

IRREVOCABLE LIFE INSURANCE TRUST

OPERATING GUIDE

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This document is for informational purposes only. Any changes in federal or state laws may invalidate the information contained herein. It is your responsibility to follow the directions herein to avail of all benefits provided by a Living Trust. If you do not, then adverse consequences will apply.

IRREVOCABLE LIFE INSURANCE TRUST

This trust is an irrevocable “Crummey” trust. The trust is designed primarily to be the owner and beneficiary of insurance policies on the life of one person. The death benefit is to be used to pay the final expenses and/or estate taxes of the insured if needed, with any balance going to the beneficiaries. The trust is designed to keep the death benefit out of the taxable estate of the insured.

Property which the insured or other donor places in the trust is a complete gift to the trust beneficiaries, with no strings attached by the donor. A discussion of the functions and mechanics of this trust follows:

Irrevocability. An insured or other donor cannot take anything back after putting it into the trust, cannot change the beneficiaries in any way, cannot control the distribution of income or principal to any beneficiary, and cannot control the trust in any way. An insured person cannot have any control over insurance policies in the trust nor have any incidents of ownership in the policies. If an insured person or other donor violates any of these prohibitions the trust can be held to be a “grantor” type of that person and all the transfers to it by that person would be invalidated as gifts, and all the gifts and death benefits would be included in his/her taxable estate.

Tax Consequences and Rules. Since the insured does not own or control the trust property in any way, anything the insured puts into the trust is subject to gift tax laws. This trust is designed to allow certain transfers to it to be considered as “gifts of a present interest”. This is important because only gifts of a present interest are eligible for the annual gift tax exclusion. It is also possible to make “gifts of a future interest” to the trust, and use the donor’s unified gift and estate tax exemption to avoid some gift taxes.

Special Note on Income Taxes and Returns. Since the beneficiaries of the trust, through the use of the Crummey provision, are deemed by the IRS to have a power of appointment, the beneficiaries will be treated as the owner of that portion of the trust which is subject to their withdrawal right. This means that the beneficiaries are not merely passive recipients of trust income, but they are treated as the owners of the source of income, the trust assets, it is as if the trust does not exist for income tax purpose. The trust does not simply report gross income and deductions on its return and then allocate the net to the beneficiaries. The trust is treated as a 100% grantor trust and the beneficiaries are treated as if they are the grantors. Each beneficiary must include his pro-rate share of all items of income, capital gains, deduction and credit on his/her tax return.

Do Not Issue K-1’s to Beneficiaries/Grantors. The trust cannot recognize any income as earned by it, so none can be reported out. The trust is required to file a 1041 Tax Return if it has a Tax ID number. If no income is received in the trust, and the bank account can be held with someone’s Social Security number, then a “final” return can be filed until such time as there is income. If a 1041 is filed with the IRS, check the “Grantor type trust” box in Section A of the form (upper left corner). Generally fill out

the return as show in the attached example. Include an “attached statement” which identifies each beneficiary as a grantor, and list the Social Security number of each beneficiary/Grantor. Included with this memo is a blank attachment form that may be used.

Please note however, if any income of the trust is used to pay premiums insuring anyone’s life, that income must be taxable to the insured. For this reason, it is best to have someone other than the insured be the grantor. Any beneficiary under the age of 14 is subject to the “Kiddie tax” rules. This means that the young beneficiary’s trust income will be taxed at his/her parents rate, not at their own rate.

Any capital assets transferred to the trust will retain the same basis that the transferor had in the asset, and the two year rule on paying the capital gains tax at the grantor’s rate is in effect (IRC Section 644).

Crummey Trust. The name “Crummey” comes from a 1968 Ninth Circuit Court case involving the IRS vs. Mr. Crummey. This court ruling allows a trust to give a notice to each beneficiary whenever a present interest gift has been transferred into the trust. The notice gives each beneficiary 30 days in which to claim any part of the present interest gift, up to the per year limit rule. (This trust is not subjected to the so-called “five and five” rule. This is due to the facts that no surviving insured person receives benefits, and each beneficiary’s share is separately held with any remainder of each share to go to the beneficiary’s estate if he/she died before receiving a distribution). The beneficiary must have an absolute right to claim and withdraw up to the limits of the gifted amount, or \$10,000 per donor, whichever is less. If the beneficiary fails to claim any of the gifts, the funds are retained in the trust for that beneficiary’s benefit and administered according to trust terms. The effect of the notice procedure is that the gift becomes a “present interest” and qualifies for the annual gift tax exclusion.

Most grantors will want to have a discussion with their adult beneficiaries and explain the use of the trust. They will advise the beneficiaries that withdrawing their gift is perfectly legal and proper. But withdrawals interfere with the estate planning, and further gifts probably would not be made to a beneficiary who withdraws one. Children under the age of 21 cannot make a withdrawal due to their minority status. The trustee is in charge of their right to withdraw and will allow the withdrawal right lapse.

