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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.

TOPIC: Selecting the Right ILIT Trustee – Art or Science?

MARKET TREND: The increasing complexity and duration of irrevocable life insurance trusts ("ILITs") and the sophistication of life insurance products heighten the importance of selecting the right trustees for a client's ILIT.

SYNOPSIS: ILITs are a staple in many estate and life insurance plans, addressing both practical and tax planning needs. Unfortunately, clients often create ILITs without adequate reflection on trustee selection, focusing more on cost and simplicity rather than experience, knowledge, and other critical factors. While the pool of available trustees extends from family and friends to professional advisors and corporate trustees, each group has its own advantages and limitations. Further, depending on the client's objectives and the trust terms, it may be advisable to appoint co-trustees, to appoint different trustees for different phases of the ILIT, or to divide fiduciary duties among different trustees. ILITs with spouses or family members/beneficiaries named as trustees also require special drafting to limit the trustee's powers to make distributions for his or her benefit or that would discharge the trustee's legal obligations. Improper trustee selection or drafting of ILIT trustee powers can undermine the intended objectives of the ILIT, both from a legacy management and estate tax perspective.

TAKE AWAYS: ILIT trustees play an important role in managing ILIT assets (which could be significant), balancing family harmony with the trust provisions, and making crucial investment, tax and legal decisions. The pool of possible trustees is quite large, however, and there is no one perfect choice that fits every circumstance. Accordingly, advisors can provide value by (1) helping clients understand a trustee's duties in administering ILITs, (2) reviewing the characteristics of a good ILIT trustee, (3) evaluating the needs of the specific client and ILIT with regard to what type of trustee(s) (individual, entity, or combination) may best fill the position, and (4) ensuring clients incorporate flexibility into the trustee position, including the power to remove and replace.

PRIOR REPORTS: 13-08; 12-28.

ILITs are a staple in many estate and life insurance plans, and selection of a knowledgeable and conscientious trustee based upon the needs of the trust and the beneficiaries is crucial to an ILIT's successful implementation and administration. Unfortunately, trustee selection typically receives the least amount of thought and discussion, with clients often choosing family members or friends based on expediency, convenience or cost concerns, rather than focusing on the trustee's duties and responsibilities and the current and future needs of the beneficiaries. Advisors can add significant value by educating clients about the trustee's fiduciary duties and responsibilities and in counseling clients on the selection of an appropriate ILIT trustees.

EXAMPLE SCENARIO

One example of a situation for ILIT implementation involves the following fact pattern, which will be used to illustrate the application of general considerations for ILIT trustee selection:

> Mr. and Mrs. Smith own a business worth $25 million and have other, liquid assets of $15 million. They wish to pass the business to their two children who are in their early 30's. Mr. Smith is close with his brother, a doctor, but his brother knows nothing about Mr. Smith's wealth or his company, nor does his brother have any investment management or trust administration experience. Mr. Smith plans to create an ILIT to purchase a second-to-die policy insuring him and Mrs. Smith as part of his succession plan, which, upon death of the survivor, will use the policy's death benefit to purchase the business or other assets from the survivor's estate. Mr. Smith is considering asking his brother to serve as the trustee of the ILIT.

SELECTING ILIT TRUSTEES – CRITICAL COMPONENTS

<u>ILIT Trustee's Fiduciary Duties</u>
The trustee selected by the client must be able to fulfill several fiduciary duties imposed by both state law and the trust instrument, which include the following:

TRUSTEE'S PRIMARY FIDUCIARY DUTIES	
Administer the ILIT according to the trust instrument	Act loyally - Administer the trust and act solely in the interests and for the benefit of the beneficiaries
Act impartially – Deal impartially with multiple beneficiaries and when investing and managing the trust property	Avoid self-dealing – Do not use or deal with trust property for the trustee's own profit or take part in any transaction in which the trustee has an interest adverse to any beneficiary
Control and protect trust property	Make trust property productive
Keep trust property separate from trustee's personal property (title trust assets in trust's name)	Diversify trust investments and comply with the prudent investor rule in managing and investing trust assets
Keep beneficiaries reasonably informed of the trust and its administration	Act reasonably when exercising discretionary powers

Depending on state law, the trust agreement may limit, expand or otherwise modify some of these duties.

