STEPHAN R. LEIMBERG AND ALBERT E. GIBBONS

# Performing Due Diligence With Respect to Life Insurance Trusts Is Crucial

Irrevocable life insurance trusts are among the most important of all estate planning tools. We've asked Drew A. Bender of U.S. Trust Company of New York to analyze the issue of due diligence with respect to life insurance and life insurance trusts from a trust officer's viewpoint. Every attorney who drafts trust documents, every trust officer who accepts trust documents, and every life insurance agent or financial planner involved in establishing these trusts will find Drew's responses to our questions eye-opening and his checklist invaluable.

### Due diligence defined

*Leimberg/Gibbons:* What exactly do you mean when you use the term "due diligence"?

*Bender:* The concept and performance of due diligence is an integral part of the work done by nearly all corporate attorneys and others who work in the mergers and acquisitions field, but when this term is applied to the realm of estate planning and personal trusts, due diligence means different things to different people. Due diligence consists of the steps taken to lessen the risk to a fiduciary prior to entering into a contract (e.g., an irrevocable trust instrument) and purchasing, accepting, or retaining trust assets (e.g., life insurance).

Considering the almost myopic effort by business managers to mitigate risk within the financial services industry in general, due diligence ought to be a daily mantra recited by all those business managers, their trust officers, and others who are responsible for the review, acceptance, and ongoing administration of a private bank or trust company's irrevocable life insurance trust business (ILIT—pronounced "eye-lit").

If you are one of those business managers or trust officers who has not yet recognized that there *is* a risk associated with this particular trust product, perhaps now is a good time to "wake up and smell the coffee." The potential risk of ignoring the risk is immense.

### Guidelines for effective due diligence

*Leimberg/Gibbons:* A well thought-out due diligence policy is the linchpin of a good corporate fiduciary risk management program, no matter what the trust product. This is especially true when it comes to trusts that are irrevocable, and contain "special assets" (those assets that require extraordinary oversight because their value and performance cannot be ascertained in the same manner as other types of assets, such as stock in a publicly traded corporation).

By their very nature, ILITs are complicated. Their life insurance and Crummey[1] provisions are esoteric and very technical, and with life insurance as their primary asset, they are somewhat enigmatic due to the fact that life insurance is not well understood by everyone.

An ILIT that contains Crummey provisions can offer a tantalizing assortment of tax advantages to the grantor, namely: (1) the gift tax advantage of being allowed to use one's annual exclusion for contributions to the trust; (2) the income tax advantage of the trust's owning cash value life insurance, where increases in the cash value of the insurance policy (whether as a result of earning interest and dividends or by growth) are not subject to ordinary income tax or

STEPHAN R. LEIMBERG is an attorney and CEO of Leimberg Information Services, Inc. (http://www.leimbergservices.com), a provider of commentary on recent cases, rulings, and legislation; CEO of Leimberg and LeClair, Inc., an estate and financial planning software company in Bryn Mawr, Pennsylvania; and President of Leimberg Associates, Inc., a software and publishing company. His e-mail address is steve@leimbergservices.com. ALBERT E. GIBBONS is President of AEG Financial Services in Phoenixville, Pennsylvania (securities offered through Capital Analysts, Incorporated, Member NASD-SIPC). His firm specializes in life insurance planning for high net worth individuals, high-level corporate executives, and successful entrepreneurs. He works closely with professional tax advisors in designing and implementing sophisticated life insurance strategies to help solve clients' unique estate protection needs. His e-mail address is algibbons@algibbons.com.

capital gains tax;[2] and (3) the estate tax advantage of not having the life insurance death benefit included in the grantor's estate for federal estate tax purposes.[3]

The lure of this triple tax-advantaged trust is intoxicating! Clients, together with their estate planning attorneys, are creating these trusts at a staggering clip. And why not? It seems so easy...a "no-brainer," as they say. Simply create the trust instrument, throw in some cash, the trustee sends a Crummey notice to the withdrawal beneficiary, the trustee then applies for and subsequently purchases an insurance policy on the grantor's life, the trustee pays the life insurance premium and then sticks the file in the credenza until next year, when the process of contributing cash to the trust, sending a Crummey notice and paying the premium is repeated. What could be easier, right?

***Bender:*** Wrong! Do you remember what you were taught in grade school: *"Ignore your teeth and they'll go away"?* Well, the exact opposite is true with respect to ILITs. Ignore the issues and they *won't* go away. They necessarily represent risk. If no initial due diligence was performed when the trust business was brought in, and if no ongoing risk management policies were put in place and adhered to, the large number of ILITs as part of your book of trust business may eventually rise up and give you one big collective bite.

