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Pitfalls When Guaranteed Universal Life Insurance Is Held in Trust

Pay attention to Crummey notices and the timeliness of premium payments

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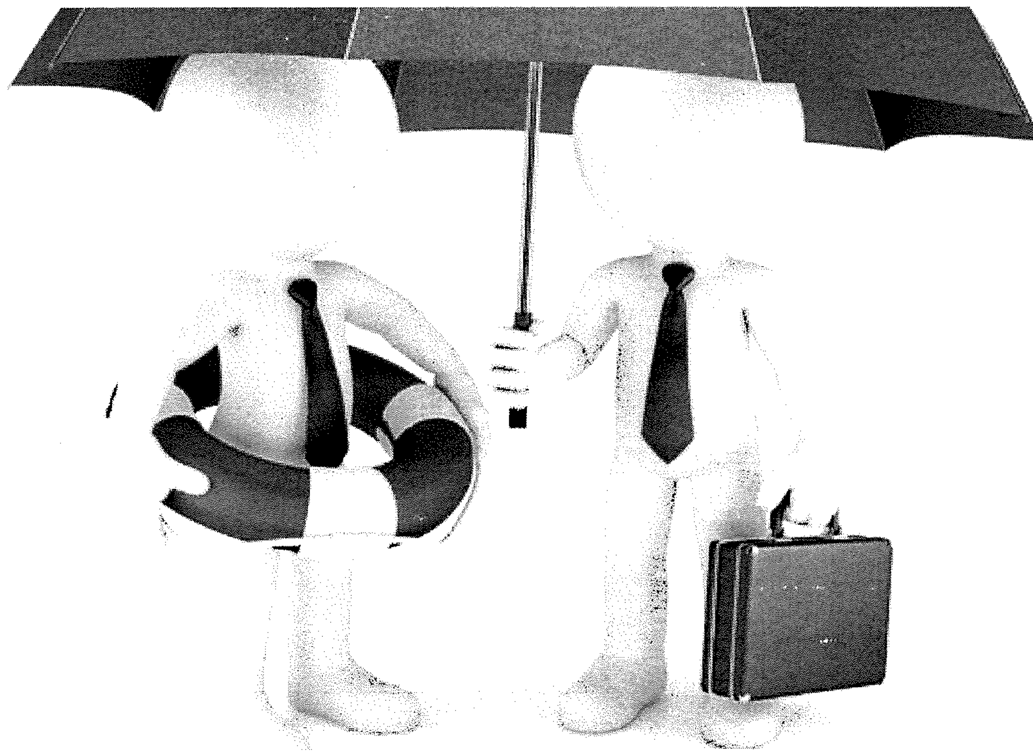

There are many different variations of life insurance policies available, for example first to die, survivorship, term, universal and whole life policies. Each type of "no lapse" guarantee insurance policy has its benefits and drawbacks. The focus of this article is the guaranteed universal life insurance policy and, specifically, when the policy is owned by a trust, ensuring compliance with both the policy and trust terms.

Premiums paid for guaranteed universal life insurance policies are more expensive than the premiums for term life insurance but less costly than premiums for whole life policies. The primary benefits of guaranteed universal life

insurance policies are: (1) that the premiums are level for the life of the policy which may extend until the insured reaches a specific age (hypothetically age 100), and (2) the death benefit will not decrease. Such no-lapse guarantees make these policies popular. Unfortunately, such benefits may be easily lost without close adherence to all the requirements of the policy, including "timely" payment of premiums.

Most insurance policies provide that a premium paid after the due date, but within a grace period (typically not more than 30 days) will be accepted, preventing lapse of the policy. Generally, neither interest nor a late fee is charged if payment is made within the grace period. Moreover, generally by statute or company policy, notice must be provided to the policy holder before the policy may lapse. However, with respect to many guaranteed universal life insurance policies, a late payment notwithstanding the fact that it is made within the grace period, and even if made only one day after the due date, can result in the loss of the "guaranteed" features. Even if the policy is not forfeited, the death benefit may be reduced or annual premium payments may no longer be guaranteed based on the premiums quoted. As a practical result, the face amount of the policy may be required to be reduced or additional annual premiums paid to keep the policy in force and effect.