Application to Example Scenario: If appointed as trustee, Mr. Smith must ensure that his brother is aware of, and can fulfill, the applicable fiduciary duties. In addition, Mr. Smith may want his ILIT agreement to modify or waive (when possible) one or more of the duties to ensure greater protection from unintentional breaches. For example, during the Mr. Smith's life, the ILIT agreement could waive the duties to diversify the ILIT's assets and to make the assets productive in order to allow the trustee to hold the life insurance policy as the trust's sole or primary asset.

Scope of ILIT Trustee's Responsibilities

ILIT trustees also must perform several investment, administrative and other tasks both during the client's lifetime and after the client's death, including as follows:

ILIT TRUSTEE'S RESPONSIBILITIES	
Select an appropriate life insurance product based on the trust objectives and the insured's circumstances	Review the specific policy design and assumptions and assess whether the product will perform consistent with the assumptions
Pay life insurance premiums on a timely basis	Make income and principal distributions to beneficiaries in accordance with ILIT standards
Pay the trust's expenses	Manage the trust's assets
Send Crummey withdrawal notices to the beneficiaries	Maintain the trust's records and prepare accounts and reports for beneficiaries
Consult with beneficiaries regarding their needs	Collect trust assets
Balance needs of current and future beneficiaries	File the trust's federal and state income tax returns and pay taxes due
Provide timely Schedule K-1s to beneficiaries	

Certain administrative tasks may be specific to ILITs, for example, the sending of Crummey withdrawal notices to ILIT beneficiaries and ensuring timely premium payments from the trust's bank accounts (rather than directly by the settlor/insured). Any trustee selected by the client must be capable of carrying out these activities.

Application to Example Scenario: Mr. Smith's brother likely will not be aware of these responsibilities or why they are critical to the success of the ILIT. Also, as a busy doctor, he likely will not have the time or the necessary experience to perform the required administrative tasks, recordkeeping, tax filings or investment management. If Mr. Smith appoints his brother, Mr. Smith also should ensure that his brother will engage third parties to provide the necessary administrative and tax services. In addition, Mr. Smith may want to consider appointment of an investment advisor to handle or direct his brother on the trust's investment management. Alternatively, Mr. Smith could consider appointing a professional co-trustee who would be tasked with the administrative and investment management services.

Desirable ILIT Trustee Characteristics

Given the duties and responsibilities required of ILIT trustees, they also should have several desirable personal characteristics, including honesty, reliability, experience, knowledge, etc.

PERSONAL CHARACTERISTICS OF THE TRUSTEE	
Honest, trustworthy, integrity, reliable	Ability to act fairly and reasonably
Knowledge of the client's values and goals regarding ILIT	Financial skills and ability to handle his/her personal financial affairs
Prior experience as a trustee	Availability/time to serve as trustee
Competency to serve	Prior experience as a trustee
Ability to make and execute decisions	Organized/detail oriented
Interpersonal skills, ability to communicate, potential responsive to the beneficiaries	Willingness to serve
Discrete/exercises good judgment	Ability to recognize when assistance is needed (i.e., when to retain and investment advisor, accountant, etc.)
Sensitivity to the needs of and cares about the beneficiaries	Impartiality/objectivity

Application to Example Scenario: Given their close relationship, Mr. Smith can best assess his brother's personal characteristics. Mr. Smith's brother also will have a personal understanding of Mr. Smith's family and may be better able to assess what is in the best interest of the trust beneficiaries. The brother's lack of experience in trust administration and investments, his limited familiarity with Mr. Smith's business, and his busy schedule, however, make him ill-equipped to handle all aspects of the ILIT's distribution and management. This may be a good situation for a bifurcated trusteeship, with Mr. Smith's brother having distribution authority, and a professional or corporate trustee tasked with trust administration and investment management. Mr. Smith also could consider appointment of an investment advisor and a business advisor to provide guidance on the trust's investments and business interests.

WHO CAN AND SHOULD SERVE

As illustrated above, clients can choose among family members/beneficiaries, friends, professional advisors or corporate trustees to serve as ILIT trustees. While each group has its advantages and disadvantages, with forethought and a properly drafted trust, persons in each category or from multiple categories can serve, which may maximize the benefits of each type of trustee while minimizing the issues.

