TABLE OF CONTENTS

Feature Articles:
2006 Desktop Reference on the Economics of Probate and Estate Planning Practice in Michigan .................................. 3

Attorney and Estate Planning Client Relationships and Practices Involving Charitable Planned Giving in Michigan ....................... 35

Preparing Heirs for the Challenges of Wealth Ron Yolles ............................................. 52

Swatting Gnats, Ignoring Elephants Hon. Kenneth L. Tacoma ..................... 56

Drafting a Flexible Irrevocable Life Insurance Trust, Part 2 Julius H. Giarmarco ......................... 59

New Law Clarifies Funeral Rights Douglas G. Chalgian ......................... 66

Plus:
Uniformity of Practice—Are We There Yet? Joan C. Von Handorf .................. 68
This is part two of an article on drafting flexible irrevocable life insurance trusts (ILITs). Part one of this article, which appeared in the last issue of the Michigan Probate and Estate Planning Journal, focused on building flexibility in an ILIT with respect to the grantor’s access to cash values, Crummey powers, and amending or terminating the ILIT. Part two of the article focuses on drafting considerations relating to trustees and beneficiaries. Sample drafting language is also offered for the practitioner’s consideration.

**Dealing With Trustees**

**Removing and Replacing Trustees**

It is usually a good idea to include a provision in an ILIT giving the grantor and, after the grantor’s death, the beneficiaries the right to remove and replace trustees. Otherwise, judicial action will be required to remove a trustee who is unresponsive or ineffective, or whose fees are not competitive.

In Rev. Rul. 95-58, the IRS ruled that the grantor’s power to remove and replace trustees is not a reservation of the trustee’s discretionary powers of distribution that might cause the trust property to be included in the grantor’s estate under IRC §2036. Rev. Rul. 95-58 also held that any successor trustee must not be related or subordinate to the grantor within the meaning of IRC §672(c). In PLR 9607008, the IRS extended its holding in Rev. Rul. 95-58 to beneficiaries who are given the right to remove and replace trustees.

Is the use of IRC §672(c) appropriate? IRC §672(c) is an income tax standard used in the grantor trust rules and, prior to Rev. Rul. 95-58, had no estate tax significance. The requirement of a trustee who is not related or subordinate to the grantor or beneficiaries does not have any support under IRC §2036(a)(2) nor §2038(a)(1) or the Regulations promulgated thereunder. In addition, reliance on IRC §672(c) is inconsistent with the Tax Court’s holding in Estate of Wall, 101 T.C. 300 (1993). Nevertheless, most clients will be more willing to accept the IRC §672(c) limitation than face a possible IRS challenge.

Sample wording for the removal and replacement of trustees might look like this:

The grantor reserves the right to remove any incumbent Trustee or Co-Trustee and any successor Trustee designated to act in the future and appoint a successor individual or Independent Trustee or a series of successor individual or Independent Trustees or Co-Trustees. As a condition precedent to removing a Trustee or Co-Trustee hereunder, the grantor must first appoint an Independent Trustee (if no successor Trustee has already been named herein), as such term is defined below.

After the grantor’s death, or during any period that the grantor is disabled, the grantor’s spouse may remove any incumbent Trustee or Co-Trustee and a successor Trustee designated to act in the future and appoint a successor Independent Trustee or a series of successor Independent Trustees or Co-Trustees. As a condition precedent to removing a Trustee or Co-Trustee hereunder, the grantor’s spouse shall first appoint an Independent Trustee (if no successor Trustee has already been named herein) or a series of successor Independent Trustees, as such term is defined below.

