

Checklist for Drafting the Irrevocable Life Insurance Trust

(with Sample Forms)

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To make an ILIT work, you have to cover all the details.

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THIS ARTICLE IS A CHECKLIST of selected key tax and drafting issues that should be considered when preparing an irrevocable life insurance trust to hold insurance on the life of just the grantor. The article highlights provisions that are either necessary or desirable (for purposes of flexibility). The Appendix to the article contains sample drafting language for a practitioner to consider when preparing an irrevocable life insurance trust. (All section references are to the Internal Revenue Code ("Code") unless otherwise indicated.

Drafting Checklist

(A) Limit the spouse's withdrawal right to 60 days after the contribution. The grantor's spouse's withdrawal right should (i) be limited to 5 by 5 and (ii) lapse 60 days after the date of contribution (not 60 days after notice). This will avoid the estate tax inclusion period ("ETIP") issue for the spouse. Treas. Reg. §26.2632-1(c)(2)(ii). Obviously, the spouse should not be given a hanging Crummey power. See Paragraphs 3.1(A) and 3.2 (D) of sample ILIT.

(B) Avoid naked Crummey withdrawal powers. Draft the ILIT so that there are multiple present-interest beneficiaries. See Paragraph 3.1(A) of sample ILIT.

(C) Use tiered withdrawal rights. Consider providing for tiered withdrawal rights by which the spouse may withdraw the gift first, the children second, and the grandchildren third. Tiered withdrawal rights make notice easier, particularly if the annual contributions are limited in amount. See Paragraph 3.1(A) of sample ILIT.

(D) Withdrawal rights must be ascertainable. Ensure that the amount subject to the Crummey withdrawal right is ascertainable.

(1) Do not condition the amount of the withdrawal on whether a split gift election is to be made under section 2513. The IRS has ruled that this constitutes a condition subsequent to the gift and hence makes the gift amount, i.e., the withdrawal amount, unascertainable until the condition subsequent occurs. Rather, limit the withdrawal right to single present interest

exclusion or provide that if a donor is married at the time of the contribution, the amount subject to withdrawal is the amount otherwise available under gift-splitting, irrespective of whether the gift-splitting election is, in fact, elected. See Paragraph 3.1 (A)(3) of sample ILIT.

(2) Condition any distribution of principal, termination of trust, trustee discretion, or exercise of any lifetime power of appointment, so that such distributions, discretions, terminations, or exercises will not thwart or otherwise defeat an existing Crummey withdrawal right that is unexercised and has not lapsed. See Paragraphs 3.2 (E), 4.1 (B), 7.4, and 7.7 of sample ILIT.

(E) Prohibit the grantor from becoming trustee or exercising any powers. Prohibit the grantor from exercising Crummey powers on behalf of the beneficiaries (including the ability to exercise the power pursuant to a power of attorney or as a natural or legal guardian of the beneficiary), and from becoming a trustee. See Paragraphs 3.2 (C) and 6.1 (E) of sample ILIT.

(F) Use section 677. Ensure that the trust is defective as to the grantor for income tax purposes. Although the trust will not hold many income-producing assets, nevertheless it is desirable that the trust be a defective grantor trust for income tax purposes. Section 677 treats the grantor as the owner of the trust if income can be used (without the approval or consent of any adverse party) for the payment of life insurance premiums on the grantor or grantor's spouse's life. This provides potential planning opportunities if the trustee desires to subsequently sell the life insurance policies for full and adequate consideration to another grantor trust under the tax-free exchange rules of section 1035 and the transfer for value rules exception under section 101 (a)(2). (See also, *Swanson v. Commissioner*, 33 T.C.M. (CCH) 296 (1974), *aff'd*, 518 F.2d 59 (8th Cir. 1975)). If the grantor holds a power under sections 673 through 677 and the beneficiary holds a section 678 power (of withdrawal) over the same income, the beneficiary's power is disregarded, and the grantor is taxed as the owner of the trust income. Note, however, that it is unclear concerning the grantor being taxed as the owner of the principal, since section 678 (b) refers only to "income."

(G) Give the trustee broad discretion to satisfy withdrawal right notice requirements. Do not require the trustee to give written notice of a beneficiary's withdrawal rights. Rather, give the trustee discretion in how to effectuate notice to the beneficiaries. See Paragraph 3.2(A) of sample ILIT.

