life insurance (Mark Teitelbaum, "Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make," *Journal of Financial Service Professionals*, July 2005). This is a far cry from any definition of due diligence, and, as shown below, CPA financial advisors are obligated to do better.

The Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA), first promulgated in 1992 by the American Law Institute's *Third Restatement of the Law of Trusts* and adopted by most states, establishes standards for trustees in upholding their duty to manage and invest trust assets as a prudent investor would, exercising reasonable care, skill, and caution. This care must be extended not only to traditional forms of investments—stocks, bonds, mutual funds, and real estate—but to all portfolio assets, including life insurance portfolios. The risks and quality of assets given to a trust or subsequently purchased by the trustee must be constantly reviewed.

The UPIA provides that the trustee has a "continuing responsibility for oversight of the suitability of investments already made, as well as the trustee's decisions respecting new investments."



(/cpaj-images/CPA.2016.86.9.028.uf001.jpg)

The UPIA provides that the trustee—that is, the individual, financial institution, or CPA charged with operating and managing the trust—has a “continuing responsibility for oversight of the suitability of investments already made, as well as the trustee's decisions respecting new investments.” In addition, “within a reasonable time after accepting a

trusteeship or receiving trust assets, a trustee shall review the trust assets and implement decisions concerning retention and disposition of assets.” The UPIA standards relevant to life insurance include:

- Assessing risk tolerance, and taking into consideration “the purposes of the trust and the relevant circumstances of the beneficiaries.”
- Taking into consideration general economic conditions, expected tax consequences of investment decisions and strategies, adequate diversification of the investments, and an asset's special relationship or value, if any, to the purpose of the trust.

The UPIA applies to all trustees, whether individuals, professionals, or corporate trustees. When the trustee, however, is not a corporate trustee (such as a bank trust department), but rather an individual (typically a family member or friend), it is not uncommon for the maker of the trust (the grantor) to attempt to relieve the trustee of some or all of his fiduciary responsibilities with respect to any life insurance gifted to or purchased by the trust.

Illustrated Promises and Unmet Expectations

At bank trust departments, investment assets of a trust are regularly reviewed at investment committee meetings, and specially trained investment personnel may even monitor them on a daily basis when dealing with traditional investments such as securities. Investment research is either subscribed to or performed personally by the staff of the trust department's investment unit in order to assess the financial strengths of companies and government agencies and to determine if their equity or bond offerings are “investment grade.” Trust departments can rely upon rating services and other resources (e.g., Moody's, Standard and Poor's). Furthermore, from those approved investments, the trustee must determine what is appropriate to the overall objectives and purposes of the trust itself. Individual trustees rarely have the ability to do this type of investment management and may need to hire third-party managers. The same holds true for life insurance owned by an ILIT.

Unfortunately, the illustrations life insurance professionals use to promote their services typically bear no resemblance to the actual performance of policies. As Richard Weber says, “the illustrations create the illusion that the insurance company knows what will happen in the future and that this knowledge has been used to create the illustration” (“Illustrated Promises, Unmet Expectations,” *Insurance News Net Magazine*, July 2013, <http://bit.ly/2b4c1Rk> (<http://bit.ly/2b4c1Rk>)). There is nothing further from the truth. All too often, policyholders conflate the cost of the policy with the “premium.” In truth, there are many ways to analyze the true cost and effectiveness of a policy, and the

premium should not be the only or even primary factor considered. Other factors of equal importance include 1) financial strength and claims-paying ability of the insurance company, 2) cost competitiveness and pricing style, 3) pricing stability, 4) relative policy value, and 5) cash value allocation options. In addition, many insurance professionals claim to document suitability, but these claims are based on hypothetical illustrations and are often subjective in nature. Insurance industry authorities consider this practice misleading and improper.

The TOLI Experience Checklist

The sad fact is that most trustees, including CPAs, do not have guidelines and procedures in place to rate and monitor life insurance. With the standards imposed by the UPIA, trustees are exposing themselves to liability from lawsuits involving trust-owned life insurance. To avoid this liability, trustees must establish and maintain adherence to policies and procedures for the evaluation of life insurance in a trust that will enable the trust to accomplish the intended purpose of the grantor, just as any trustee would for an equity, bond, or mutual fund portfolio. The *Exhibit* shows the Trust-Owned Life Insurance (TOLI) Experience Checklist used by Wealth and Legacy Group (whose CEO is one of the authors of this article) to help trustees be methodical with documenting completed items that pertain to their responsibilities.