Family Members/Beneficiaries as Trustees

Potential Benefits. The unique benefits provide by appointing a family member/beneficiary ("**FMBs**") as trustee include the following:

- FMBs are usually familiar with the client's goals and values.
- FMBs generally don't ask or expect to be paid for their services.

- FMBs arguably have a personal interest in the success of the trust.

- FMBs care about the beneficiaries and can assess the needs of each beneficiary perhaps more readily than a non-family member.

- The client is familiar with the prospective trustees and can assess each FMB's ability to serve as trustee.

Additional Considerations.

- FMBs generally are not insured or bonded. If the FMB trustee breaches his or her fiduciary duties, the trust likely will not be able to recoup any losses.

- The appointment of a FMB as trustee can create or exacerbate conflicts in family relationships, particularly if the FMB trustee denies a beneficiary's request for a distribution. For example, if the spouse from the client's second marriage and children from the first marriage are beneficiaries of the trust, naming the spouse or a child as trustee may lead to conflicts and disagreements.

- FMBs may not have the time or interest in serving – especially if they are not paid.

- FMBs may not have the skills or experience needed to successfully administer the trust or its investments (although these gaps can be filled by outside professional service advisors, such as investment advisors and accountants/bookkeepers).

- A FMB trustee who is also a beneficiary may not be able to act objectively or fairly. Also, a FMB trustee/beneficiary cannot make discretionary distributions of income or principal (1) to himself or herself (unless restricted to an ascertainable standard such as for health, education, maintenance and support) or (2) that would discharge the beneficiary's legal obligations, as these distribution powers could cause inclusion of the assets in the FMB trustee's estate.

- The client's spouse should not serve as a trustee if the trust is to hold a second-to-die policy, as the spouse-trustee's powers over the policy will be deemed incidents of ownership that will pull the policy or the proceeds into the spouse's estate at death.

Friends and Professional Advisors as Trustees

Clients also can draw from their pool of friends and professional advisors (such as the client's accountant or attorney) to serve as ILIT trustees.

Potential Benefits.

- Like FMBs, this group should be familiar with the client's goals and values and the reasons for creating the ILIT.

- They are likely to be more objective and analytical in managing the trust and making distributions to the beneficiaries.

- Professional advisors should have the skills and experience necessary to administer the trust and its investments or the ability to retain other professionals with the necessary expertise.

Additional Considerations.

- As with FMBs, fiduciary insurance or bonding may be unavailable or not feasible.
- Professionals likely will charge a fee for their services, but may only be able to provide limited, non-discretionary services.
- Busy schedules may not allow the individual or professional to devote the time and effort to administration that the trust will require.
- Friends and professionals may be less familiar with the needs of the beneficiaries than FMBs.
- Friends or professionals may resign more readily if the responsibilities of serving as trustee become too burdensome.

Corporate Trustees. Banks and trust companies can offer certain advantages over the appointment of FMBs or other individuals as trustee due to their institutional nature, but their appointment also raises unique challenges and considerations.

Potential Benefits.

- Corporate trustees have experienced personnel, access to resources, and the administrative infrastructure necessary to properly administer the trust.
- Corporate trustees provide continuity in trustee services, particularly for long-term dynasty trusts.
- Corporate trustees often are insured and/or bonded and have "deep pockets" to reimburse a trust due to losses from a breach.

Additional Considerations.

- Many corporate trustees prefer to serve only after the insured's death – when the policy proceeds require investment management - unless there is an existing relationship with the client or other significant assets in the ILIT besides the life insurance policies.
- Corporate trustees serving during the insured's life may require limitations on their duties and authority – e.g., will serve only based on written direction of another trustee or advisor (a "**directed trustee**") - since corporate fiduciaries may not wish to be responsible for the insurance product selection or its future management.
- A corporate trustee may not be able or willing to hold or manage private business or equity interests held by the ILIT (or acquired after the insured's death) or may again require a directed trusteeship with regard to these assets.
- A corporate trustee may wish to manage all trust assets on its investment platform, which may limit the trust's options for asset management and diversification.
- A corporate trustee will charge a fee for its services, often based upon a percentage of assets under management, plus additional fees for non-typical duties, such as tax preparation or

management of real estate. For ILITs that only hold insurance products, however, the corporate trustee (if willing to serve) is likely to charge a flat annual fee.

