

Administration Of An Irrevocable Life Insurance Trust¹

If you are reading this memorandum that probably means that you have adopted an irrevocable life insurance trust (referred to as an “ILIT” in this memorandum) as a part of your estate plan. But now that you have it, what do you do with it? This memorandum is a guide for the administration of an ILIT.

The principal function of an ILIT is to own and be the beneficiary of one or more life insurance policies. The principal motivation for adopting an ILIT is to cause the proceeds of the life insurance to escape estate taxes not only at the death of an insured but also at the death of the insured’s spouse. The insurance proceeds will usually be free of income tax as well. The ILIT will preserve any exemption from claims of the creditors of the insured which is granted under state law. Finally, the trustee will be in a position to assist the estate of the deceased insured with liquidity needs, including the payment of estate taxes on other assets. For all these reasons and more, the ILIT is an effective and popular tool in estate planning.

The Document

There is generally one original document signed. The insured is usually the creator, or grantor, of the trust. The original document may be kept by the insured, the attorney who drafted the document or by the trustee. Wherever it is kept, the original document should be kept in a safe place and be available when needed for any purpose.

The document will be drafted to fit your needs. There are certain provisions which should be included for tax purposes and others which will be designed specifically for your estate plan. The ILIT is a very technical document and should be prepared by someone familiar with the tax rules associated with its use.

The matters discussed in this memorandum may differ in some respects from your particular trust. *Always refer to the document itself for guidance in the administration of the trust.*

Ownership of the Insurance Policy

If an insured person dies owning any “incident of ownership” (a term defined by the Internal Revenue Service) in an insurance policy, the proceeds of the policy will be included in his or her estate at death when the proceeds are paid. This is true even though the value of the policy may have been very little, if anything, during the lifetime of the insured. An incident of ownership can be something very simple and basic, such as the power to name the beneficiary of the insurance.

To insure that the ILIT accomplishes its goal, you should follow these general rules with respect to policy ownership:

1. If you are transferring an existing policy to the ILIT, you should obtain from your insurance company the appropriate forms to both transfer ownership and to change the beneficiary designation to the trust. The ownership of the policy should be listed in words such as “George Washington, trustee, of the Thomas Jefferson Insurance Trust dated July 4, 1776.” The same general wording should be used for designating the trust as beneficiary.²
2. If you are purchasing a new policy, it is important that the trust be the applicant for the policy. You will sign the application only as the insured. The trustee of the ILIT will sign the application as the applicant and owner.³
3. You may not, if you are the insured, have any power or control over the policy which amounts to an incident of ownership. This does not mean that you lose all control over the trust. For example:

You may:

- Have the power to remove a trustee without cause
- Have the power to appoint a successor trustee provided that the trustee is not the insured or a person who is related or subordinate person (such as an employee) with respect to the insured
- Make additional gifts of property to the trust, including assets other than insurance policies
- Pay the insurance premiums directly to the insurance company or make contributions to the trust to provide funds for the trustee to pay the premiums.

² You should be aware that when a “transfer” of an existing policy will not be effective for tax purposes for three years from the date of the transfer. The trust will own the policy and the trust will govern the disposition of the proceeds if you die within the three year period but the proceeds will be a taxable asset for your estate nevertheless.

³ If you are the applicant, even though the policy is issued to the ILIT the IRS may argue that a transfer of the policy has occurred. As discussed in the preceding footnote, a “transfer” triggers a three-year wait for tax effectiveness. If the ILIT is the applicant, no transfer occurs and the trust is effective for tax purposes immediately.

- Under certain circumstances, you may retain ownership of the cash value of the policy during your lifetime although the death benefit must be irrevocably assigned to the trust

You may not:

- Be the trustee if you are the insured person
- Revoke the trust nor withdraw property from trust ownership
- Change the terms of the trust including the selection of trust beneficiaries
- Direct the trustee as to the management of assets owned by the trust, including the management of funds held within an insurance policy owned by the trust
- Pledge trust assets as security for any of your debts
- Receive any income or other economic benefit from the trust

Payment of Premiums

Since the trust is the owner of the policy, the trustee has the obligation to pay the insurance premiums. However, it is a common practice for an insured to pay the premiums on a policy of insurance owned by another person or by a trust. If you pay the premiums, you will be considered to have made a gift to the trust's beneficiaries since it was not your obligation to pay the premium. Payment of the premiums by the insured does not, of itself, cause the policy to be included in the insured's estate for federal estate tax purposes. However, some planning is required to insure that the premium payments are properly made under federal gift tax rules.