(H) Give the trustee broad powers to satisfy any withdrawal rights. Make sure that any Crummey withdrawal right may be satisfied not only against the contribution but also against property of the trust, including any insurance policy or fractional interests in the insurance policy. This will provide substance to a Crummey withdrawal right especially as concerns any group term policies held by the trust. See Paragraph 3.2 (E) of sample ILIT.

(I) Consider special language for group term and split dollar assignments. The assignment of the group term policy should include any replacement or renewal insurance and any increase in the amount of coverage. Also, the trust should provide that contributions to the trust will include indirect contributions, such as deemed gifts arising from a third-party's payment of premium on group term insurance or insurance subject to a split dollar arrangement. See Paragraphs 1.2, 3.2(F), 7.2 and Schedule A of sample ILIT.

(J) Give the trustee the power to purchase assets and make loans. If the insurance proceeds are needed to provide liquidity to the grantor's estate the trustee should be specifically permitted to buy assets from the grantor's estate or loan funds to the estate. Similarly, the trustee can also have this authority as concerns the grantor's spouse and descendants. The trustee must not be required to purchase assets or loan monies, otherwise such requirements may be tantamount to "proceeds being receivable by an executor." *Treas. Reg. §20.2042-1(b)*. See Paragraph 5.2 of sample ILIT.

(K) Avoid inclusion of ILIT property in beneficiary's estate. Take care to insure that no beneficiary possesses any

impermissible powers that might cause inclusion of some or all of the trust property in the beneficiary's estate under section 2041. If a beneficiary serves as a trustee or co-trustee, that person's powers as trustee must be sanitized so as to reduce any trustee powers to non-general powers, i.e., ascertainable standards such as "health, education, support and maintenance," as permitted under Treas. Reg. §§ 25.2514-1(c)(2) and 20.2041-1(c)(2). Typically, an Upjohn clause is used to accomplish this purpose. See Paragraph 7.1(B) of sample ILIT. Also, do not give the beneficiaries a withdrawal power in excess of 5 by 5, otherwise the lapse, in conjunction with an income/principal interest in the trust, will constitute a retained interest in the beneficiaries' share of the excess property, which will be included in the deceased beneficiaries' estate as a retained interest (following the release of a general power of appointment). §§ 2036 and 2040. See Paragraphs 3.1 (A)(1) and 3.2 (D) of sample ILIT.

(L) Draft to anticipate changing circumstances.

(1) During the grantor's lifetime appoint a special powerholder with a limited power to appoint the trust property. This will permit the trust property to be distributed in the event of changed circumstances. However, make sure the limited power of appointment cannot be exercised so as to defeat a Crummey withdrawal right which is then in existence, has not been exercised, and has not lapsed. Also, avoid giving the grantor's spouse the special power of appointment if gift-splitting will be elected.

(a) If the spouse consents to gift-splitting and has the power to appoint the trust property, arguably an issue could be raised by the IRS that the gift made by the spouse is not complete for Chapter 12 purposes. Of course, this is a highly technical argument, and there is no case on point that supports or denies this position, but as a matter of caution it might be wise to avert this potential argument. See Paragraph 4.2 of sample ILIT.

(2) Allow the donor to vary the rights of withdrawal before each year's contribution. Pvt. Letter Rul. 8138102. See Paragraph 3.2 (G) of sample ILIT.

(3) When drafting contingent marital deduction provisions, consider a QTIP arrangement so as to preserve whatever GST tax inclusion ratio has been established for the ILIT before the insured's death. Treas. Reg. § 26.2642-4(a)(3). See Paragraph 5.1 of sample ILIT.

(4) Consider a clause which states that if the grantor and his or her spouse become divorced, the spouse shall forfeit all interest in the trust. Be careful of conflicts of interest under the applicable Rules of Professional Responsibility. See Paragraph 10.1 of sample ILIT.

