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IRREVOCABLE LIFE INSURANCE TRUST

CAUTION:

The purposes of this memorandum are to assist you and the trustee of your irrevocable life insurance trust in:

1. Creating your irrevocable life insurance trust and transferring assets to the trust;

2. Setting up procedures to pay premiums and giving required notices to beneficiaries;

3. Maintaining records for the trust; and

4. Filing any required tax returns.

This memorandum can only provide *general* information. If you or your trustee have any questions, please contact us.

INTRODUCTION

Part I of this memorandum discusses the documents that are required to create your irrevocable life insurance trust. The most important of those documents is the trust agreement, but there are other documents that must be signed and filed. The purpose of the trust is to own life insurance policies on your life, and to avoid estate taxes being imposed on the proceeds of the policies at your death. To obtain this significant estate tax advantage, there are a number of formalities that must be observed, both in the creation of the trust and in the continuing administration of the trust.

Part II of this memorandum discusses the procedures that the trustee must observe in notifying the beneficiaries of their withdrawal rights. Such rights are granted to the beneficiaries to minimize the gift tax consequences of creating the trust. Part II also outlines the recommended method for payment of premiums on policies owned by the trust, and discusses the filing of any necessary fiduciary income tax returns.

PART I -- CREATING YOUR IRREVOCABLE LIFE INSURANCE TRUST

Trust Agreement

A separate summary was prepared outlining the terms of your irrevocable trust agreement. In general, the agreement tells the trustee how to administer the trust property both during your lifetime and after your death. You cannot change the trust or any of its terms after it is executed and funded. It must be *irrevocable* in order to give you the advantage of not having the life insurance proceeds taxed in your estate at your death.

Life insurance proceeds are usually not subject to income tax when they are paid on the death of the insured, but they are included in the assets subject to estate tax if the insured held any "incidents of ownership" in the policy. To avoid estate taxation of the proceeds, you must not have any continuing rights in the policies owned by the trust. For example, you cannot be a trustee of the trust, because the trustee holds legal title to the policies and makes the decisions affecting the policies. You also cannot retain any right to take out loans against the policies or to change the beneficiary designations. In addition, you cannot receive any benefits from the trust.

As much flexibility as possible has been built into the trust agreement without jeopardizing the estate tax result. Of course, it should be noted that Congress may change the law so that life insurance proceeds will be subject to estate tax whether or not the insured retains incidents of ownership. If that happens, it is possible that policies owned by an existing irrevocable life insurance trust could

become subject to estate tax. While no guarantee can be given, when Congress changes the tax law, it usually “grandfathers” irrevocable trusts that were established before the change in the law.

Trust Registration Statement

Because the trust is irrevocable, the trustee is required under Colorado law to register the trust with the district court of the county in which the “principal place of administration” is located. The principal place of administration is where the trustee usually keeps the records pertaining to the trust, such as the trustee’s usual place of business or the trustee’s residence. The purposes of the trust registration statement are to give the current beneficiaries notice of the creation of the trust, and to establish the court that has jurisdiction to hear any dispute concerning the trust.

We will prepare the Trust Registration Statement. After the trust is signed, the trustee must sign the Trust Registration Statement, and we will file it with the court. We will ask you for the filing fee of $126. If the trustee is not located in Colorado, this form will not be used, and the law of the state where the trustee is located will control any registration requirements.

Taxpayer Identification Number

Because irrevocable life insurance trusts are generally “grantor trusts” under the IRS rules, your social security number can be used as the taxpayer identification number for the trust during your lifetime under the Treasury regulations. The trust must obtain its own taxpayer identification number after your death.

Even though the regulations permit the grantor’s social security number to be used as the taxpayer identification number for the trust during the grantor’s lifetime, we have found that most banks are unfamiliar with this rule, and require a separate taxpayer identification number before they will permit the trustee to open a bank account in the name of the trust. Therefore, we will apply for that number on the IRS’ website, and we will notify you of the number assigned. You should then use this number on any accounts opened in the name of the trust, and the insurance companies will need the number for policies owned by the trust.

Transfer of Life Insurance Policies to the Trust, and Acquisition of New Policies by the Trust

If you currently own any life insurance policies on your life that are to be transferred to the trust, *ownership* of those policies must be assigned to the trustee. The beneficiary designation for the policies must also be changed to name the trust as beneficiary. Most companies have their own assignment of ownership and change of beneficiary forms. If the life insurance agent is contacted before the trust agreement is to be signed, and the specific company forms can be obtained, then you can sign the assignment of ownership forms at the same time you sign the trust agreement.

The trustee, as the new owner, usually signs the change of beneficiary forms. The designation of the trust as owner and beneficiary of the life insurance policies would ordinarily read as follows:

The then acting trustee of the ______________________________
Your Name
Irrevocable Trust, dated __________________________________.
Date of the Trust Agreement

The trustee's address should be used for future premium notices, although the trustee can ask that duplicate notices be sent to you.