Most gifts under \$11,000 to a single donee in a single calendar year can be sheltered by the federal gift tax annual exclusion. However, the exclusion is available only if the gift is one of a "present interest." Since a trust typically delays the beneficiary's receipt of property, a gift through a trust is a gift of a "future interest" and therefore does not usually qualify for the exclusion.⁴

⁴ In addition to use of the \$11,000 annual exclusion, gifts may be sheltered using the lifetime exemption. This exemption is \$1 million which may be used in whole or in part at any time. The lifetime exemption does not have the restriction that the gift must be a present interest. However, to the extent that the lifetime exemption is used to shelter insurance premiums, it is not available for other gifts or against the estate tax at death. For that reason, most donors prefer to qualify premium payments for the annual exclusion if possible.

One technique for creating a present interest, is to grant one or more beneficiaries of a trust a right to withdraw property from the trust for a limited period of time following the gift. If the withdrawal right is not exercised within the limited time period, it lapses. Because there is an unrestricted right to withdraw property during the limited time period, the withdrawal right causes the gift to be a present interest.

The withdrawal right must be meaningful. There must be adequate notice of the right given to the beneficiary and there must be property available to the trustee with which to fund the withdrawal right if it is exercised. The IRS has agreed that the property which is the subject of the gift need not be the same property used to fund the withdrawal right so long as it is funded with property of equivalent value. Therefore, the premium money might be the subject of the gift but the withdrawal right might be satisfied from other property available to the trustee. The trustee must have the ability to fund the withdrawal right, if exercised, from property available to the trust.

There are several different ways to make the premium payments and to qualify for the \$11,000 gift tax annual exclusion:

1. Payments can be made to the trustee. The trustee could then hold the funds for the withdrawal period before turning the funds over to the insurance company. This requires you to make the payment to the trustee at least 30 days prior to the premium due date and for the trustee to hold the funds subject to withdrawal until the withdrawal period expires. This is the most conservative option since it makes the same funds available for withdrawal which were the subject of the gift.
2. Payments can be made to the trustee in one year equal to two or more years' premiums. In year one, all of the funds are held for the 30 day withdrawal period. After 30 days, the premium is paid and the remainder of the funds are permanently invested by the trust. In year two and thereafter, premiums can be paid to the trustee who can in turn immediately pay the premiums to the insurance company without holding them for 30 days. The permanent investment assets could be used to fund a withdrawal demand if made.
3. The most common method is for the insured to pay the premiums directly to the insurance company. This is treated as a deemed gift to the beneficiaries of the trust just as if the funds had been given to the trustee. However, since the premium money will not be available to fund a withdrawal gift, other arrangements must be made to guarantee satisfaction of a withdrawal demand.
 - 3.1 One possibility is to follow option 2 in year one with direct payments to the insurance company commencing in year 2. If funds in excess of the annual premiums were given directly to the trustee and invested as in option two, the investment assets could be held permanently by the trustee as a fund from which to satisfy a withdrawal demand. This is similar to option 2 in that the

first year's gifts would be made to the trustee but is different in that premium payments in subsequent years would be made directly to the insurance company.

- 3.2 The IRS has recognized in private letter rulings that the insurance policy itself is property which could be used to fund a withdrawal right.⁵ This means that, if a beneficiary exercises the right, the trustee could satisfy the demand by distributing to the beneficiary an ownership interest in the insurance policy itself. The trustee need not keep a separate investment fund from which to satisfy withdrawal demands. The trust document must expressly authorize the trustee to satisfy a withdrawal demand by distributing an interest in the insurance policy.

Although the option described in subparagraph 3.2 is not sanctioned by statute nor other authority which carries the weight of law, it has been agreed to privately by the IRS. Although there can be no assurance that the IRS will not change its informal policy as described in its private letter ruling position, we believe it is unlikely that the IRS will do so. If the withdrawal right fails for some reason to qualify for the federal estate tax annual exclusion, the gift will typically be sheltered by the \$1 million lifetime exemption. Loss of the annual exclusion does not affect the exclusion of the insurance proceeds from the insured's taxable estate for federal estate tax purposes. For these reasons, in many cases the insured's prefer the convenience of direct payment.

The Limited Withdrawal Right

As discussed above, the purpose for the limited withdrawal right is to create a present interest gift qualifying for the federal gift tax \$11,000 annual exclusion. It is important that all of the administrative procedures stated in the trust relating to the withdrawal right be strictly followed and that records be preserved. Upon the death of the insured, the IRS may wish to examine these records.