- Corporate trustees likely will not be familiar with, understand, or consider the needs of the individual beneficiaries. Further, corporate trustees are trending towards establishing committees to make discretionary distributions to beneficiaries, resulting in delays if a distribution is required on an urgent basis.

Use of Multiple Trustees. To take advantage of the benefits provided by the various categories of trustees, clients can appoint co-trustees with complementary skills or consider dividing the role of trustee into its different components, with different trustees responsible for each component. For example, a FMB could serve as a distribution trustee with authority to make distributions limited to an ascertainable standard, an independent distribution trustee could be used to make distributions based on a broader standard, an investment trustee could be used to manage the trust's investments, and an administrative trustee could be used to deal with the ministerial and administrative functions of the trust.

> ***Application to Example Scenario: For Mr. Smith, dividing the trustee responsibilities among different trustees over different phases of the ILIT may accomplish most of his goals. As illustrated above, Mr. Smith could complement the benefits of appointing his brother, a FMB, as trustee by naming a professional advisor or having the ILIT hire third party service providers to handle administrative tasks and product performance reviews during the lives of Mr. and Mrs. Smith. After the death of the survivor, Mr. Smith may consider appointing a corporate trustee to serve as a co-trustee to handle the trust's investments and administration (or naming investment and business advisors to provide binding investment management guidance), leaving his brother (and/or a successor FMB or friend) responsible for distributions.***

OTHER CONSIDERATIONS IN ILIT TRUSTEE SELECTION

Considerations specific to the client, his or her circumstances, and the proposed structure of the ILIT also impact trustee selection. For example:

- **Duration**. For ILITs structured as dynasty trusts, which benefit multiple generations, long term management and investment of the trust assets will play a larger role in the selection.

- **Policy Type and Value**. ILITs designed to hold policies with significant face values or investment components (which require performance reviews) will increase the need for a trustee with (or access to) highly sophisticated and technical asset management and investment skills.

- **Subsequent Trust Acquisition**. If the ILIT will use the policy proceeds to buy real estate or closely held business interests from the insured's estate, the trustee will need to have skills or receive guidance specific to the management of these particular interests.

- **Trustee's Residence**. The trustee's residence may have income tax implications for the trust. For example, if the trustee is a California resident, undistributed trust income will be subject to California income taxes even if no beneficiaries reside in that state. In addition, application of a desired governing law may be impacted if appointment of a trustee changes the situs of the trust due to the trustee's residence. It also may impact the ability of the beneficiaries to meet in person with the trustee if needed.

- **Special Needs/Circumstances**. If any beneficiaries have special needs, such as health issues, substance abuse, former spouses, creditor issues, or the inability to manage finances, the ILIT trustee must be able to assess and deal with those issues (particularly the trustee that will serve upon the insured's death).

- **Need for Independent Trustee**. Certain circumstances may recommend appointment of a completely independent (unrelated) trustee, including to allow for fully discretionary distributions not related to an ascertainable standard, to minimize the potential for conflict among related trustees and beneficiaries, or to allow for the transfer of trust assets from the existing ILIT to a second trust for the benefit of one or more of the current beneficiaries (*i.e.*, a "decanting" power, which typically requires exercise by an independent third party as trustee).

CORRECTING TRUSTEE APPOINTMENTS

Even with the most careful planning, it may become necessary to remove a trustee. Including provisions in the ILIT for the removal of a trustee is as important as selecting the initial trustee. This authority can be granted to the client, his or her spouse, one or more beneficiaries or a third party. If, however, 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 an independent person (that is, someone who is not related or subordinate to the person making the appointment, as defined in Internal Revenue Code § 672).

TAKE AWAYS

- ILIT trustees play an important role in managing ILIT assets (which could be significant), balancing family harmony with the trust provisions, and making crucial investment, tax and legal decisions.

- The pool of possible trustees is quite large, however, and there is no one perfect choice that fits every circumstance.

- Accordingly, advisors can provide value by (1) helping clients understand a trustee's duties in administering ILITs, (2) reviewing the characteristics of a good ILIT trustee, (3) evaluating the needs of the specific client and ILIT with regard to what type of trustee(s) (family member, friend/professional, corporate fiduciary, or combination) may best fill the position, and (4) ensuring clients incorporate flexibility into the trustee position, including the power to remove and replace trustees, to allow the trust to adapt to future changes in circumstances and needs.

recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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