Crummey Notices. Three form letter “Crummey” notices are included with the trust. One form is for gifts which are made periodically or annually (identified by the term “PERIODIC” on the lower left corner). Another is for a single or lifetime notice (identified by the term “LIFETIME”). A third form is only used to notify beneficiaries of their right to withdraw an existing policy (or its cash value) that is transferred to the trust (identified by the term “EXIST”). The lifetime notice may be sufficient to cover all gifts made to the trust in case the Trustee forgets to send out a periodic notice at some time. There is no guarantee of this, though, so the lifetime letter should be considered only a safety net. The lifetime notice should be sent out when the first gifts/funds are placed in the trust (excluding existing policies). Thereafter, a periodic letter must be sent out to

adult beneficiaries by the trustee/trust officer every time a present interest's gift is put in trust. Any time an existing policy is transferred to the trust, the "exist" letter should be sent out. If the trustee/trust officer anticipates difficulty in getting acknowledgements of the notices back from the beneficiaries he or she should send the notices by registered mail, return receipt requested.

Notices do not have to go to beneficiaries under age 21, because the trust makes the trustee the guardian of these underage (and also mentally incompetent) beneficiaries for trust business only. It therefore is not necessary for the trustee to send himself, as the legal guardian, the notice. The trustee may keep the money for these beneficiaries in the trust through the 30 day period, and beyond, with no notice and no problems. Any beneficiary over the age of 21 will have to get the Crummey notices, however.

If the grantor wants to make larger gifts than the per donor per donee limit, they may do so and use their unified gift and estate tax exemption. Any amount of gift over the annual exclusion are gifts of a "future interest" because the beneficiary does not have immediate and complete withdrawal rights of such amounts (due to withdrawal limits imposed by the trust). These type gifts will be immediately subject to the terms and provisions of the trust, rather than having to wait 30 days. That is OK, and not a problem. In fact, the future interest portion may possibly be discounted in value due to the beneficiary's lack of marketability and lack of control over the gift.

Use of "Absolute Assignment" Forms. One of these is provided for the insured. They should satisfy the insurance company's requirements for transferring ownership and beneficiaries of existing policies. (The insurance company may simply return their own form to the owner to be filled out.) Make copies of the form before filling it out if there are multiple policies for a given insured.

Separate Shares. The trustee/trust officer must use some procedure to account for each beneficiary's share separately. There must be, in effect, a separate account in the trust for each beneficiary. Funds held for one beneficiary can never be given to another beneficiary. Any transfers into the trust must be immediately separated into equal shares for each beneficiary. A breach of these requirements not only violates the trustee's fiduciary responsibilities, but has negative gift tax implications as well (the "five and five" rule would apply). All the shares can be co-mingled for the most efficient investment management (investment of all funds in one investment account), but the value of each beneficiary's share must be separately identifiable.

If the only asset is a life insurance policy of policies, nothing has to be divided or separately accounted for until the policy pays the death benefit. Each beneficiary's share of the death benefit will be the percentage specified for them in the trust. If a given beneficiary's share of the death benefit is to be held in trust for some time, then his/her share should be segregated or separately accounted for .

Paying Premiums. The insured person should never pay a premium directly on either a new or existing trust policy. All premiums should be paid by the trustee from a trust

bank account. The insured should make sufficient cash gifts to the trust to allow the trustee to pay the premiums. The gifts should go in the trust checking account, and the trustee should write and sign a trust check for the premium payment. The insured must make the gifts soon enough to allow the trustee to send out the 30 day “Crummey” notices. The trust must have the cash resources available to meet the rights of withdrawal of the beneficiaries, even though they are not going to exercise the right. If the insurance policy has enough accessible cash value, or if other trust assets in sufficient amounts are available, then the early timing of the grantor’s gift is not necessary.

Waiting Period for Existing Policies. If an insured transfers an existing policy to the trust, he/she must survive at least three more years before the policy death benefits will be removed from the grantor’s taxable estate, according to current federal tax law. It may be wise for the trust (trustee) to consider exchanging the existing policy for a new one, or cashing in the existing policy and purchasing a new one. Either maneuver should avoid the three year rule if the maneuver is done by the trust after the existing policy is transferred to it. In the case of a 1035 exchange inside the trust, it is advisable for the trustee to wait at least 30 days after receiving the old policy before exchanging it for a new one.

Use of Death Benefits. When an insured person dies, any cash or asset easily and prudently convertible to cash in the estate, or available to the estate, should be used first to pay the taxes, debts and expenses of the estate. When this occurs there may be a shortfall of readily available cash in the estate. At this point the trustee of the trust should consider whether to use death benefit proceeds to help with the estate taxes, debts and expenses of the deceased before paying distributions to beneficiaries. The purpose of helping the estate with trust assets is to prevent the possibility of the estate having to make a fire sale (a sale below market price) of its assets in order to pay taxes or debts. In most every case the beneficiaries of the trust are also the heirs of the estate, so it is in the best interests of the trust to help the estate. If the trust covers the shortfall of readily available cash in the estate, the estate assets can be sold without time pressures, or they can be transferred to heirs in lieu of cash where the estate plan call for that.