⁵ The IRS has privately ruled that a withdrawal right may qualify as a present interest even though the only property available to fund the withdrawal right is the insurance policy itself and even where the insurance policy had no cash value. The trust, however, must give the trustee the authority to satisfy the demand by distributing an interest in the life insurance policy. For examples of private rulings involving whole life policies, see PLRs 8044080, 8015133 and 8008040. For examples of private rulings involving individual term policies, see PLRs 7826050, 7935091, and 7947066. Private letter rulings are binding only between the IRS and the specific taxpayer who requested and obtained the ruling. By law, private letter rulings may not be cited as authority for the results obtained. However, private letter rulings are a good indication of the policy position of the IRS and as to how the IRS might treat similar fact situations involving other taxpayers in similar situations.

Although you should refer to the express language of your document, the following rules generally apply:

- Not all gifts or premium payments need by the subject of withdrawal. You have the option to designate which gifts are withdrawable by notice to the trustee. For convenience, one written notice by you to the trustee that all gifts are withdrawable is sufficient. This notice may be revocable as to future gifts but not as to past gifts
- You may designate those beneficiaries who are to receive withdrawal rights and the amounts each may withdraw. You may change this designation as to future but not past gifts. Again, a written notice from you to the trustee is required.
- Each beneficiary who is to receive a withdrawal right must receive actual and immediate notice of the right.
 - ▶ The trustee will deliver, usually by mail, written notice to each beneficiary receiving a withdrawal right stating the terms of the right. Terms must include the time limit, the amount, and the procedure the beneficiary must follow to claim the right
 - ▶ In the case of a minor beneficiary, notice can be delivered to a parent with whom the minor resides. Preferably, notice should be addressed to the parent who is not the insured. There is no minimum age for a beneficiary. An infant can be the recipient of the withdrawal right but the infant must still receive notice through his or her parent.
 - ▶ The beneficiary should sign the notice since that will be proof of receipt. The beneficiary can waive the balance of the withdrawal period causing the right to lapse immediately. The beneficiary cannot waive the right to receive notice of future gifts not yet made.
 - ▶ If the time and amount of future premium payments is known, a single notice can include a schedule of future withdrawal rights and notice need not be given again with each gift. However, the date and amount of each gift must be specific; otherwise, separate notice will have to be given with each gift.
 - ▶ So long as any withdrawal right is outstanding, the trustee must have sufficient property in the trust to satisfy the right if it is exercised. The property may be the insurance policy itself, provided the trust document permits its use for this purpose.

Whatever method of premium payment you choose, it is important to follow the notice requirements and other requisites of the withdrawal rights as described in the trust instrument.

Samples of letters which might be used to effect the required notice are included with this letter. *Do not use these sample letters without comparing them to the specific language of the limited withdrawal rights in your trust document!* If necessary, modify the sample letters to reflect the language of your document.

The beneficiaries of the trust should be informed as to the purpose for the insurance trust and the purpose for the withdrawal rights. It is very unlikely that an informed beneficiary will exercise the withdrawal right. Moreover, should a beneficiary do so, it would be short-sighted since a donor might reevaluate other parts of the estate plan to the disadvantage of the withdrawing beneficiary!

Sources of Funds for Premium Payments

Generally, both for practical reasons and for tax planning reasons, premiums are paid by the insured. In many cases, the beneficiaries are children who do not have the resources to fund the premium payments. Gifts of premium money by the insured parent not only provide the insurance benefit but also removes the premium money as an asset of the insured's estate. Lifetime gifts from parent to child are good estate planning and one of the most effective, and leveraged, gifts is that life insurance premiums.

Private Split Dollar Arrangements

The insured may simply have sufficient liquid resources to fund the payments. However, often the insured may wish to either (i) preserve his own access to the cash value of the insurance policy, such as for his own retirement, or (ii) may wish to use his federal annual gift tax exclusion for some other purpose. In this case, you may consider a technique called "private split dollar" arrangements.

In a private split dollar arrangement, the ILIT owns the death benefit associated with the insurance policy. The insured, however, continues to own the lesser of his cumulative premium payments or the cash value of the policy. The insured's ownership interest, generally the cash value of the policy, is in the insured's taxable estate. The excess of the insurance proceeds are, however, excluded from the taxable estate and are owned by the ILIT just as in traditional situations. During the insured's lifetime, the insured can withdraw cash value or borrow against cash value since it is his property. And, since the insured retains ownership of the cash value up to the amount of his premium payments, he is not making a gift when he makes a premium payment.

Family Business Owners

In some cases the insured depends on funds originating in a closely-held business as the source of funds for premium payments. If the insured is in control of the business, compensation can sometimes be adjusted to increase cash flow for premium payments. If children are employed by the business, their compensation may be increased and part or all of the premium burden can be shifted to the children. If children who are beneficiaries of the trust are also owners of the business,

distributions from the business may permit the children to carry part of the burden of premium payments which preserves the parents gift tax exclusion for other gifts. The latter technique works best if the business is an “S” corporation, partnership or limited liability company where distributions are not treated as taxable dividends.

