

## MEMORANDUM

### Irrevocable Life Insurance Trusts

Many clients for whom we have prepared irrevocable life insurance trusts have asked about the proper procedures to follow in order to achieve the optimum tax effect from their trusts. In anticipation of further similar questions, we have prepared the following general comments.

The irrevocable life insurance trust is a sophisticated form of tax planning and one which is a frequent subject of new Internal Revenue Service regulations and litigation. Accordingly, proper practices must be established to meet the criteria, of which we are currently aware, relating to the ongoing management of the trust. Some of the matters enumerated in this memorandum may have already been accomplished or are in the process of being accomplished, and with respect to any such matters, this Memorandum is merely a reminder of facets of proper implementation of the trust.

Owner and Beneficiary. The primary purpose of the trust is to remove the proceeds of policies of insurance which insure a single life or two lives jointly (commonly called "survivorship policies") from estate taxation. To accomplish that goal, each such policy must be applied for and initially owned by the trust, or be transferred to the trust (as owner, not just as beneficiary) at least three years prior to the insured's death. In the latter case, this ownership arrangement can be achieved, for each policy, by executing a change of ownership form which can be obtained from the issuing insurance company for the purpose of naming the trust as the policy's new owner. The beneficiary designation of the policy must also be changed so that the death proceeds are payable to the trust. Some insurance companies accomplish both changes (ownership and beneficiary) on a single form, while other companies utilize two separate forms. Please use the following language to designate the trusts as owner and beneficiary:

[Trustee's name], Trustee of the [Settlor's Name] Irrevocable Life Insurance Trust, under Trust Agreement dated \_\_\_\_\_, or [his or her] successor in trust.

Whether you or your insurance agent obtains the forms to make these changes, we request that they be reviewed by our office before they are executed. The proper ownership and beneficiary designations are critical to the success of the trust, and we should have an opportunity to evaluate these changes to assure their legal adequacy. Please let us know if any of the policies which you contemplate transferring to the trust are presently owned by anyone other than you, as that fact adds an item of concern which may require special attention.

Gift Tax Consequences. When a life insurance policy is transferred to the trust, a gift is made to the trust's beneficiaries in an amount equal to the interpolated terminal reserve value of the policy as of the date of the transfer, plus the unused portion of the premium. The interpolated terminal reserve value is roughly equivalent to the cash value of the policy. The gift tax value of a policy can be obtained from the issuing insurance company, and can be minimized by withdrawing all dividend accumulations and making a maximum loan against any existing cash value just prior to transferring the policy to the trust. However, to avoid potential "transfer for value" exposure, total borrowings from any such policy should not exceed the total of all premiums which have been paid on the policy. Please contact our office if you think this issue might arise with respect to any policy. Future premium payments on policies owned by the trust represent additional gifts to the trust equal to the amount of the premium. We will carefully evaluate the gift tax consequences of transfers to your trust. You should, however, keep these rules in mind in connection with any possible additional transfers in the future. The trust has been prepared in such a way as to minimize gift tax consequences.

Withdrawal Powers. One of the critical factors in reducing the gift tax consequences of premium payments to or on behalf of the trust involves the powers of certain designated beneficiaries to request withdrawals from the trust each year. One of the most litigated features of the irrevocable life insurance trust involves the effectiveness of these withdrawal provisions. In order to comply with the requirements of existing cases and regulations, the trustee should establish a non-interest bearing checking account in the name of the trust. At least 30 days before a premium payment becomes due, the amount of the premium should be transferred by you, as the Settlor of the trust, by check, to the trustee, who should immediately deposit it to the trust checking account where it should be maintained until the premium due date. On the premium due date, the trustee should draw a check on the account, payable to the insurance company, in the amount of the premium. Presumably, the checking account will have a zero balance for most of the year, so you should check with your bank to determine whether any minimal balance must be maintained in the account in order to prevent it from being closed. Please let us know if any policies which have been transferred or which you contemplate transferring to the trust have premium due dates during the month of December.

Reports to Beneficiaries. As indicated above, in order to minimize the gift tax consequences incidental to administration of the trust, certain persons have been given an annual power to withdraw property from the trust. In order for this withdrawal power to be meaningful, the trustee is required by the terms of the trust to give the appropriate individuals notice of additions to the trust in sufficient time to permit the exercise of their withdrawal powers. With respect to additions to the trust through deposits to the trust checking account, the trustee should immediately give the beneficiaries such notice so

that they will have the prescribed thirty days prior to a life insurance policy premium due date in which to make a withdrawal. If premiums are paid directly to the insurance company by your employer corporation under a group or "split dollar" plan, notice of the payment should also be given immediately to the beneficiaries, and they will have withdrawal powers for thirty days following such payment. Of course, it is not anticipated that any beneficiary would, in fact, ever exercise these powers.

Generation-Skipping Transfer ("GST") Tax Consequences. Although insulating the proceeds of your life insurance policies from federal estate tax at the death of both spouses is, as mentioned previously, the primary goal of your irrevocable life insurance trust, we have discussed the possibility that a portion of these proceeds, or assets purchased from your estates by the Trustee utilizing the proceeds, may remain as unconsumed by the trust property held for the benefit of a child of yours at the death of the child. As we have discussed, your trust has been drafted in such a manner as to exclude the value of any such property from the taxable estate of the deceased child/beneficiary for federal estate tax purposes. In order to prevent the federal GST Tax from being imposed against the property at the death of the child, however, it will be essential that you allocate to gifts to the trust each year a portion of your respective \$2 million GST exemptions equal in amount to the total of all such gifts during the year. Form 709, the U.S. Gift and GST Tax Return, is the appropriate vehicle for making an allocation of GST exemption. You should contact your accountant to assist you in making this allocation and filing the Form 709. We would be pleased to assist you with these matters if you wish.

Income Tax Matters. Although the trust is a separate taxpayer, the provisions of your irrevocable life insurance trust have been drafted in such a way that the trust is what is known under the Internal Revenue Code as a "Grantor trust." This means that any income or deductions of the trust during your lifetimes will be treated as if they belonged to you individually. If the trust has gross income of \$600 or more during any taxable year, then it must file an income tax return on Form 1041 for each such year. As far as your irrevocable life insurance trust is concerned, however, there should be no need to file trust income tax returns during your lifetimes, as the only type of property intended for ownership by the trust is policies of insurance on your lives which are typically not income producing assets. Moreover, even if the trust were to have enough income to require the filing of a return, all of the income would be reported as taxable to you personally during your lifetimes. I am sure your accountant is familiar with the proper procedures for income tax reporting, but if either of you need additional information or assistance, please feel free to contact us.

This memorandum covers the basic steps which must be taken to properly initiate and maintain the irrevocable life insurance trust. If you have any questions about these matters, or if you are uncertain as to who has the responsibility for initiating

or completing any of them, please let us know. Any planning device such as the irrevocable life insurance trust which has such great potential for saving taxes is continually subject to scrutiny by the Internal Revenue Service. Because of the rapid developments in this area of the tax law, we recommend that you contact us at least every few years to ensure that the trust is being properly managed and that there have not been changes in the laws that would necessitate reevaluation of this important planning device.