Please check with us before transferring any policies on your life to the trust, especially if they are owned by someone other than you. For example, your spouse may own insurance on your life. In most cases, such a policy should <u>not</u> be transferred by your spouse directly to the trust. Instead, your spouse should make a gift to you, and then you should transfer the policy to the trust. If there are policies on your life owned by someone else, we should discuss those policies, and whether and how they may be made part of the trust. If a policy is transferred to the trust by a trust beneficiary, then the policy and/or its proceeds may be includible in the estate of the beneficiary. Similarly, if a policy insuring the life of a trustee is transferred to the trust, the trustee will then have *incidents of ownership* in that policy, and the proceeds will be includible in the trustee's estate.

As we discussed, under current law, life insurance proceeds from policies assigned by you within three years prior to your death will *not* be excluded from your estate for federal estate tax purposes. You must live more than three years after the date the policies are assigned to the trust in order to achieve the intended estate tax advantages of the trust.

On the other hand, if the trustee decides to purchase a life insurance policy on your life with funds that were transferred to the trust, and the trustee is designated in the application for insurance as the owner of the policy from the outset, then, under current law, the proceeds should be outside of your estate for estate tax purposes, and the three year rule should not apply. Consequently, if new insurance is being applied for on your life, *it is very important* that the trust be established first, before the life insurance is issued, and that the trust apply for, and be named as initial owner and beneficiary of, the policy.

We will be glad to work with your insurance advisor on the proper procedures for obtaining new insurance on your life, or for transferring existing policies to the trust.

Gift (and Generation-Skipping) Tax Considerations

Before transferring any existing policies to the trust, we must obtain the values of the policies from the companies. We must also obtain the annual premium for all policies to be owned by the trust, to determine if there will be any gift tax consequences from assigning policies to the trust, and transferring cash to the trustee each year to pay premiums. Because the trust is irrevocable, any transfer of property to the trust by you is a completed gift. For example, when you transfer cash to the trustee so that the trustee will have sufficient funds to pay premiums on the policies, that cash is a gift from you to the trust beneficiaries.

By including withdrawal rights in the trust agreement (as discussed in Part II), the amount of the *taxable* gift can be reduced or even eliminated. However, if there are taxable gifts, then a gift tax return must be filed for each calendar year in which a gift is made. In addition, if you and your spouse want to elect "gift-splitting," so that each gift made by either of you to a third party during a particular calendar year will be treated as made one-half by each of you, you must file gift tax returns in order to make the gift-splitting election. The gift tax return is made on IRS Form 709, is filed with the Internal Revenue Service, and is due by April 15 of the year following the calendar year in which the gift is made.

Whether or nor there are taxable gifts for gift tax purposes, you may want to consider filing a gift tax return to allocate a portion of your generation-skipping tax (GST) exemption to the trust, if the trust includes generation-skipping provisions, or to "opt out" of the automatic allocation rules under the Internal Revenue Code. (Generally, generation-skipping involves providing benefits to persons who are two or more generations younger than you, such as your grandchildren.) We recommend that whether you want GST exemption to be allocated, or if you want to opt out of the automatic allocation, that a gift tax return be filed making that election, and providing that it will apply to all future contributions unless a later different election is made.

If gift tax returns are required (to report taxable gifts, to make the gift-splitting election, and/or to allocate GST exemption to the trust), you may want to have your accountant prepare and file the returns. Unless you make specific arrangements for us to prepare the returns, we will assume that your accountant will prepare and file all necessary gift tax returns. Please send us copies of any returns that are filed.

PART II - ADMINISTRATION OF THE TRUST DURING YOUR LIFETIME

Beneficiaries' Withdrawal Rights

As discussed above, whenever you transfer property to the trust (such as a life insurance policy, or money with which the trustee will pay premiums for a life insurance policy), you will be making a gift to the trust beneficiaries. There may also be "imputed" gifts to the trust in certain circumstances. For example, if you transfer employer-provided group term insurance to the trust, each premium payment by your employer will result in a deemed gift from you to the trust.

The gift tax law allows you to exclude the first $14,000 per year of gifts to each donee from your taxable gifts (and therefore not pay any gift tax or use any of your "unified credit" against gift and estate taxes). However, this "gift tax annual exclusion" only applies to a gift of a "present interest." A gift is a present interest if the donee has the immediate right to the use, possession or enjoyment of the gifted property. If the donee's rights to use, possess or enjoy the property are restricted, then the gift is a "future interest" and the gift tax annual exclusion does not apply.

If the trust simply provided that each contribution made by you would be retained by the trustee for investment (in the insurance policies) and distribution to the beneficiaries at some time in the future (after your death and the receipt of the life insurance death benefits), then all gifts to the trust would

be future interests, and the gift tax annual exclusion could not be used. Your trust probably includes provisions to create present interests in the beneficiaries, and thereby make the gift tax annual exclusion available. Under those provisions, whenever you transfer property to the trust, certain beneficiaries may make withdrawals from the trust. These powers are referred to as "Crummey" powers, named after the court case involving similar powers. Usually, these withdrawal powers are structured so that you may specify which beneficiaries may make withdrawals, but if you do not specify otherwise, then your children (and perhaps your spouse) will have withdrawal rights. These withdrawal rights give the beneficiaries present interests, so that the gift tax annual exclusion will apply.