Generally, for tax planning purposes the burden of premium payments is shifted to the children only when the parent intends to use his or her gifting ability and exclusions to make other gifts. This might occur, for example, where the parent wishes to make gifts of interests in the closely-held business to the children. Otherwise, premium payments by the parent should be made so as to further reduce the parent’s estate rather than reducing the children’s property.

Due Diligence

From the day you first consider the purchase of an insurance policy throughout the existence of the policy, you should continue to review many aspects of the policy if you want to obtain the maximum benefit from your purchase. What you need to monitor depends on what type of policy you purchase and how you expect to pay for it.

Although modern life insurance products are increasingly complex, they generally fall into four broad categories: term, whole life, universal life, and variable. It will help to sort through the complexity if you remember that the insurance itself is simple—you agree to pay the insurance company the cost of the death benefit at least yearly (often referred to as the “mortality” charge) and the insurance company agrees to pay to the beneficiary the death benefit if you die during that year. The mortality charge differs from company to company based on its own experience with its own insured customers.

Why then are insurance policies and illustrations given you by agents so difficult to understand? That’s because the insurance industry has come up with a complex “rating” system for potential insureds and many different ways to “assist” you in the payment of the mortality charge. The rating system is each company’s way of evaluating the risk of your death compared to others of your age group. Assistance with your premium payments takes the form of allowing you to invest excess funds inside the policy with the investments to be directed either by the insurance company or by you.

Ratings

You are “rated” by the insurance company when you obtain the insurance based on your health and age. Thereafter, the mortality charge increases each year as you get older based on your rating. For example, a smoker is rated as a higher risk for the insurance company than a non-smoker and pays a significantly higher mortality charge even though both are the same age. Other ratings are imposed for other health reasons. It may be possible, but is usually difficult, to obtain a better rating during the life of the policy if the reason for the rating ends. Although terminology differs from company to company, usually the very best rating is referred to as “preferred”, the next as

“standard” and thereafter as table 2, 3 or 4 (for some reason there doesn’t seem to be a table 1). You may get several offers of insurance from different companies offering different ratings. You may find one company offers to insure you as a standard while another offers a table 2. You may also find that the cost of a table 2 from one company might be cheaper than a standard rating from another! Shop around.

Investing Additional Funds In Your Insurance Policy

Income earned on investments inside the insurance policy enjoy freedom from income tax and so are favored forms of investment. Putting investment money inside an insurance policy is much like investing in an individual retirement account without all the restrictions associated with an I.R.A. However, with the opportunity to invest inside the insurance policy come additional administrative fees and other costs. Some, but not all, of these costs will be disclosed in the illustration provided by the agent when you purchase the insurance. In addition, these costs can be changed arbitrarily by the company from year to year.

Your insurance “premium” therefore consists not only of the mortality charge but also of various administration costs such as agent commissions, investment manager fees and other costs. It also includes, and this can be as much as you wish with some policies, the additional amount which you wish to invest inside the policy to take advantage of the income-tax sheltered feature of life insurance.

It helps to understand the different types of insurance products if you think of the differences as relating only to how you fund the premium payment, i.e., whether and how you use investments inside the policy to build a fund from which to pay the mortality and administration costs. The differences essentially differentiate the four primary categories of insurance policies:

- *Term:* A term policy is one in which there is no cash value. This is the cheapest form of insurance in terms of current premiums because you are paying the insurance company no more than the minimum necessary to fund the cost of insurance. Most term insurance is referred to as “level” term meaning that the annual premium is fixed, or level, for a maximum number of years (typically no more than 20 years). Term is appropriate for younger persons who need the cheapest form of death benefit protection while they build their estates and for older persons who need death benefit protection for a limited number of years.
- *Whole Life:* This the oldest form of policy which includes an investment element and is also the most expensive. With a whole life policy, the insurance company gives you certain guarantees which typically include: (i) a fixed premium for life; (ii) a predictable increase in the cash value; and (iii) endowment at age 100. Endowment means that if you reach age 100, you need not die for the policy to pay and you can walk away with the full face value of the policy! Because of the endowment feature

and because the insurance guarantees the level of the premium to remain fixed, the costs of this type of insurance is very high.