EXHIBIT

TOLI Experience Trustee Checklist

- Understand the objectives and terms of the trust
- Develop a reasonable investment strategy
- Adopt a written Investment Policy Statement (IPS)
- Implement the strategy with appropriate financial products
- Regularly review policies and investments
- Make changes as needed
- Monitor performance of life insurance policy
 - Review in-force policy illustrations
 - Compare in-force illustrations to the original illustration given when the policy was purchased
 - Compare to previous years' in-force illustrations to determine performance needs
 - Analyze policy performance to date and estimate likely performance in the future
 - Review the current ratings of the insurer, noting any changes since last review
 - Complete and submit an application for one or more new policies from an insurer whose ratings meet the standards in the IPS
 - Compare the projected premiums, death benefits, cash surrender values, and provisions of current policy and new policy(ies)
 - Assess the competitiveness of the current policy with the new policy
 - Add, subtract, or exchange policies owned by the trust as needed
 - Document all actions made in this review process
 - Reevaluate all trust-owned policies every year
- Keep a record of all information about the trust
 - Objectives of the trust
 - How long the trust is likely to last
 - Beneficiaries of the trust
 - Actions required of the trustee
 - Provisions regarding life insurance
 - Provisions regarding diversification
 - Contributions to the trust
 - Projected additional contributions to the trust
 - Estimated timing and amounts of distributions
 - Provisions for trustee succession
 - Observations or concerns about the trust
- Obtain trustee signature on checklist document

Life insurance is complicated and outside the normal investment management and review practices of most trustees. While there are resources available to assess the financial strength of an insurance carrier, prudent investor review may cause trustees to conclude that they are not sufficiently familiar with the many complicated issues that could negatively affect TOLI and that they lack the resources necessary to perform the analysis and evaluation themselves. As good as the ratings services and other resources are, they cannot address the many permutations and differences among policies—different carriers, designs, guarantees, expenses, riders, endowment considerations, and mortality assumptions—all contributing to the wide variety of policies and their appropriateness given the grantor's goals and objectives and the beneficiaries' needs. While many trustees are reluctant to delegate this function of their fiduciary responsibility, they are nevertheless under an obligation to do so.

TOLI is not a stagnant financial asset, but rather an ongoing and changing investment among a world of alternatives that requires prudent analysis and review by a fiduciary on an annual basis, as with any other trust investment. The duty of the trustee, individual or corporate, is clear: determine the financial soundness of the insurer on a regular basis (carrier solvency) and whether the policy is performing as anticipated to meet the goals and objectives of the grantor when considered against alternative available policies (product performance). Only by so doing can the trustee rest assured that she has properly performed her fiduciary duty.

Trustees must establish and maintain adherence to policies and procedures for the evaluation of life insurance in a trust that will enable the trust to accomplish the intended purpose of the grantor.

Failure to Appreciate the IRC Section 2036 Problem

Consider the following scenario: Joe and Jane are married and have three children. Joe establishes an ILIT by the transfer of property owned by him. The trust provides that trust income is payable to Jane for life, with the trust corpus distributable in equal shares to the children upon Joe's death. The couple anticipates that both Joe and Jane will contribute additional funds to the trust in the future. Therein lies a potential tax trap: Under IRC section 2036, one of the so-called "strings-attached" provisions of the estate tax, lifetime transfers of property in which the transferor retains a life income interest are, in effect, treated as incomplete transfers. If the transferor still retains the income interest as of the date of death (or within three years prior to death), the property will be includable in his gross estate. Therefore, any contribution by Jane to the trust in which she is the life income beneficiary will be subject to section 2036, and upon Jane's death at least some portion of the trust will be includable in her gross estate. This result can be avoided by having all transfers to the trust made from the separate assets of the grantor-spouse (i.e., Joe), with none originating from the income beneficiary-spouse (Jane).

The IRC section 2036 tax trap is well illustrated by the facts of a private letter ruling involving a Crummey trust. PLR 200130030 dealt with a case where a wife and mother of three children established a trust by the transfer of property owned by her. The trust provided that trust income was payable to her husband for life, with the trust corpus distributable in equal shares to the children upon the death of the last of the couple, provided that all of the children were over 25 at that time. The husband was named trustee of the trust; he did not have a general power of appointment over the trust property, and his discretionary authority to distribute the corpus to himself and to the children was limited by an ascertainable standard.

In order to take maximum advantage of this Crummey trust arrangement, the couple intended to make annual transfers of the maximum that could be excluded from gift tax through the \$10,000 (at that time) per donee annual exclusion. Since all three children held Crummey withdrawal powers, if the parents each transferred \$10,000 for each child, the couple could transfer a total of \$60,000 each year free of transfer taxes. But the husband held a life income interest in the trust; thus, as explained above, any transfers by him to the trust would eventually cause at least some portion of the trust to be includable in his gross estate.

As confirmed in PLR 200130030, the section 2036 tax trap can be avoided in such a situation through statutory gift-splitting under IRC section 2513(a). Instead of the husband and wife each transferring \$30,000 to the trust (\$10,000 with respect to each child/beneficiary), the wife would transfer \$60,000 from her separate property, and the husband would consent to a gift-splitting election. IRC section 2513 provides that, for gift tax purposes, a gift made by one spouse to any person other than his or her spouse shall be considered as made one-half by each spouse, provided that both spouses signify their consent in compliance with the requirements of IRC section 2513(b). Thus, through an effective gift-splitting election, the husband and wife would each be deemed to have made \$10,000 gifts to each of the three children.