Set clear guidelines for review and acceptance of both the ILIT instrument and the life insurance product you are going to either purchase or accept via assignment. Do the review at the outset, and the risk of being "bitten" in the future—in all likelihood—will be substantially reduced.

Your due diligence policy ought to be comprehensive and encompass everything from the trust instrument to the asset. Here's another proverb to consider: *"If you don't change course now, you'll end up where you're headed."* The following are some suggestions for changing course and heading in the right direction:

1. *Don't assume the trust instrument you are given to execute on behalf of your institution is actually ready for signature.* Mary Poppins, in the Disney movie bearing her name, described herself as "...practically perfect in every way." But no *one* and no*thing* else is! Insist on receiving a draft of the ILIT instrument for review by you early in the drafting process so as to avoid unnecessary delays. Most attorneys will be happy to receive suggestions that are constructive and enhance the final product.

2. *Create a checklist of 'must-have' ILIT provisions.* Consider those trust provisions that—from a purely administrative perspective—you feel ought to be included in *every* ILIT instrument for the sake of efficient and effective administration. While it is not suggested that the trust officer or other nonattorney professional who reviews a trust engage in the unauthorized practice of law, it is suggested that the due diligence process include such a list of provisions and that all members of the estate planning team use the list as a quality control guide. For example, the right to resign as trustee at any time and for any reason, or the right to collapse a small trust should at least be considered in every trust situation. The absence of provisions such as these, and others, in a majority of one's ILITs can cause an administrative nightmare—and can be a signal that other key provisions may have been omitted.

Similarly, you may want to create a short list of those administrative provisions your institution feels ought *not* to be included in ILIT instruments that you accept—i.e., those provisions that may hinder your institution's ability to administer ILITs profitably and properly.

3. *Don't assume that the client fully understands his or her role as grantor-insured.* Due diligence should extend to the client, and not just as to federally regulated "Know Your Customer" bank practices. The grantor-insured's role does not end with his or her signature and date at the end of the trust instrument and on the insurance application.

Trust officers are urged to engage the grantor-insureds and ascertain how the grantor-insureds view their role. Some grantors do not understand the concept of "no strings attached" as it applies to the life insurance owned by the trust. While there may be some actions that the grantor-insured *must* take in order for the trust to work, there are other actions that surely ought *not* to be taken for fear of tainting the trust. Take the time to go over what is expected of your clients after they sign their trust document. You might want to include the grantor's attorney in any related discussions of this nature, and perhaps even memorialize in writing the key points

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[1] Named after the court case from which this principle was established, Crummey, 397 F. 2d 82, 22 AFTR2d 6023 (CA-9, 1968). See *Tax Planning With Life Insurance* (800-950-1216), for more details.

[2] As long as withdrawals are not made from the cash value of the policy.

[3] If structured properly, life insurance purchased and owned by an ILIT may be excluded from the grantor-insured's estate for estate tax purposes at his death without regard to the three-year rule of Section 2035.

that were addressed. Place this memo in the file for posterity (and protection); someone (including your malpractice carrier) may thank you for it in later years.

4. *Don't assume that all life insurance carriers are created equal.* Developing a set of conditions for acceptance (as to life insurance carriers) that can be applied across-the-board for all ILITs is extremely important. Rather than blindly purchasing and/or accepting any and all life insurance contracts that are presented to you, devise a set of criteria that will be used in determining whether a life insurance carrier is acceptable as a seller of the product you are going to purchase. Consider such factors as industry ratings (for example, you may decide to accept only those carriers with "A" or better ratings from some or all of the rating agencies), carrier size (in terms of their admitted assets), the states within which a carrier's products are offered for sale (or *allowed* to be sold), and a carrier's retention limits and re-insurance agreements.

In addition, you may want to subscribe to an industry newsletter or some other periodical that will help you keep abreast of developments and adverse trends occurring within the industry. Such a newsletter or periodical may also give you some indication or advanced warning of class actions, demutualizations, and other events that you ought to know about before your client knows. Your lack of awareness about current developments could prove embarrassing and costly.

