



## IRREVOCABLE LIFE INSURANCE TRUSTS

*Memorandum to the Settlor and to the Trustee*

*by Layne T. Rushforth*

### 1. GENERALLY

1.1 This Memo: This memorandum is for the Settlor and the Trustee of an irrevocable life insurance trust. In addition to this introductory section, there is a section for each of you, but we recommend that the Settlor and the Trustee read the entire memo. This is a general memo that does not address the provisions of any specific trust instrument; be sure to read the trust instrument carefully to determine if there are exceptions that may apply to a particular trust or situation.

1.2 Overview: A life insurance trust is an irrevocable trust that is designed to own life insurance on the life of the Settlor.

(a) It is intended that life insurance proceeds will be free from federal income taxation and federal estate taxation upon the Settlor's death, and it is possible that an insurance trust could pass several generations free from the federal generation-skipping transfer tax as well.

(b) Whether or not the intended benefits are obtained depends primarily on following very strict guidelines with respect to the transfer of insurance to the trust, the making of gifts to the trust, the payment of insurance premiums by the trustees, and the trustee's compliance with all trust provisions.

(c) As is explained below, if the Settlor dies within three years of owning any incident of ownership in a life insurance policy, the entire proceeds are taxable for federal estate tax purposes.

1.3 Grantor Trust: Because the irrevocable trust is designed to permit a trustee to purchase life insurance on the life of the Settlor, the trust is a "grantor trust" for income tax purposes. This means that any income received by the Trustee during the Settlor's lifetime will need to be reported on the Settlor's individual income tax return (IRS Form 1040), regardless of whether the Trustee retains the income in the Trust or distributes it to one or more beneficiaries. Because of this, we recommend that the Settlor consult us before transferring any significant funds or other assets to the Trust. A beneficiary's right of withdrawal ("Crummey power") can adversely affect the grantor trust status of the trust, so it is important to review the importance of the grantor trust status before making a contribution that is subject to a withdrawal right.

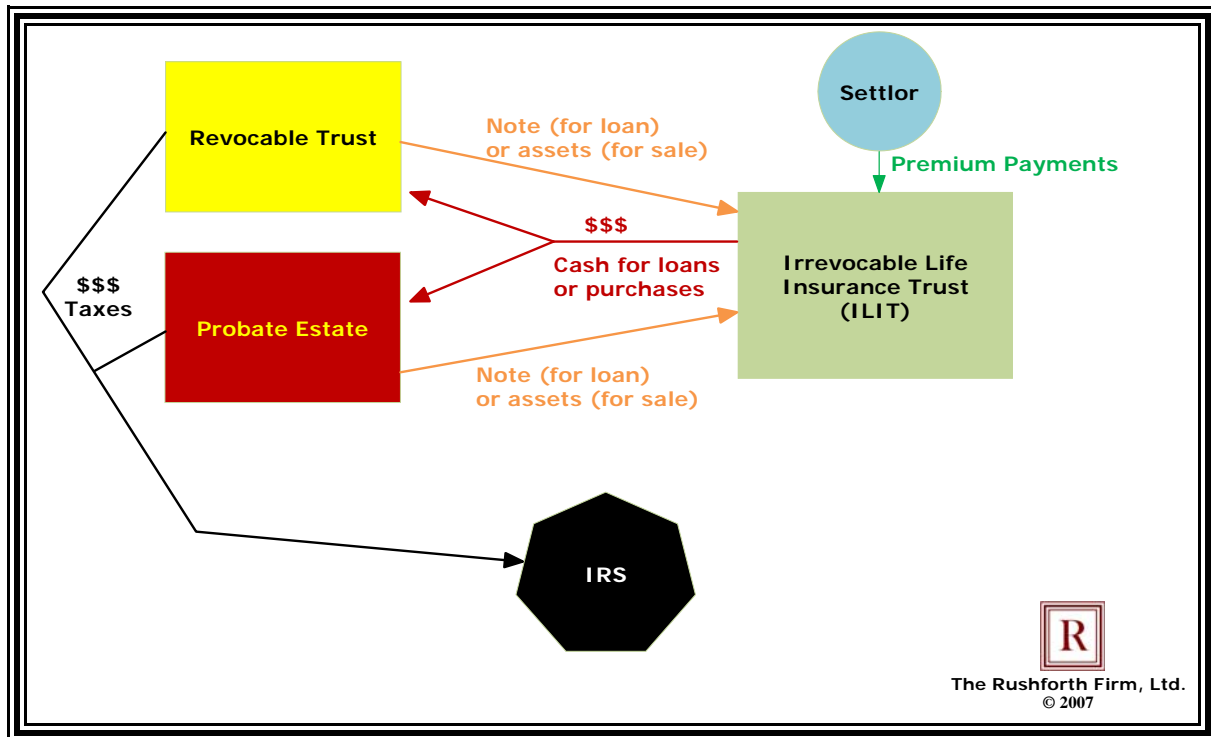
1.4 How It All Works: In order to avoid estate taxation, the insurance trust cannot be required to pay any taxes or other expenses allocable to the Settlor's probate estate or to the Settlor's revocable trust. The insurance trust specifically allows its trustee to engage in fair-market transactions with those other entities, allowing the insurance trust to purchase illiquid assets and giving the probate estate and/or revocable trust the liquid funds it needs.