- *Universal*: Several years ago, universal insurance was offered as an alternative to whole life for persons who were willing to forego the guarantee of a fixed premium through age 100 in return for the opportunity to enjoy returns on money invested with the insurance company at rates greater than the insurance company was willing to guarantee. In effect, the consumer is bearing some of the market risk of investments in return for the opportunity to achieve a higher return. Investment of your excess premium dollar is still done by the insurance company but the insured gets a return credited to his account equivalent to money market interest rates (sometimes referred to by the insurance company as the crediting rate). Sometimes a minimum crediting rate will be guaranteed but, if so, it will be very low.
- *Variable*: Especially in recent years with the success of the stock market, consumers of life insurance have wanted to invest their excess premium dollars in equities rather than in money market type funds. The insurance industry responded with what is referred to as variable insurance which allows the owner of the policy to direct the investment account in equity type investments—typically among a family of mutual funds offered by each insurance company. Variable insurance also differs from other forms of insurance in that the investment account is not “owned” by the insurance company and is thus not subject to claims of the company’s creditors if the company should become bankrupt.

A term policy is generally straight forward and relatively simple to understand. Once it is in place and a payment method adopted, it requires little maintenance on your part during the term of the insurance. A whole life policy requires the most attention at the time of its purchase. Be sure you understand all of its features and costs before you purchase. Once purchased, because of its guarantees a whole life policy is also relatively simple to administer during the life of the insured.

However, with universal or variable life policies, you should evaluate the performance of the policy at least annually to be sure that its performance is at least in accordance with your expectations or whether some change needs to be made. When you purchase a universal or term policy, the agent will offer you an “illustration” of predicted performance. This illustration will disclose the assumed return you will make on your investment in the insurance product in excess of costs. The assumed return will be stated as an interest rate in the case of universal or a percentage annual return in the case of variable. If, in fact, your account performs exactly as assumed, then the illustration gives you the predicted increases in your account value and the age to which you can expect the account value to be sufficient, together with any projected premiums, to pay the mortality costs and administrative charges. The initial illustration may assume that the account will, for example, carry the insurance to age 90, 95 or 100.

The only thing you can be certain of is that the illustration is wrong! It is very unlikely that you can predict interest rates next year let alone what they might become in five or ten years. And who could predict where the stock market will be in five or ten years? If your investments do better than the illustration, fine. If, however, your investments do less well then your investment account will not grow as predicted and there will be fewer funds to pay mortality costs and charges in later years.

The effects of lower investment returns than predicted can be several. First, you may be required to pay premiums for more years than you anticipated. Policies are sometimes sold on a “5 pay”, “7 pay” or other predicted number of premium payments.⁶ This prediction is based on an assumed investment return which, if not achieved, will mean that the prediction fails and more premiums are required. Second, you may find that the anticipated age to which your insurance will be carried is less than illustrated. Rather than carrying the policy to age 95, for example, the current premium payment level might only carry the policy to age 92. Worst of all, you might find the current premium level will not carry the policy at all!

Fortunately, universal and variable policies are designed to be flexible. Should you find that the policy is not performing as predicted, you have several options. You can accept the changed circumstances and hope that they improve in the future. This usually means that you accept that the insurance coverage may not exist as long as you expected. Alternatively, you may be able to accept a lower face value of coverage in order to obtain a longer period of coverage.⁷ Finally, you can elect to pay more premium.

If none of these options are attractive, you can examine the possibility of replacing your current policy with a new policy. Often, because people are living longer than ever before, insurance companies are offering policies with lower mortality charges than those which may have been offered when you bought your policy. Also, you may wish to change the form of your insurance such as from universal to variable. It may be to your advantage to replace your policy even though you may incur additional commissions or administration charges resulting from the exchange. The tax laws permit you to exchange one policy for another without recognizing a taxable gain or loss.⁸ To

⁶ This is sometimes referred to by the agent or insurance company as a “vanishing premium.” It may be that the premium vanishes after a number of payments but the mortality charges and administration costs certainly do not vanish. Your account value must be built high enough with the number of premiums paid to sustain the costs of the insurance through the predicted life of the policy. The insurance company, except with whole life, never guarantees the number of premiums in a vanishing premium prediction.

⁷ You generally do not have the option of increasing the face value of the policy without additional evidence of insurability but you usually can decrease the coverage.

⁸ This is called a “Section 1035” exchange. Not all exchanges of policies qualify as income tax-free.

obtain a new policy, you will generally be required to provide evidence of your insurability (usually a new physical examination).

Obviously, someone must pay attention to the economics of your investment. This person most likely should be you as the purchaser of the insurance. It may also be your trustee, depending on your choice of trustee. You should expect your insurance company to provide at least annually, or more frequently upon request, what is called an “in force statement” which will summarize the current status of the policy.

Changing Trustees

When you created your ILIT, you chose an initial trustee. For tax reasons, that trustee cannot be the insured. Sometimes it can be the spouse of the insured but this is tax sensitive if the spouse is to be a beneficiary of the ILIT. The trustee can be a beneficiary but this too can be tax sensitive. If you have retained the power to remove a trustee and to choose the successor trustee, the successor trustee cannot be a related or subordinate person as defined by the Internal Revenue Service.