After the death or disability of the grantor’s spouse, a majority of the beneficiaries (with any beneficiary under a legal disability acting through his/her Agent) then eligible to receive mandatory or discretionary distributions of net income under this agreement may remove any incumbent Trustee or Co-
Trustee and a successor Trustee designated to act in the future and appoint a successor Independent Trustee or a series of successor Independent Trustees or Co-Trustees. In addition, each beneficiary (with any beneficiary under a legal disability acting through his/her Agent) for whom a separate trust is named or established hereunder may remove any incumbent Trustee or Co-Trustee and a successor Trustee designated to act in the future and appoint a successor Independent Trustee or a series of successor Independent Trustees or Co-Trustees with respect to his/her separate trust. As a condition precedent to removing a Trustee or Co-Trustee hereunder, the grantor’s beneficiaries (or their Agent as the case may be) shall first appoint a successor Independent Trustee (if no successor Trustee has already been named herein) or a series of successor Independent Trustees, as such term is defined below. In no event shall the grantor serve as a Trustee hereunder. Notwithstanding the foregoing, at such time as a beneficiary is acting as a co-trustee of a trust named or established hereunder for such beneficiary, the beneficiary need not appoint a replacement for a co-trustee being removed if there is at least one other co-trustee then serving with the beneficiary, it being the grantor’s intention that there be at least two co-trustees serving at all times.

The beneficiaries need not give any Trustee being removed any reason, cause, or ground for such removal. Notice of removal shall be effective when made in writing by either: Personally delivering notice to the Trustee and securing a written receipt, or Mailing notice in the United States mail to the last known address of the Trustee by certified mail, return receipt requested.

As used in this instrument, the term “Independent Trustee” means a person: (i) who is not related or subordinate (within the meaning of IRC Section 672(c)) to any donor or beneficiary with respect to the trust in question; (ii) who cannot be benefited by the exercise or non-exercise of any power given the Trustee by this Trust Agreement or by law; (iii) who is neither a beneficiary nor a donor of the trust in question; and (iv) who is experienced in business, finance or investments or is an attorney or accountant experienced in the areas of trusts or taxes. In the event that any Independent Trustee should for any reason cease to meet such qualifications, he or she shall immediately cease to be a Trustee as though he or she had resigned immediately prior to the occurrence of such disqualification.

**Liability Protection for Trustees**

Many times during the grantor’s lifetime, the trustee of an ILIT is a family member or close advisor. If a corporate trustee is named in the trust agreement, the corporate trustee will usually not serve until the grantor’s death, at which time the ILIT receives the insurance proceeds. In such cases, the initial trustee may not be qualified to properly select any new policies to be purchased by the ILIT or to evaluate any existing policies transferred to the ILIT.

The terms of a trust generally determine a trustee’s duties. *In re Estate of Butterfield*, 418 Mich 241, 341 NW2d 453 (1983). Generally, the grantor can limit a trustee’s liability except for actions committed in bad faith. See Restatement (Second) of Trusts §§164 and 222. Therefore, to protect a non-professional trustee, the trust agreement should contain a provision limiting the trustee’s liability with respect to those life insurance policies selected by the grantor. The trust agreement should also indemnify the trustee from any liability resulting from his reliance on a life insurance agent’s representations.

Consider the use of the following provision to limit a trustee’s liability:

The Trustee, conclusively and without inquiry or independent investigation, may rely upon the representations of any person selling or in any way associated with the marketing, promotion or sale of a given life insurance policy regarding the relative quality of such policy (as compared to other available policies) or
regarding the absolute quality of such policy (without regard to other available policies). Specifically, but not by way of limitation, the Trustee at no tie shall have any duty whatsoever (i) to verify that any particular life insurance policy satisfies the requirements for a life insurance contract under IRC Section 7702; (ii) to compare the performance or pricing or the projected performance or pricing of a particular life insurance policy with the performance or pricing or projected performance or pricing of any other life insurance policy which may then be available from any source; (iii) to assess the appropriateness of purchasing or retaining any life insurance policy as an asset of the trust as compared to other then-available vehicles that are not life insurance policies; or (iv) to investigate the strength or solvency of the company which issued or is offering a given life insurance company policy. The Trustee may retain any life insurance policy purchased by the Trustee or transferred to the Trustee by the Grantor, a predecessor Trustee, or any other person, and the Trustee shall have no duty at any time to make any inquiry or investigation into the advisability of such retention (including, but not limited to, inquiry or investigation into the same or similar matters set forth above). With respect to any such policies retained by the Trustee, the Trustee shall have no liability to the Grantor or to any present or future beneficiary of the Trust for non-productivity, decline in value or lack of diversification of the trust assets. The fact that the Trustee may have made inquiry regarding any such matter prior to the acquisition of a policy or after the acquisition of such policy shall place no duty upon the Trustee to make any further inquiry, but shall be considered activity beyond the scope of the Trustee’s duties. The Trustee shall not be liable to the Grantor nor to any present or future beneficiary of the Trust for any loss or damage suffered in connection with performance or lack of performance of any life insurance policy owned by the Trust or by the insolvency of any life insurance company issuing any such policy. The Trustee’s duties and responsibilities with respect to any life insurance policy owned by the Trust, until such policy matures or is surrendered or otherwise disposed of, are to provide safekeeping services with respect to the policy, and to pay premiums as and when they come due or, under the terms of the policy, may be paid, if, but only if, the Trustee has sufficient available funds to do so. Grantor specifically acknowledges that the Trustee would not accept the position of Trustee unless the Trustee’s duties, responsibilities, and liabilities were limited as set out herein.

Dealing With Beneficiaries

Testamentary Limited Power of Appointment

A testamentary limited power of appointment (“LPA”) allows the beneficiary to change the dispositive terms of the trust. An LPA can be used to adapt to changed circumstances that were unknown at the time the trust was drafted. A testamentary LPA is particularly useful in ILITs with generation skipping provisions because of the long duration of the trust. The power can be given to a beneficiary without federal transfer tax consequences. IRC §2041.

Usually, the LPA limits the permissible appointees to the grantor’s descendants. However, the appointees may include anyone other than the power holder, the power holder’s estate, the power holder’s creditors, or the creditors of the power holder’s estate. For example, the LPA can include any or all of the following as permissible appointees: charities, spouses of the grantor’s descendants, or an income interest for the benefit of a spouse of the grantor’s descendants. The LPA can also be designed to allow the power holder to direct that appointed assets be held in further trust for the appointee.

A sample testamentary limited power of appointment clause might read as follows:

Each beneficiary for whom a trust is named shall have the limited testamentary power to appoint the remaining property in his/her trust to, or in trust for the benefit of, a person or
persons among my then living descendants, the spouse of a descendant of mine, or such religious, scientific, charitable or educational organizations described in IRC Section 501(c)(3), in such proportions and upon such terms and conditions and estates, with the powers, in the manner and at the times as the beneficiary appoints by a valid last will or by a valid living trust agreement which specifically refers to this power, provided, however, that any property allocated to the spouse of a descendant of mine shall be held in trust and the trust must provide that (i) only income, but not principal, may be distributed to the spouse, (ii) the spouse shall not be a trustee of such trust, (iii) the trust will terminate no later than the spouse’s death (and the trust may terminate earlier on events such as the spouse’s remarriage or cohabitation with an unrelated person), and (iv) upon termination, the trust property shall be allocated or distributed (in a manner designated by the beneficiary) among my then living descendants.

Creditor Protection

Many grantors want the assets in the ILIT to either be distributed to the beneficiaries at stated ages (e.g. one-third at ages 25, 30, and 35) or they want to permit the ILIT beneficiaries to withdraw assets at those ages. In either case, the trust assets will be subject to the claims of a beneficiary’s creditors, including divorced spouses. Therefore, the trust agreement should permit an independent trustee (or co-trustee) to postpone distributions to a beneficiary beyond the stated ages for certain reasons (i.e., a pending divorce, bankruptcy, etc.). Such a provision, coupled with a spendthrift clause, will protect the beneficiaries from their inability, their disability, their creditors and their predators.