(a) During the Settlor's lifetime, the Settlor makes gifts to the Trustee, and the Trustee makes trust investments, usually including the payment of premiums on life insurance policies on the Settlor's life.

(b) Upon the Settlor's death, the Trustee collects all trust assets, including the insurance policy proceeds. Because of the insurance, the insurance trust is liquid, but it owes no taxes. The entities that are taxable (the probate estate and revocable trust) can sell illiquid assets to the insurance trust so that they can, without losing value, raise sufficient cash to pay taxes and other expenses. The



insurance trust will usually wind up owning illiquid assets, but because there are no taxes to pay, there is no rush to liquidate assets at "fire sale" prices. Hopefully, the diagram below helps illustrate this point.



## 2. SETTLOR-INSURED

Here are a few guidelines for the Settlor-insured to keep in mind after signing an irrevocable life insurance trust:

2.1 Incidents of Ownership: If you transfer an existing policy, you canNOT retain any incident of ownership in the policy, including any right to change the beneficiary, borrow against cash value, or otherwise participate in any decision affecting the policy or its benefits.

2.2 Gifts: If a policy on your life is owned by someone else, that person may transfer the policy to the trustee as a gift so long as that person is not a potential beneficiary under the terms of the trust.

2.3 Sales/Purchases: A policy should never be sold to the trust by anyone except an insurance company. You, as the insured, can purchase an existing policy from another owner and contribute it as a gift, but the proceeds from any insurance policy transferred from you within three years of death will be taxed in your estate under federal estate tax laws. There are exceptions involving "grantor trusts", but you need to consult with an attorney or your accountant before arranging for such a transaction.



2.4 Initial Contribution: After signing the trust, make the initial contribution of assets to the trustee.

(a) It is acceptable for you to transfer all ownership rights in one or more existing life insurance policies to the trustee, but the proceeds from any insurance policy transferred from you within three years of death will be taxed as a part of your estate under federal estate tax laws. The initial transfer of existing policies will generally be reflected on a trust schedule, but it may not be legally binding until it is done using forms provided by each insurance company that are filed with and accepted by the company. Always insist on a written confirmation regarding the change of ownership.

(b) It is better if the initial contribution is made in cash, giving the trustee the discretion to find the best insurance policy and/or other investments for the trust and avoiding the 3-year-of-death rule for existing life insurance policies.

2.5 Premium Payments: You should NEVER make the premium payments for the trustee, allow premiums to be deducted from your personal account, or pay premiums from a business account (unless made pursuant to a "split-dollar" arrangement that is compliant with the IRS regulations).

2.6 Periodic Contributions: You may periodically make contributions of cash or insurance policies to the trust, as you deem appropriate, but never tell the trustee what to do with those contributions.

(a) Even if you want the trustee to make insurance premiums on policies owned by the trustee, do not give the trustee any instructions. Even by making the notation "insurance premiums" on a contribution check may be seen by the IRS as an instruction from you, and the IRS may feel that the trust is being controlled by you rather than by the trustee.

(b) For the same reasons, avoid making contributions only when insurance premiums are due and in the exact amount of the insurance premiums. Even if your primary goal is to keep the life insurance paid for, it is better to make contributions in excess of the insurance premiums so that the trustee can keep an interest-bearing bank account open and even invest in other assets, as the trustee deems appropriate.

(c) Contributions are taxable gifts. Under federal gift tax laws, annual gifts of \$12,000 are excluded from the donor's taxable gifts, but only if the gift is presently available to the beneficiary. Annual contributions to a life insurance trust are treated as taxable gifts unless the trust provides some present benefits for the beneficiaries. To avoid having contributions of \$12,000 or less per beneficiary treated as taxable gifts, the insurance trust provides that contributions may be withdrawn by one or more beneficiaries.