(5) Consider a 90-day survival clause to take advantage of the GST tax predeceased-parent exception. Treas. Reg. § 26.2612-1(a)(2)(i). The 90-day survivorship rule provides, "A living descendant who dies no later than 90 days after the subject transfer, is treated as having predeceased the transferor to the extent that either the governing instrument or applicable local law provides that such individual shall be treated as predeceasing the transferor." This survivorship rule expands the "predeceased-parent rule" of section 2651(e), by allowing a grandchild to move up into his parent's generation for GST tax purposes if the parent dies within 90 days of a transfer of property into an ILIT. See Paragraph 9.1 of the sample ILIT for sample 90-day survival clause. (Note: The Regulations have not been updated to reflect implementation of the predeceased-parent exception as expanded by The Tax Reform Act of 1997 ("TRA 1997"). Before TRA 1997, only direct skips were eligible for the predeceased-parent rule. Thus, Treas. Reg. § 26.2612-1(f) Example 7, which has not been updated to reflect the changes brought about by TRA 1997, is inaccurate—as concerns the "predeceased parent rule.")

Administration Checklist

(A) Ensure that notice is given. Do not attempt to have the beneficiaries waive notice of their Crummey withdrawal rights each year. Rather, each year give notice and obtain a written acknowledgment from the beneficiary that he or she is aware of that year's contribution and is aware of his or her withdrawal rights. If the policy requires monthly or quarterly premium payments, consider making a single contribution at the beginning of the year, giving notice once, and then using the contribution to pay the premiums as they become due. See Paragraph 3.2(A) of sample ILIT.

(B) Ensure that the ILIT is liquid. Ensure that the trust has sufficient funds or property to satisfy a withdrawal right. For a trust that holds only group or term insurance, it may be desirable to fund the trust with cash or savings bonds sufficient to support a withdrawal right. See Paragraph 3.2(E) of sample ILIT.

(C) Be cognizant of the Generation Skipping Tax risk. Except when the ILIT is a section 2642(c) or section 2503(c) generation-skipping trust, every ILIT has potential GST exposure. Therefore, every time a transfer is made, a decision must be made whether GST exemption will be allocated to the ILIT on a timely filed gift tax return via the required Notice of Allocation attachment.

Coordination with Grantor's Other Estate Planning Documents

(A) Coordinate with revocable trust and will. If the grantor transfers existing life insurance policies to the ILIT, then not only should a contingent marital trust provision be inserted in the ILIT (or the insurance proceeds be paid to some other trust that qualifies for a QTIP marital deduction (See Paragraph 5.1 of Sample ILIT)), but the tax apportionment clause in the grantor's will should deal with the contingency concerning the payment of death taxes on the life insurance policy. In the absence of such a provision, section 2206 states that the beneficiaries of the insurance proceeds are to pay their pro rata share of death taxes. It is particularly important that if a contingent marital trust provision is used that the tax apportionment provisions in the surviving spouse's will be coordinated so as to ensure consistency with the grantor's overall intent. For example, if the grantor has allocated generation-skipping tax exemption to the ILIT, the proceeds are included in his or her estate, the proceeds are paid to a marital deduction qualified terminable interest trust for the grantor's surviving spouse, and the grantor's executor makes a section 2652(a)(3) reverse QTIP election as to the whole marital deduction trust (so as to preserve the grantor's previously allocated generation-skipping tax exemption), then the grantor's spouse's will should provide that the right to recovery under section 2207A is waived and the tax is to be apportioned against the residue of the surviving spouse's estate. Be careful, however, particularly if the surviving spouse is a second spouse and there are children from different marriages involved.

(B) Coordinate with durable power of attorney. The grantor's durable power of attorney ("DPA") should contain gifting provisions and permit the attorney-in-fact to make irrevocable gifts and transfers directly to beneficiaries and to any irrevocable trust that has been established by the grantor. This ensures that in the event of the grantor's incapacity, the trust can continue to be funded, and thus avoid a potential lapse of the insurance policies.

(1) Example of DPA language:

"Gifts - Restricted Amount. My Agent may make irrevocable gifts that are eligible for exclusion under sections 2503(b) or 2503(e) (concerning direct payment of tuition and/or medical care) as my Agent deems proper, with any of my real estate or personal property, to or for: my spouse (if I am married), any of my children, their spouses, or their descendants (and their spouses), any of my relatives or in-laws, or any persons who are listed as beneficiaries or devisees (present or contingent) under my will or any trust created by me (and not my Agent), or any charitable organization (including gifts to