Most people will appoint an individual to serve as trustee during the lifetime of the insured. This person is frequently chosen as a convenience and the person frequently serves for no compensation as a favor to the insured. Under this type of arrangement, it is usually planned that the individual will be replaced by a professional trustee upon the death of the insured when the proceeds of the insured are received and require professional management. At a minimum, the individual trustee will be required to prepare and send the notices required with respect to limited withdrawal rights as stipulated in the trust document.

If you have selected a person to serve as your trustee without compensation as a favor to you, you cannot expect that this person will perform the due diligence with respect to the insurance policies owned by the trust as discussed above. If you want the trustee to perform this function, then you should consider a professional trustee even during your lifetime. Corporate trustees will charge you an annual fee which will include the cost of performing the due diligence.

Changing Policies

If as a result of your due diligence examination of policy performance you decide to change the insurance policy, the trust should be the applicant for the new policy. Reasons you might wish to change the insurance policy include: (i) you believe a new policy may be issued with a more favorable rating (you’ve stopped smoking for example), (ii) the new policy offers new forms of investment options you find more attractive (replacing universal with variable for example), or (iii) the costs of insurance in the new policy are more favorable. Since the trustee is the legal owner of the policy, the trustee must accomplish the change but will usually do so in accordance with your wishes. The trustee is not, however, *required* to follow your wishes since that would cause the insurance to be included in your estate for estate tax purposes.

One alternative is simply to stop premium payments on the old policy and cause the trust to apply for the new policy. If there is cash value in the old policy, you may either (i) elect to reduce the face value of the existing policy to a level where the existing cash value will carry the policy, or (ii) roll the cash value into the new policy through a tax-free exchange of policies. In some policies, the “account value” may be higher than the “surrender value” so that more efficient use of the old policy may be to preserve it at a lesser face value.

In any case, changing the insurance policy will generally require that you provide new evidence of your insurability. You will probably take a new physical examination.

Tax Returns and Reporting Requirements

An ILIT is an income tax paying entity and will be required to obtain a taxpayer identification number. The tax I.D. number is obtained by the trustee who submits an IRS form SS-4 to the IRS regional office where you file your tax return. Some, but not all, regional offices will provide an I.D. number to the trustee (and only the trustee) by telephone. The most reliable way to obtain the number is for the trustee to fax the completed Form SS-4 to the IRS and the number will be received back by fax in a few days. The I.D. number may also be obtained by submitting the Form SS-4 by mail but the IRS reply time takes weeks. You can obtain a Form SS-4 from us or from any IRS office. Instructions for completing the form are included with the form.

However, unless you transfer substantial funds to the trustee of the ILIT for investment, or use the ILIT for some purpose other than to hold the insurance policy, it is unlikely that the trust will have taxable income. Unless it does have taxable income, the trust will not be required to file a federal income tax return. State income tax filing requirements can differ from federal. If an income tax return is required, the responsibility for filing the return lies with the trustee. If you have appointed a convenience trustee, you should determine whether there is a filing requirement and cause the appropriate returns to be prepared for the trustee’s signature.

Premium payments by you may require the filing of a federal gift tax return (IRS Form 709). You are required to file a gift tax return if your gifts to any one person in any one calendar year exceed \$11,000 in value. This limitation includes the value of any deemed gifts made to that person as a result of premium payments by you. If gifts by you exceed \$11,000 but do not exceed \$22,000, your spouse may consent to allow up to one-half of your gift to be deemed a gift by him or her so as to utilize the spouse’s annual exclusion. This is known as a “split-gift.” A split-gift requires filing a gift tax return with the consenting spouse’s signature to indicate that consent. Gift tax returns are due by April 15 of the year following the year of the gift.

Gifts exceeding the gift tax annual exclusion require filing of the gift tax return. The return will report the amount of the lifetime exemption used by the excess gift. A gift tax return is also required if the ILIT is designed as a “generation-skipping tax exempt” trust. By allocating a portion of your exemption from the generation-skipping tax to the trust, you can cause the trust to be exempt from estate tax at the death of trust beneficiaries. Filing of a gift tax return may be required simply

to allocate the generation-skipping tax exemption even if the gifts alone are not large enough to require a return. On the other hand, an allocation of the generation-skipping tax exemption may be automatically allocated to the trust when this is not desirable. If so, you can elect to “opt out” of automatic allocation by so indicating on a timely filed gift tax return. **THIS CAN BE VERY IMPORTANT!** You should confer with us or with your accountant responsible for preparing your tax returns about the necessity to file a gift tax return.