(1) In order to qualify for the annual gift tax exclusion, trust contributions must be subject to withdrawal by one or more beneficiaries. Because of a court case that validated this method of qualifying for the annual gift tax exclusion, the withdrawal right is often referred to as a "Crummey power".

(2) If the trust document grants a withdrawal right, you and the Trustee must comply with the terms of the trust language. Some documents require a specific written election by the Settlor or other grantor to make the withdrawal right effective. If the trust document does not make the contributions subject to a withdrawal right at all, you must give



the trustee notice that you want a withdrawal right to apply before making a contribution to the trust.

(3) You may designate different beneficiaries who have the right to make the withdrawals for each contribution. A withdrawal right should not be given to a person who is not a bona fide trust beneficiary because the IRS will disallow the annual gift tax exclusion.

(4) In addition, you may specify that any contribution is not subject to this withdrawal right; however, if you do, a gift tax return (IRS Form 709) will be required for that contribution, and you will have to "spend" part of your lifetime gift and estate tax "exclusion" of \$1,000,000<sup>1</sup> (or actually pay a gift tax at a rate as high as 46%<sup>2</sup> if you've already used up your "exclusion".) There can be adverse tax consequences for your beneficiaries if "withdrawable" contributions exceed \$5,000 per beneficiary, so we recommend that you contact us or other counsel before making such contributions.

(5) Even if the beneficiaries have a withdrawal right, your contributions may exceed your available annual gift tax exemption requiring you to pay gift tax or use up your gift and estate tax credit.

(6) We recommend that you consult us before giving grandchildren or lower generations ("skip persons") a right to withdraw trust contributions. Whenever skip persons are beneficiaries or even potential beneficiaries, the federal generation-skipping transfer tax ("GST tax") is a concern. Each person has a "GST exemption" that exempts \$2,000,000<sup>3</sup>, but that exemption needs to be allocated wisely.

(A) Under the Internal Revenue Code, some allocations of the GST exemption are automatic and others must be made affirmatively on a federal gift tax return (IRS Form 709). Certain contributions for your grandchildren or lower generations may automatically use up your GST exemption for purposes of the federal generation skipping tax, but if your GST exemption is better used elsewhere, you may want to elect out of the automatic allocation.

(B) On the other hand, you may wish to allow the automatic allocation for skip persons and to affirmatively elect to allocate GST Exemption to contributions being made to children if the trust permits GST-exempt shares to pass tax free to the next generation.

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<sup>1</sup>Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called "the exemption equivalent of the Unified Credit". For ESTATE TAX purposes, the applicable exclusion has been, is and will be: \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000 and 2001; \$1,000,000 in 2002 and 2003; \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006, 2007, and 2008, \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and beyond. The applicable exclusion for GIFT TAX purposes is the same as that for estate tax purposes until 2004, when the applicable exclusion for GIFT TAX purposes remains frozen at \$1,000,000.

<sup>2</sup>The maximum rate imposed for federal estate tax purposes is 46% in 2006. It is scheduled to be: 45% in 2007, 2008, and 2009; 0% in 2010; and 55% in 2011 and beyond.

<sup>3</sup>The GST tax is imposed at the highest rate imposed for federal estate tax purposes, which is shown in note 2. The GST exemption is the same as the applicable exclusion for the estate tax, which is shown in note 1.



(C) It is better to use up the GST exemption (especially with respect to the gifts of insurance premiums) than to expose the trust (including the insurance proceeds) to the generation-skipping tax (which is currently a 46% flat rate). If you determine that GST Exemption should be allocated to any or all trust contributions for a calendar year, that GST Exemption allocation should be shown on a gift tax return (IRS Form 709), which is due April 15 of the following year.

(D) Even if the withdrawal right makes all trust contributions excluded for gift tax purposes, a federal gift tax return (IRS Form 709) may be required to allocate the GST exemption (or to cancel the automatic GST exemption allocation) to trust contributions so that the trust is either exempt or nonexempt in the proportions you decide for purposes of the federal generation skipping transfer tax ("GST tax"). *If this is not done right, the problem will probably not be discovered until it's too late to correct.*

2.7 Special Rules If Spouse is Beneficiary: If you have created a trust which provides benefits to your spouse after your death, all contributions to the trust must be made from your separate property.

(a) If contributions of community property funds are made to an insurance trust and the noninsured spouse is a beneficiary, the assets (or at least some of the assets) will be included in the spouse's estate for federal estate tax purposes.

(b) If you do not have separate property funds which can be used to pay the premiums, then community funds must be converted into separate funds. For example, if you have decided to contribute \$3,000 to the insurance trust, you must take \$6,000 of community funds and give \$3,000 to your spouse, to be placed in a separate property account, and the remaining \$3,000 can be contributed to your insurance trust.