If section 2513(a) deems such a split gift to have come 50% from the husband, does this trigger the section 2036 trap? Not according to the letter ruling, which cited several published Revenue Rulings. Although the couple filed an election under section 2513 to treat the gifts to the trust made by the wife as if made one-half by each spouse, the wife was treated as the transferor of the entire value of the gifts to the trust for purposes of the strings-attached estate tax provisions (IRC sections 2036, 2037, and 2038). Thus, the ruling stated that section 2036 does not apply to property interests that the decedent did not actually own, and thus did not actually transfer.

Failure to Appreciate Potential Gift and Estate Tax Exposure of Holders of Crummey Powers

The lapse of a Crummey demand power is treated as a release of a general power of appointment to the extent that the lapsed withdrawal right exceeds the five-and-five rule. For example, assume that the Crummey power holder allows a right to withdraw \$7,000 to lapse and that, during the period when the withdrawal right could have been exercised, the total value of the trust was \$80,000. The five-and-five rule will treat \$5,000 (the greater of \$5,000 or 5% of the total value, in this case \$4,000) as a nontaxable lapse and the remaining \$2,000 as a release of a general power of appointment (i.e., as if the power holder had transferred \$2,000 of his own assets to the trust). Whether or not there is a taxable gift will depend upon the terms of the trust and general principles of gift taxation.

As far as estate taxes are concerned, IRC section 2041(a)(2) includes the value of property subject to a general power of appointment that was released or exercised prior to the decedent's death in her gross estate if the result of the release or exercise is the creation of a retained interest (IRC sections 2036, 2037, and 2038). Thus, in the case of a Crummey power granted to a spouse, if the demand power is not limited by the five-and-five rule, the lapse of the spouse's Crummey power is treated for transfer tax purposes as a release of a general power of appointment. Under these circumstances, if the post-death dispositive provisions give the surviving spouse a life-income interest in trust assets, the spouse has made a transfer with a retained life income interest per section 2036, creating an estate tax problem.

Failure to Plan for Mitigation of Potential Three-Year Rule Impact

In circumstances where an irrevocable trust is established for the transfer of an existing policy owned by the insured, the risk of an early death causing the policy proceeds to be included in the insured's gross estate will remain during the first three years after the transfer. While this risk cannot be eliminated, the ILIT can contain certain contingency provisions designed to mitigate the adverse estate tax impact of inclusion of the insurance proceeds in the gross estate. These provisions represent, in effect, an alternative plan that would automatically go into effect only if the insurance proceeds ultimately must be included in the gross estate.

The contingency provisions in the trust should be triggered by any circumstances that result in the insurance proceeds being includable in the gross estate.

In a situation where a surviving spouse is to be a major beneficiary of the insurance proceeds received by the trust, the first alternative for escaping estate tax, if the insurance proceeds must be included in the gross estate due to the three-year rule, is to include a marital deduction savings clause. In general, property passing from an estate to a surviving spouse is fully deductible from the gross estate. Thus, the trust should contain contingency provisions that would transfer the property to the surviving spouse in such a manner that it would qualify for the marital deduction either outright or in trust. In a situation where the marital deduction is not a feasible contingency plan (e.g., a widow who transfers a policy to a trust for the exclusive benefit of adult children), consideration should be given to whether the estate tax on the insurance proceeds should be paid from the trust or from other assets in the estate, whether the estate is expected to have sufficient other assets, and whether the estate beneficiaries differ from (or hold interests that are different from) the trust beneficiaries.

Although the above contingency discussion centers on the three-year rule of IRC section 2035(d), the operation of the contingency provisions in the trust should be triggered by any circumstances that result in the insurance proceeds being includable in the gross estate. This would cover changes in the tax law or IRS interpretation and inadvertent or intentional retention by the insured of what the IRS may deem an incident of ownership.

The Duty of Care

Like most estate arrangements, ILITs are complex, with stringent duties of care and a labyrinth of tax issues to navigate. CPA financial advisors have a professional duty to guide their clients through the process of establishing, maintaining, and eventually disbursing the assets of these trusts in a way that meets the clients' financial goals. The task is far from easy, but with proper diligence and mastery of the rules, it can be done.

Chad L. Reyes is president and CEO of Wealth and Legacy Group, Staten Island, N.Y.

Robert J. Adler, JD is a wills, trusts, and estates lawyer at Adler & Adler PLLC, New York, N.Y.



([http://www.copyright.com/ccc/openurl.do?
&issn=0732-
8435&WT.mc.id=New
York State Society
of Certified Public
Accountants](http://www.copyright.com/ccc/openurl.do?&issn=0732-8435&WT.mc.id=New York State Society of Certified Public Accountants))

[Advanced search » \(search\)](#)

©2016 New York State Society of Certified Public Accountants