The following language is offered to achieve that result:

The Trustee shall have the power to refuse a withdrawal request or to postpone any distributions of principal otherwise required to a beneficiary upon or after the beneficiary’s attainment of a specified age or the death of a third person, and to postpone the termination of such trust which might otherwise be required, all as if such withdrawal right had not been available, or such age had not been attained, or such death had not occurred, if the Trustee, in its sole discretion, determines that such refusal or postponement is consistent with my overall intent. In exercising such discretion, I authorize and approve the Trustee’s use of such information as may be available and pertinent, such as the beneficiary’s serious physical or mental disability, the beneficiary’s addiction to drugs or alcohol, the beneficiary’s incarceration, a pending divorce, a gambling problem, the beneficiary’s involvement in a “cult” type organization, the involvement of the beneficiary as a defendant in a civil or criminal lawsuit or in any bankruptcy proceeding, present or imminent financial difficulty, a serious tax disadvantage in making a distribution, or similar substantial cause. Any such refusal or postponement may be continued by the Trustee from time to time, up to and including the entire lifetime of the beneficiary. The Trustee’s exercise of discretion in such refusal or postponement shall be final and binding upon all parties in interest. No Trustee shall at any time be held liable for any action taken or not taken pursuant to this Section, nor shall any Trustee be required to take any affirmative action pursuant hereto, and no Trustee shall be required to inquire into or investigate any beneficiary’s status as it may relate to this Section. Notwithstanding anything contained in this Article to the contrary, during any period of time that a beneficiary’s distributions are being postponed pursuant to the foregoing provisions, the Trustee may also distribute the income and/or principal of such beneficiary’s trust to or for the benefit of the beneficiary’s spouse and descendants (if any) for said spouse’s and descendants’ health, education, maintenance and support. The Trustee may make unequal distributions to said spouse and descendants or may at any time make a distribution to fewer than all
Beneficiary-Controlled Trusts

In lieu of distributing trust assets to beneficiaries outright, consideration should be given to leaving the assets in trust for the beneficiary’s lifetime. With a beneficiary-controlled trust, the beneficiary is a co-trustee over his/her trust and has the right to remove and replace trustees (with someone who is not related or subordinate to the beneficiary, as defined in IRC §672(c)). Having a co-trustee along with the beneficiary ensures that the ILIT’s spendthrift clause will be upheld. The trust agreement usually allows the trustees to distribute income and principal to the beneficiary and his/her descendants. In addition, the beneficiary typically is the “primary” beneficiary and, therefore, his/her needs take priority over those of his/her descendants. More importantly, the trust agreement allows the trustee to acquire assets such as vacation homes and artwork for the beneficiary’s use and enjoyment (without remuneration). The trustees can also use trust assets to invest in a business that can employ the beneficiary.

Upon the beneficiary’s death, the assets remaining in the trust can be distributed by the beneficiary according to a testamentary limited power of appointment. If the limited power of appointment is not exercised, the trust property could pass to the beneficiaries’ descendants, per stirpes. Subject to the governing rule against perpetuities, the trust can continue for the primary beneficiary’s descendants upon the same terms.

There are several advantages to using beneficiary-controlled trusts. First, the assets remaining in trust for the beneficiary’s use and enjoyment are protected from creditors, including divorced spouses. Second, the grantor controls who the remaindernen are upon the beneficiary’s death, thereby ensuring trust property stays in the family. Third, to the extent of the grantor’s generation skipping tax exemption allocated to the ILIT, the assets remaining in the trust are not subject to future estate taxes. Finally, the beneficiary’s ability to name a “friendly” trustee and to act as a co-trustee over his/her trust is as close to outright ownership that one can have, while still enjoying protection from creditors, divorce, and future estate taxes.

Disabled Beneficiaries

A thorough discussion of the Medicaid program for Supplemental Security Income (“SSI”) recipients is beyond the scope of this article. However, if an ILIT provides a beneficiary with so much of the income and principal, or either, as is necessary for the support of the beneficiary, the trust is referred to as a “support” trust. If the beneficiary of a support trust is receiving SSI or becomes eligible for SSI after the ILIT is established, then the support trust is subject to claims for reimbursement by the State of Michigan. Miller v Dep’t of Mental Health, 432 Mich 426, at 429 (1989).

