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The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Who Can You Trust with Your Policy? Finding the Right Fiduciaries for Insurance Trusts.

MARKET TREND: With the trust departments of many banks and retail brokerage firms turning away irrevocable life insurance trusts ("ILITs"), trustee selection becomes a rather challenging issue.

SYNOPSIS: ILITs are a mainstay in legacy and life insurance planning, and having a responsible, experienced trustee is critical for the ILIT to achieve the client's objectives. Finding suitable ILIT trustees, however, has become increasingly difficult, particularly given the complexities and potential liabilities associated with ILIT administration (both before and after receipt of policy death benefits), and the reluctance of many financial institutions to serve. Clients often need other alternatives, such as friends, family members, and professional advisors, to find the right trustee. This report offers a framework for making that selection.

TAKE AWAYS: When an ILIT holds only a life insurance policy, typical trustee options, such as banks and trust companies, may be unavailable. For these ILITs, using some combination of family members/friends and professional advisors can maximize the benefits of each type of trustee while minimizing the issues. Advisors can provide value by (1) understanding a trustee's duties in administering ILITs both before and after the receipt of policy death benefits, (2) educating clients on the full range of options, and (3) ensuring clients incorporate flexible powers to remove and replace trustees, which allows the trust to adapt to future needs.

ILITs are a mainstay in legacy and life insurance planning, and having a responsible, experienced trustee is critical for the ILIT to achieve the client's intended objectives. Finding suitable ILIT trustees, however, has become increasingly challenging, given the administrative complexities, potential fiduciary liabilities, and the reluctance of many financial institutions to serve. But with some careful planning, there are options that can meet most of the client's needs.

ILITs: THE BEFORE & AFTER

An ILIT has two unique timeframes: (1) before the insured's passing and receipt of life insurance death benefits ("pre-DB") and (2) after the insured's passing and receipt of death benefits ("post-DB"). While the specific administrative tasks vary in each period, they both require substantial effort from the trustee, even for pre-DB ILITs that only hold life insurance.[1]

	Pre-DB ILIT	Post-DB ILIT
Funding	Often minimally funded apart from the life insurance policy	Policy death benefits - available for reinvestment
Premium Payments	Must ensure timely payment to keep policy in force	Not applicable[2]

	Pre-DB ILIT	Post-DB ILIT
Annual "Crummey" Notices to Beneficiaries	Required for annual exclusion treatment for ILIT contributions	Not applicable
Management of Split Dollar Arrangement	May be used as additional or alternative funding to Crummey notices. Requires tracking of annual economic benefit costs or split-dollar	Not applicable.

	Pre-DB ILIT	Post-DB ILIT
	loan payments.	
Investments	Per state law fiduciary duties or the trust instrument may be required to review policy design, assumptions, performance, and alternative options (as newer policies are developed), as well as insured's health and liquidity	Must invest assets per fiduciary duties or trust instrument
Annual Accountings to Beneficiaries	Often not required during life of trust grantor (typically the insured)	Required in accordance with state law and the trust instrument
Tax Reporting	Typically a grantor trust during insured's life. Must file trust's tax returns or provide information to grantor. Grantor pays income taxes	Becomes a non-grantor trust. Must file trust's federal and state income tax returns and pay taxes
Distributions	Often none required or made during insured's life (particularly if ILIT has no assets other than policy)	May need to make mandatory distributions or exercise discretion as to who should receive distributions

LIMITS ON CORPORATE TRUSTEE OPTIONS

Given the significant administrative duties required pre- and post-DB, a desirable ILIT trustee will have prior experience, familiarity with life insurance, and the administrative capability to serve as trustee. These factors often lead clients to initially think of a bank, trust company, or other financial institution ("corporate trustee"') as an ILIT trustee. Corporate trustees offer several advantages, including experienced personnel, an administrative infrastructure, fiduciary insurance/bonding, trustee continuity for multi-generational ILITs, and, maybe most importantly, a conflict-free environment.

<u>Pre-DB</u>. Unfortunately, many corporate trustees are declining to serve for pre-DB ILITs unless the financial institution has an existing relationship with the client or the ILIT holds other significant financial assets. Otherwise, corporate trustees cannot apply their traditional compensation models (e.g., a percentage of assets under management) to a

pre-DB ILIT, and charging a fee sufficient to offset the administration and liability risk will be uneconomical for most clients.

Post-DB. Generally, corporate trustees are willing to serve, as they will be able to offer their traditional investment management services bundled with their trustee services. Keep in mind, however, that a corporate trustee may wish to manage trust assets solely on its investment platform, limiting options for asset management and diversification. Further, a corporate trustee may be unwilling to manage any of the insured's private business, real estate, or equity interests acquired by the post-DB ILIT. Finally, corporate trustees may lack familiarity with the trust beneficiaries and the client's overall goals and values.