(c) We strongly recommend against having a spouse as the beneficiary of an irrevocable trust. Because the division of community property is binding only between spouses [NRS 123.220(1)], the IRS may take the position that the gift to the trust is still community property and that the beneficiary-spouse has made a gift with a retained interest, thus requiring the inclusion of the trust assets in the spouse's estate for federal estate tax purposes. [IRC § 2036(a)].

### 3. TRUSTEE

The trustee of an irrevocable life insurance trust should follow these instructions:

3.1 Acting as Trustee: All transactions you make in behalf of the trust should clearly reflect that you are acting as trustee.

3.2 Owner and Beneficiary: You should be the owner and beneficiary of all life insurance policies held by you as trustee.

3.3 Purchases and Gifts: Never purchase life insurance from anyone except an insurance company. You may accept a gift of life insurance policies so long as the gift is not made by a potential beneficiary of the trust.



3.4 Tax Identification Number: We recommend that you immediately apply for a “tax identification number” or “TIN” (also referred to as an “employer identification number” or “EIN”) for the trust. This is done using IRS Form SS-4<sup>4</sup> or it can be applied for online on the IRS web site<sup>5</sup>.

3.5 Cash Account: All cash contributions should be deposited into a separate account established solely for the trust. The bank (or other financial institution) should be given the trust's tax identification number when the account is opened. The Trustee should never use his or her own social security number (or, for a business entity, its EIN) for a trust bank account.

3.6 Personal Account: Never deposit trust contributions into a personal account or make payments in behalf of the trust from a personal account.

3.7 "Withdrawable" Contributions: The primary beneficiaries of the trust will usually be given at least 30 days to withdraw their pro rata shares of contributions to the trust (up to \$12,000 each). This withdrawal right may be outlined in the trust document or in a separate document.

(a) If contributions are subject to a withdrawal right, you must maintain liquid funds to be able to satisfy those rights until the withdrawal right lapses.

(b) You should comply with the trust provisions relating to giving notice to the trust's beneficiaries of their withdrawal rights. The IRS' position is that unless a beneficiary has actual knowledge of the right of withdrawal, the gift cannot qualify for the gift-tax annual exclusion, resulting in the use of Unified Credit (or the payment of gift taxes if the Unified Credit has already been used). *It is imperative that you comply with the requirements of the Trust regarding the sending of notice. Because the IRS does not recognize notice waivers, the notice of a beneficiary's right of withdrawal should be sent even if a beneficiary signs a waiver indicating that he or she waives the right to receive future notices!*

(c) Under some situations, a portion of trust contributions withdrawable by grandchildren or lower-generations must be set aside as separate trusts, particularly if the Settlor does not elect to allocate some of the GST exemption to such contributions.

3.8 Records: Keep meticulous records relating to the trust's assets, including financial accounts as well as insurance policies.

3.9 Independence: You *must* act independently. If the IRS perceives that you are merely an agent for the Settlor, the trust assets, including life insurance proceeds, may be included in the Settlor's estate for federal estate tax purposes. If the Settlor asks you to do something, even informally, the ultimate decision must be yours and you can be personally liable for losses to the trust if you take any action that is not permitted in the trust instrument or that is not prudent for someone who is managing funds and assets that belong to others, such as placing funds into speculative investments.

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<sup>4</sup>Which can be downloaded from the IRS web site: <http://www.irs.gov/pub/irs-pdf/fss4.pdf>.

<sup>5</sup>The form at [http://sa2.www4.irs.gov/sa\\_vign/newFormSS4.do](http://sa2.www4.irs.gov/sa_vign/newFormSS4.do) does not permit punctuation of any kind. Omit commas, dashes, periods, and all symbols.



3.10 Investments: Under current law, life insurance can often be the best way to provide for tax-free funds; however, you are not restricted to life insurance investments. You may purchase certificates of deposit, treasury notes, stocks and other securities, precious metals, and all other types of investments.

3.11 Taxes; Liabilities: This trust is written so that its assets will NOT be considered part of the Settlor's estate for federal estate tax purposes. You should never pay any tax or other liability owed by the Settlor, the Settlor's estate, or the trustee of any other trust created by the Settlor.

3.12 Sales; Loans: If cash is needed by the Settlor, the Settlor's estate, or the trustee of any other trust created by the Settlor, you may purchase assets belonging to any such entity. You may also make loans. The terms of any sale or loan should be those that are commercially acceptable at that time between unrelated persons.

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