If it becomes necessary to pay any estate taxes or debts from the trust, the best procedure is to have the trust lend money to the estate, or have the trust purchase assets from the estate. The trustee is not “required” under the trust agreement to purchase assets, to lend to the estate or give to the estate. Such a requirement would cause the trust assets (death benefit) to be includable in the decedent’s estate which is exactly what the trust is setup to avoid. The trustee merely has the option of helping the estate, but as stated in the previous paragraph, that usually is in the best interest of the trust beneficiaries.

If money is lent, it should be at current interest rates. If assets are purchased, they should be bought at fair market value on the date of the purchase. By paying prevailing rates of interest, the estate can prevent the IRS fro asserting any gift tax issues as they could with no or low interest loans. If assets which are sold to the trust have the same fair market value on the date of the sale as they have in the estate tax return, there will be no gain to the estate, due to the step up in basis that the estate gets. If the fair market value of the

purchased assets has increased since the estate tax valuation date, the estate will realize long term capital gains on its sale, but the trust will receive a higher basis (equal to the purchase price).

If money is lent to the estate or if estate assets are purchased, the cash for this must come pro-rata from each beneficiary's divided share. In other words, a 25% beneficiary must have 25% of the cost of helping the estate taken from his/her share. The bookkeeping in the trust needs to reflect this.

Benefit of Naming a Successor Trustee. It is advisable to name a successor trustee in the original trust agreement to prevent any contention by the IRS that the insured(s) retained any power to select a future successor trustee. If successful, such a claim by the IRS would cause the trust assets (death benefits) to be includable in the estate of the insured.

Trustee/Trust Officer Protections. There are some liabilities which can fall on the trustee or trust officer. Here is a list of cautions and possible pitfalls to be aware of:

1. Make sure the trust names the specific policy that will be purchased (if any are to be purchased) so that the beneficiaries cannot later claim that the trustee was responsible for the purchase of inappropriate insurance or insurance that under performed.
2. Make sure that any activity that will be engaged in with regard to life insurance policies is provided or allowed for in the trust.
3. Be certain that the agent, broker or insurance company for the policies held in the trust does not pay the trustee or trust officer for something that could be construed as a commission or rebate for the purchase of trust owned insurance.
4. Beware of putting corporate or company benefits policies in the trust. The corporation pays the premiums, and/or may have some incidence of ownership or may have a loan takeout provision on split dollar insurance. Any of these can cause the death benefit to be included in the taxable estate of the insured.
5. Beware of a 1035 exchange for a policy outside the trust for a new policy inside the trust. This type transaction will invoke the three year waiting period on the new policy.
6. Carefully document and retain all records related to Crummey notices. Failure to do so could cause the inclusion of the death benefits in the estate of the insured.
7. Systematically notify both beneficiaries and grantor of any financial downgrading of insurance companies and dividend rate reductions that may occur on policies owned by the trust (though the trust carefully protects the trustee against any failure or poor performance when he accepts existing policies or buys the one stipulated in the trust).

8. Avoid all transactions which could have the appearance of a conflict of interest.
9. Permanently retain correspondence. Illustrations and analysis related to policy design, company selection and the amount of insurance benefit purchased, particularly if directly involved in this process.

Precautions to Minimize Possibility of Inclusion of Policy in Estate of the Insured

1. Communication and contact with the life insurance company prior to the actual application should be made only by the trustee and under no circumstances should any contact be made with the insurance company by a member of the family who may become the insured or a controlled person of the insured.
2. Gifts being made to the trustee from any source should not be in amounts equal to or approximately equal to the premium due; a diverse portfolio may well eliminate the possibility of inclusion in the estate of life policies upon the death of the insured.
3. Under no circumstances should the insured act as either a trustee or a co-trustee.
4. The trustee should be independent of the insured and/or not a person “controlled” by the insured.
5. The trust grantor should be someone other than the insured.

Gift Tax Returns for the Insured. The insured or other donors must file a gift tax return in any year when the amount given to the trust for any beneficiary and any other amount amounts given to the same individual in that year outside the trust exceed the gift tax annual exclusions available for that beneficiary. In other words, if the combination of inside and outside gifts exceed the annual limit to any beneficiary, a gift tax return must be filed. A gift tax return will be required for each year, even if no gifts are made in a given year, if the trust requires allocation of the generation skipping transfer tax exemption (which normally is not the case).

If an insured or policy owner transfers an existing policy to the trust, any cash values are subject to gift taxes. If the cash value exceeds the per year/per donee rule, a gift tax return is necessary.

Read the Trust. There are many vital and specific benefits, provisions, and requirements in the trust that are not discussed here.