POTENTIAL TRUSTEE SOLUTIONS

Non-Corporate Options. Given the limitations on corporate trustees, clients may turn to their family and friends or professional advisors (such as accountants or attorneys). When comparing the options, a client should consider the following:

	Family & Friends ("F&Fs")	Professional Advisors
Familiar with Client & Family	Yes. Usually familiar with the client's goals, care about the beneficiaries, and can assess each beneficiary's needs.	Maybe. Often understand client's goals, but may be less familiar with family members and beneficiaries, unless there is a long-term relationship.
Independent for Distributions	Maybe, if not "related or subordinate" to the ILIT grantor.[3]	Yes.
Objective	Maybe. Can struggle with fiduciary duty of loyalty to the trust vs. personal loyalty to grantor. Family relationships may impact impartiality in treatment of beneficiaries.	Usually. More likely to understand need for independence from grantor and typically do not have specific ties to the trust beneficiaries.
Compensation	Usually no. Often willing to serve without compensation.	Yes. Likely will charge an annual service fee.
Fiduciary Insurance/Bond	No, and unlikely to be able to reimburse trust for losses from breach,, assuming a grantor or	Maybe. Should be asked during selection process.

	Family & Friends ("F&Fs")	Professional Advisors
	beneficiary would even bring suit.	
Experience with Administration	No, usually.	Yes.
Time/Willingness to Serve	No. Often have their own careers, families etc.	Yes. But confirm whether they have a dedicated service model.

Best of All Worlds. As shown, F&Fs, professional advisors, and corporate trustees each have unique advantages and disadvantages. To get the best from each group while minimizing the limitations, a bifurcation of trustee duties will likely be the optimal solution.

One option is for F&F trustees to hire an administrative "back-office" by employing (1) service providers to prepare annual Crummey notices or administer split dollar plans and file trust income tax or informational returns, (2) life insurance advisors or audit services to conduct policy audits, (3) investment advisors to manage trust investments, etc. The F&F trustee, however, generally will retain sole fiduciary responsibility to select and oversee these service providers.

To allocate actual fiduciary responsibilities among multiple persons, the client may want to use multiple or directed trustees, which should allocate fiduciary responsibilities among multiple persons.[4] With multiple trustees, the client appoints co-trustees with different trustee responsibilities. For example, a F&F could serve as the distribution trustee for beneficiary distributions (keeping in mind the ability of the selected F&F to remain impartial among those beneficiaries),[5] while a professional or corporation serves as administrative and/or investment trustee to deal with trust administration, annual reporting compliance, and investments. With a directed trustee, the client appoints a single trustee, usually a professional or corporate trustee, and distribution and/or investment advisors to provide binding directions to the trustee regarding trust distributions or investments. Both approaches may alleviate the fiduciary pressures on F&Fs who are ill-equipped to make investment decisions, comply with technical administrative requirements, or appreciate compliance measures.

ENSURE FLEXIBILITY FOR CHANGING TRUSTEES

Even with planning, grantors should be prepared for trustees to resign, become unavailable, and/or for the ILIT's needs to change. Thus, it is critical that someone always hold the power to remove trustees and appoint successors. The client, his or her spouse, or one or more of the trust beneficiaries can hold these powers, subject to certain limitations.[6]

TAKE AWAYS

- When an ILIT holds only a life insurance policy, typical trustee options, such as banks and trust companies, may be unavailable. For these ILITs, using some combination of family members/friends and professional advisors can maximize the benefits of each type of trustee while minimizing the issues.

- Advisors can provide value by (1) understanding a trustee's duties in administering ILITs both before and after the receipt of policy death benefits, (2) educating clients on the full range of options, and (3) ensuring clients incorporate flexible powers to remove and replace trustees, which allows the trust to adapt to future needs.

NOTES

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[1] Further, ILIT trustees must always carry out their obligations in compliance with fiduciary duties imposed by state law and the trust, such as the duty of loyalty to the trust and the beneficiaries. See *WRMarketplace No. 14-41*.

[2] Unless the trust uses assets to re-invests in another policy, such as on the life of a beneficiary.

[3] Otherwise, distributions should be limited to an "ascertainable standard (e.g., health, education, maintenance, support). Generally, the client's spouse, ancestors, and descendants and trust beneficiaries will <u>not</u> be independent.

[4] As the ability to use a directed trustee or multiple trustees, and whether and how fiduciary responsibilities may be allocated will vary by state, local law should be carefully reviewed to ensure compliance by the trust agreement.

[5] Note that, unless the appointed F&F is "independent" (e.g., someone who is not "related or subordinate" to the person making the appointment, as defined in Internal Revenue Code § 672), his or her authority should be limited to distributions based on an ascertainable standard, such as health, education, maintenance and support.

[6] If the power to remove is granted to the client, the spouse or anyone beneficially interested in the trust, and the same person has the power to appoint a successor trustee, the ILIT must require that the successor be independent (not related and subordinate to the person making the appointment, as defined in Internal Revenue Code § 672).

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