Upon the death of the insured, the proceeds of the policy will be received and invested by the trustee. Income earned by the trust at that time will be reported on a fiduciary income tax return (IRS Form 1041) and will generally be prepared by an accountant or by the professional corporate trustee.

If a federal estate tax return is required after the death of the insured, that return will also be required to report any insurance on the life of the decedent even if the insurance is owned by an ILIT and not taxable in the estate. The preparer of the estate tax return will be required to obtain from each insurance company a form which describes the ownership and value of the insurance which form will be included with the return when filed.

Death of the Insured

Upon the death of the insured, the transition to the professional, corporate trustee should be accomplished as soon as possible. This is usually accomplished by a resignation of the convenience trustee followed by an acceptance of the trust by the corporate trustee. The corporate trustee will then file all appropriate claim forms with the insurance company to obtain payment of the insurance proceeds.

You may have purchased the life insurance as a means of providing the cash to pay your anticipated estate taxes. The estate tax liability is imposed on those assets in your estate, usually those passing through probate or those held in a revocable living trust. The obligation to prepare and file the estate tax return and to pay the estate taxes lies with your personal representative (executor) if there is a probate, or with the person in possession of the taxable assets (the trustee in the case of a funded revocable living trust). Neither the obligation to file the return nor to pay any of the taxes is imposed on the trustee of the ILIT.

In order to keep the insurance proceeds from being included in your estate for tax purposes, the ILIT cannot be required to pay taxes directly or to deliver cash to your estate for the purpose of paying taxes. In order to provide the estate with the liquidity it needs to pay the taxes, the trustee of the ILIT may, but is not required to, cooperate with the estate in one or both of two ways. First and most likely, the ILIT trustee may purchase illiquid assets from the estate at their fair market value as reported on the estate tax return. Because the assets received a new income tax basis at your death equal to fair market value, there is no income taxable gain or loss on this purchase. This gives the estate the liquidity it needs to pay the taxes but it leaves an asset of equal value in the ILIT.

Second, the trustee of the ILIT may loan funds to the estate. Such loans must be on arms-length terms, meaning they must include adequate interest and security. Under this alternative, the ILIT will continue to have an asset but in this case the asset is in the form of a promissory note from the estate. This form of assistance by the ILIT to the estate is less common since most obligations of the estate are required to be discharged before a probate can be closed.

In either case, note that the ILIT will have assets presumably equal in value to the insurance proceeds even though it has provided the insurance cash proceeds to the estate to pay taxes or other costs. The ILIT does not disappear. Therefore, in the planning stages of your estate, be sure that the ILIT is fully considered as an integral part of your estate plan and that you are satisfied with its dispositive provisions. In many cases, the ILIT will dispose of assets of equal or greater value than those disposed of by your last will or revocable living trust. Especially if the beneficiaries of the ILIT are different from those of other parts of your estate plan, be sure that the ILIT is fully integrated in your planning.

After the ILIT trustee is satisfied that all purchases or loans appropriate to the settling of your estate have been made, the trustee will then implement the dispositive provisions of the ILIT document. This may include division among various beneficiaries with either immediate distribution or the funding of other trusts for those beneficiaries. The selection of the appropriate trustee for all of these purposes is very important.

Withdrawal Notice Examples

Examples of notice letters to be used in connection with limited withdrawal rights are included with this memorandum. Trustee and Beneficiary notices number 1 are designed to be used where gifting will not occur in a fixed schedule. Examples number 2 are designed to be used where a fixed schedule of gifting is anticipated, such as where insurance premiums are the subject of the gifts and will be paid in fixed amounts on fixed dates.

The example letters apply to withdrawal rights which are cumulative. Sometimes withdrawal rights, especially in older insurance trust documents, are not cumulative. The example letters are for general guidance only and you should conform each notice letter to the terms specified in your particular trust document.

George Washington
Mount Vernon, Virginia
July 4, 1776

Trustee Notice Example 1

Thomas Jefferson, trustee
The George Washington Insurance Trust
Monticello, Virginia

Dear Tom:

This letter serves as notice to you that all additions made by me to the George Washington Insurance Trust on or after the date of this letter are subject to withdrawal according to the terms of the limited withdrawal rights described in the trust document. Each addition shall be withdrawable in equal shares among the following beneficiaries: Benjamin Franklin; John Adams and and Betsy Ross.

This notice is irrevocable with respect to additions to the trust estate made by me prior to your receipt of my revocation or amendment of this notice. I reserve the right to revoke or amend this notice with respect to future additions to the trust estate. Any revocation or amendment of this notice will be in writing.