It is advisable to include a “fail-safe” provision in the trust agreement that “converts” a support trust into a discretionary supplemental trust if the beneficiary becomes eligible for SSI. A discretionary supplemental trust allows the trustee, in the trustee’s sole discretion, to provide the beneficiary with income and principal as needed for the beneficiary’s general welfare without disqualifying the beneficiary for public assistance. Generally, the discretionary trust provides the beneficiary with basic needs not being covered by public assistance. Since the beneficiary does not have an ascertainable interest in a discretionary trust, the beneficiary’s creditors cannot reach the assets in the trust. Miller v Dep’t of Mental Health, 342 Mich 426, at 430.

Consider the use of the following provision to protect a beneficiary receiving governmental assistance:

Whenever a beneficiary (the “disabled beneficiary”) of any trust created hereunder is eligible for any public benefits to provide for his/her basic support and maintenance (i.e.,
SSI, SSDI, Medicaid, etc.), then during the term of such trust, I direct that distributions from such trust shall be used solely for supplementing those benefits which are available to him/her. Inasmuch as possible, the Trustee is to administer such trust so that the disabled beneficiary’s eligibility for public governmental assistance programs is not endangered. Under no circumstances shall the disabled beneficiary have the power or authority to demand any distribution from the Trustee, and the Trustee is under no obligation, implied or otherwise, to make any distributions to the disabled beneficiary. Further, the Trustee may withhold distributions to the disabled beneficiary if, in the Trustee’s sole discretion, they would not be consistent with my intentions as expressed above. The Trustee has full discretion to spend a disabled beneficiary’s trust income or principal, or not to spend it, as the Trustee sees fit. The disabled beneficiary shall have no legal right to the trust’s assets, even in the case of an emergency. Notwithstanding anything contained in this Agreement to the contrary, neither the Trustee nor any Trust Protector shall have the right to terminate any trust established for a disabled beneficiary.

**Change in Marital Status**

In the typical ILIT that holds a policy on a married grantor’s life, the grantor’s surviving spouse is given a life estate in the trust assets after the grantor’s death. The spouse may also be named as a trustee of the ILIT. In addition, the spouse may have a limited power of appointment during the grantor’s lifetime over trust property, and the grantor’s in-laws may be named as trustees, power holders, or even beneficiaries or contingent beneficiaries under the trust agreement.

In the event of divorce, most grantors will no longer want their spouse (or their in-laws) to be beneficiaries, trustees, or power holders under their ILIT. Therefore, the trust agreement should provide that, in the event of legal separation or divorce, the grantor’s spouse and in-laws shall be deemed for all purposes of interpreting the trust agreement to have predeceased the grantor.

or. Alternatively, the grantor’s “spouse” can be defined in the trust agreement to mean that person the grantor is married to at the time of the grantor’s death.

Sample wording in the event of the grantor’s divorce might read as follows:

In the event the grantor and the grantor’s spouse become divorced or legally separated, the grantor’s spouse and the grantor’s spouse’s relatives (who are not also the grantor’s blood relatives) shall be deemed to have predeceased the grantor for all purposes of interpreting this Agreement (other than for purposes of the “rule against perpetuities” provisions under this Agreement). In the event a descendant of the grantor and the grantor’s spouse become divorced or legally separated, such spouse and said spouse’s relatives (who are not also the grantor’s blood relatives), shall be deemed to have predeceased the grantor for all purposes of this Agreement (other than for purposes of the “rule against perpetuities” provisions under this Agreement).

**Conclusion**

In drafting an ILIT, attorneys should resist the temptation to draft too “tightly”. Language allowing the trustees and beneficiaries to take into account changed circumstances and trust and tax laws is extremely important. While an ILIT appears by its nature to be an inflexible instrument to most clients, it is easy to build flexibility into the ILIT from inception.

Pursuant to Circular 230, to the extent this article discusses tax matters, it is not intended nor written to be used, and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer by law.
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