Timely payment of the premiums becomes more complicated if the policy is owned by an irrevocable trust. Purchase of an insurance policy by an irrevocable trust, or transfer of a policy into an irrevocable trust, is a common estate-planning device to remove the policy from the insured's taxable estate. Typically, the grantor of the trust makes contributions to the trust in order to allow the trustee to pay the premiums. These contributions constitute a gift. Unless the gift falls under an exception, a gift tax return must be filed with the IRS and a portion of the lifetime gift and estate tax exclusion (presently $5,340,000 per person) will be utilized.

One exception to the above is the annual gift tax exemption, which is presently $14,000 per year per recipient; $28,000 if a spouse joins in making the gift. In order to take advantage of such exemption, the gift must be of a present and not a future interest. Internal Revenue Code regulations define future interest as an interest that is "limited to commence in use, possession or enjoyment at some future date or time." In order that contributions made to the trust qualify as present gifts, and not be deemed future gifts, to the irrevocable trust, they must contain "*Crummey*" withdrawal rights (named after a seminal case from 1968 in the Court of Appeals for the Ninth Circuit, *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968)rev'g TC Memo 1966-144), and the trustee must act in compliance with such trust terms.
A *Crummey* or withdrawal right is a provision in the trust agreement that permits a beneficiary, upon notice of a contribution to the trust, to withdraw all or a portion of such contribution. This right of withdrawal by the beneficiary will constitute a present interest, even if the beneficiary is a minor and/or the right was not exercised, and/or it was unlikely the right of withdrawal would be exercised. In fact, it is generally anticipated (although should not be prearranged) that beneficiaries will not exercise their rights to withdraw because withdrawal would make the funds unavailable to pay the premiums.

Upon receipt of a contribution, the trustee must give each beneficiary notice (preferably written) of the contribution and the right to withdraw a stated amount (usually limited to the lesser of the contribution, $5,000 or 5 percent of the value of the trust assets) within a set time, such as 30 days. After the time period lapses, and presuming the beneficiary has waived or not exercised the right of withdrawal, the trustee can utilize the contribution to pay the premium. If the contribution was not made sufficiently prior to the due date of the premium payment in order that there is sufficient time to prepare and send the notice and allow the time to respond to lapse (or alternatively have the beneficiary decline the right to withdraw), payment of the premium will be late.

For example, if the annual premium is due May 1, and a beneficiary has a 30-day period after notice to elect to withdraw, the contribution should be made by March 1, thereby giving sufficient time to the trustee to prepare and send the notices, wait the required 30 days and then submit the payment. Where payments are not made annually but are elected to be paid quarterly, this can be more burdensome and more likely to result in the possibility of a missed payment.

Unfortunately, many clients fail to comply with the notice provisions which may lead to negative tax implications upon death. Specifically, upon audit of the federal estate tax return the IRS may challenge the annual exclusions and make an adjustment to prior taxable gifts, thereby decreasing the exemption available upon death. However, the greater immediate consequence occurs when a client, intent upon complying with the notice provisions, fails to timely pay the premiums on a guaranteed universal life insurance policy resulting in the loss of the guaranteed benefits. Although the best of scenarios would have the client make the contribution to the trust sufficiently in advance of the premium due date to ensure timely notice and timely payment as indicated above, where guaranteed universal life insurance is involved, clients must be advised of the need to insure timely premium payments regardless of compliance with the notice provisions. If necessary, other methods can be utilized to assist the client and trustee in meeting obligations under both the guaranteed universal life insurance policy and the trust.

In addition, attorneys need to work with their clients and insurance brokers or urge their clients independently to familiarize themselves with the type of insurance being placed into any irrevocable life insurance trusts to ensure clients are fully aware of potential consequences, including how easily a loss of guaranteed benefits can be incurred.

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