5. *All policy types are not created equal.* Make sure that you understand the inherent differences and risks associated with the various types of policies. Pay special attention to the policy guarantees, or lack thereof, and determine whether the investment risk associated with a certain type of policy is appropriate, given the grantor-insured's risk tolerance and the long-term goals for the trust. Put a note in the file that explains why one type of policy was chosen over another. This might be one of the most important notes you will ever write. Furthermore, make sure the client understands the important aspects of the policy. The last thing you want is a call from the client advising you that the policy was supposed to be paid up and that, therefore, he or she is no longer going to contribute to the trust.

6. *Review the appropriateness of policy size and cost given the client's overall estate-planning and gift-giving goals.* Policy illustrations *are* generally worth the paper they are printed on, but not much more than that. The policy illustration you review during the purchase process cannot foretell the future (and in some cases may provide a misleading view of the present). Interest rates, dividend crediting rates, cost of insurance, and mortality and expense charges—as well as fund management fees—do not move in tandem. They are independent of one another and all have a bearing on a policy's ultimate performance.

First, ascertain and confirm that the assumptions used in the illustration are reasonable. Then review an alternate illustration that has an interest rate, a dividend crediting rate, or an investment rate of return that is slightly lower or less optimistic than the current rate being illustrated to you. You will see that even small decreases in this rate (say, 50 basis points) may have a dramatic effect on a policy's performance over the long run. As a result of a decrease in rate of return within a policy, the grantor-insured may have to contribute substantial additional sums in order for the investment in the policy (i.e., the death benefit) to remain viable.

When structuring a policy and its cost, be sure to consider your institution's fee associated with the ongoing annual administration of the ILIT during the grantor-insured's lifetime, because paying a fee to a trust company may constitute an additional gift to the trust. Make sure that the need to pay a higher premium and/or the need to pay premiums for more years than originally illustrated does not come as a shock to the grantor-insured—if, in fact, that becomes necessary. The number of Crummey withdrawal beneficiaries in the instrument may be finite, but the amount of annual premium necessary to keep a policy in force at its originally illustrated death benefit is not finite and may increase to an amount that exceeds

the grantor-insured's annual gift tax exclusions.

Here is an extreme example of what can go wrong: A trust officer was recently presented with a successor appointment of an ILIT that had been in existence for ten years. The successor trusteeship was subsequently accepted. The policy owned by the ILIT was a $1 million joint and survivor universal life policy, and the interest rate had dropped over time from an initial 8% to a current rate of 5%. The grantor-insureds have one child who is the sole Crummey withdrawal beneficiary under the trust, and the grantors split gifts so as not to incur gift tax. Their unified credits have already been completely consumed by gift giving outside the trust.

The planned annual premium for the policy owned by the trust was initially set at $20,000. As a result of the current interest rate drop, however, it was determined that the planned annual premium would have to be increased to $30,000 and would have to be paid for 20 years instead of 12 years, as initially projected, in order to maintain the initially illustrated death benefit to the insureds' joint age 100. Consequently, at the time, the grantor-insureds had to pay gift tax on $10,000 of their now annual $30,000 gift to the trust. Two years later, the first spouse died, leaving the surviving spouse making taxable gifts to the extent of $20,000 per year in order to keep the policy at its originally illustrated death benefit. Although this example is rather extreme, it is possible, and it dramatically highlights the importance of the vetting process that ought to occur before the policy is purchased.

7. *Institute a plan for the ongoing review of the policy.* Refer to the proverb mentioned earlier in this article—the one about ignoring your teeth. Don't ignore the policy after it is purchased. Ask the insurance carrier or the servicing agent for an annual in-force illustration, and review the policy's performance annually on or about its anniversary date. Take note of changing interest rates or dividend crediting rates. Notice when the policy lapses or endows. If the policy lapses prior to age 100, you may want to increase the premium (for example, in universal life insurance policies, which offer flexible premiums). Monitoring insurance policies is very important. Remember that policies can be exchanged under Section 1035, which allows the tax-free exchange of one life insurance policy for another life insurance policy.

### Conclusion

***Leimberg/Gibbons:*** Can you give us the bottom line?

***Bender:*** The bottom line is simple: Don't give short shrift to due diligence. A good due diligence checklist and procedure for ILIT instrument review and account acceptance will save you time, embarrassment, and—in the long run—money.

Drew Allan Bender is a Vice President and Senior Trust Officer of United States Trust Company of New York. He works at U.S. Trust's headquarters in New York City, where he is responsible for managing the firm's irrevocable life insurance trusts nationwide. Drew has 15 years of experience in estate and trust administration and fiduciary tax. (U.S. Trust does not provide legal advice. Clients must speak with their legal advisors regarding their specific plans.) ■