Sincerely,

George Washington

George Washington
Mount Vernon, Virginia
July 4, 1776

Trustee Notice Example 2

Thomas Jefferson, trustee
The George Washington Insurance Trust
Monticello, Virginia

Dear Tom:

This letter serves as notice to you that I intend to pay the premiums on the King George Royal Insurance Company life insurance policy on my life which is owned by the George Washington Insurance Trust. The annual premium in the amount of \$_____ will be paid each year on August 1 by me through direct payment to the insurance company.

Until further notice, property held in the trust equal in value to each such annual premium shall be withdrawable on and after August 1 of each year according to the terms of the limited withdrawal rights described in the trust document. Each addition shall be withdrawable in equal shares among the following beneficiaries: Benjamin Franklin; John Adams and and Betsy Ross.

This notice is irrevocable with respect to additions to the trust estate made by me prior to your receipt of my revocation or amendment of this notice. I reserve the right to revoke or amend this notice with respect to future additions to the trust estate. Any revocation or amendment of this notice will be in writing and delivered to you.

Sincerely,

George Washington

Thomas Jefferson
Monticello, Virginia
July 4, 1776

Beneficiary Notice Example 1

Benjamin Franklin
c/o Farmer's Almanac Print Shop
Philadelphia, Pennsylvania

Dear Ben:

On this 4th day of July, 1776, property equal in value to \$ _____ was added to the George Washington Insurance Trust and designated as withdrawable by you. According to the terms of the trust, you have the right to withdraw property equal in value to this amount, in cash or in kind as determined by me as trustee. If additional property designated as withdrawable by you is added to the trust in the future, you will receive notice of those additions. Additions designated as withdrawable will remain so until the right to withdraw lapses.

All outstanding withdrawal rights of which you have been notified, if more than one, are cumulative. Your right to withdraw property from the cumulative total will lapse annually if not exercised in an amount equal to the greater of \$5,000 or 5% of the value of the trust estate. The lapse will occur on December 31 of each calendar year, except that no lapse will occur with respect to additions made in December until December 31 of the following year. In no event, will a withdrawal right lapse in less than 30 days from the date you receive notice. Once a lapse occurs, your right to withdraw the property subject to the lapse ends and that property will thereafter be governed by other provisions of the trust.

If you elect to withdraw property subject to withdrawal, you must notify me in writing at the above address. I must receive this notice prior to the date of lapse. You may, however, waive your right to withdraw any property subject to the withdrawal right at any time. You may not waive your right to receive notice of future withdrawable additions to the trust.

Delivered by my hand this 4th day of July, 1776, to Benjamin Franklin.

Thomas Jefferson, Trustee

RECEIPT AND WAIVER

I, Benjamin Franklin, waive my right to withdraw any part of the addition to the George Washington Insurance Trust which is identified in this notice.

Received, dated, signed and returned to Thomas Jefferson by me on this 4th day of July, 1776.

Benjamin Franklin

Thomas Jefferson
Monticello, Virginia
July 4, 1776

Beneficiary Notice Example 2

Benjamin Franklin
c/o Farmer's Almanac Print Shop
Philadelphia, Pennsylvania

Dear Ben:

Commencing August 1, 1776, and on August 1 of each year thereafter, an addition will be made to the George Washington Insurance Trust which is withdrawable by you. Each such withdrawable addition will be in the amount of \$_____. According to the terms of the trust, you have the right to withdraw property equal in value to this amount, in cash or in kind as determined by me as trustee. You will receive no further notice of the withdrawable additions described in this letter, although you will receive notice if the schedule of additions should change or if additional property designated as withdrawable by you is added to the trust in the future. Additions designated as withdrawable will remain so until the right to withdraw lapses.

All outstanding withdrawal rights of which you have been notified, if more than one, are cumulative. Your right to withdraw property from the cumulative total will lapse annually if not exercised in an amount equal to the greater of \$5,000 or 5% of the value of the trust estate. The lapse will occur on December 31 of each calendar year, except that no lapse will occur with respect to additions made in December until December 31 of the following year. In no event, will a withdrawal right lapse in less than 30 days from the date you receive notice. Once a lapse occurs, your right to withdraw the property subject to the lapse ends and that property will thereafter be governed by other provisions of the trust.

If you elect to withdraw property subject to withdrawal, you must notify me in writing at the above address. I must receive this notice prior to the date of lapse. You may, however, waive your right to withdraw any property subject to the withdrawal right at any time. You may not waive your right to receive notice of future withdrawable additions to the trust.

Delivered by my hand this 4th day of July, 1776, to Benjamin Franklin.

Thomas Jefferson, Trustee

RECEIPT AND WAIVER

I, Benjamin Franklin, waive my right to withdraw any part of the addition to the George Washington Insurance Trust which is identified in this notice, including future additions specifically identified.

Received, dated, signed and returned to Thomas Jefferson by me on this 4th day of July,
1776.

Benjamin Franklin