The withdrawal rights are limited in amount, and may only be exercised for a limited period of time after each contribution. The limitations are quite technical, and are spelled out in the trust agreement. In general, each withdrawal right is limited to make optimum use of the gift tax annual exclusion, without causing other tax problems. Although the annual exclusion is $14,000 per donee per year, and in some cases may be doubled to $28,000 per donee per year by electing "gift-splitting," there are other limitations that may apply, and which may limit a beneficiary's withdrawal power to $5,000 per year. If you have any questions about how much gift tax annual exclusion may be available each year for gifts to your trust, please ask us.

The withdrawal power provisions are included to save gift and estate taxes for you and your family. You probably will not intend that a beneficiary will ever actually exercise a withdrawal power and take money out of the trust while you are alive. However, in order for the powers to be effective to create present interests, and make the gift tax annual exclusion available, the power holders must have real, legal rights to exercise the powers. Thus, you must be aware that the powers could be exercised by the holders.

In this regard, the IRS takes the position that the withdrawal powers will not work to create present interests unless the power holders have notice of the existence of the withdrawal powers and the contributions to the trust. We recommend that, when you create the trust, you give notice to the initial power holders that they have the powers, and of the initial contribution to the trust. If future contributions to the trust are fairly certain as to timing and amounts, the initial notice could also list the planned future contributions. (However, additional notices should then be given of any change in who is entitled to make withdrawals, or in the future contributions as actually made.) The more conservative approach is for the trustee to give a new notice each time a contribution is made to the trust. We will provide you with a form that can be used to provide notice to the beneficiaries of their withdrawal rights and of contributions to the trust. If you or your insurance agent gives us information about the initial contributions, we will prepare a notice of those contribution(s) that the trustee may send to the beneficiaries.

The trustee may use the blank form we will include with the copy of the trust to prepare future notices to the power holders. We can prepare those notices if the trustee wishes us to do so. However, unless the trustee makes specific arrangements for us to prepare the notices, we will not do so, and will assume that the trustee will prepare and deliver all future notices.

The completed notices should be delivered to the beneficiaries promptly after a contribution is made. We recommend that the trustee ask each beneficiary to sign a copy of the notice to acknowledge that he or she received it. The trustee should then keep those acknowledged copies of the notices as part of the trust's permanent records. The following is a discussion of the IRS's position on these notices and withdrawal rights:

The IRS has accepted the basic premise of the *Crummey* case, but has consistently taken the position that, to have a present interest, the beneficiary must have notice or actual knowledge of the existence of the Crummey power and of the gifts to the trust. We frequently help clients prepare initial notices to Crummey power beneficiaries which advise them of the power, the date and amount of the initial gift to the trust, and the dates and amounts of planned future gifts to the trust.

So long as the future gifts are actually made as indicated in the initial notice, we think this procedure adequately informs the beneficiaries and should satisfy any reasonable notice requirement. (If future gifts vary from the notice, then a new notice should be given. Also, if the initial notice is given to a parent or guardian for a minor beneficiary, it is advisable to give a new notice directly to the beneficiary when he or she reaches the age of majority.)

Procedure for Payment of Insurance Premiums

Funds will have to be transferred by you to the trustee so that the trustee will be able to pay premiums on the life insurance policies owned by the trust. As discussed above, the funds transferred to the trust will be treated as gifts from you to the trust which should be at least partially sheltered from gift tax by the gift tax annual exclusion. We suggest that the trustee ask the insurance companies to send duplicate premium notices to you and to the trustee. You should transfer sufficient funds to the trustee before each premium is due.

The trustee should open a separate checking account in the name of the trust. The trustee will be the only signatory on the account, and the bank will use the separate number obtained for the trust in order to open the account. Whenever you transfer funds to the trustee, the trustee should deposit them in this bank account. The trustee can then use funds in the account to write checks to the insurance companies for premium payments as they come due.

Income Tax Returns

The trust is required to file federal and state fiduciary income tax returns if the trust has a certain amount of income during a taxable year. The trust is required to use the calendar year as its taxable year. Currently, a trust is required to file income tax returns if, during a taxable year it has gross income of $600 or more, or any amount of taxable income.

Because your trust will only own life insurance policies, and a bank account that will be used to pay premiums, it is unlikely that the trust will have sufficient income to have to file any income tax returns during your lifetime. The trustee may occasionally receive a form letter from the IRS asking why a return was not filed for a particular year. There is space on the form in which the trustee can

indicate that the trust did not have sufficient income to be required to file. If the trustee receives one of these forms and has any questions about how to respond to it, we will be glad to assist.

As noted, we do not expect that the trust will have enough income during your life to have to file returns. However, we do want to point out that, for income tax purposes, the trust will be a "grantor trust" in whole or in part. That means that any income earned by the trust during your life would be taxed at least in part, and probably entirely, to you, as the grantor of the trust, rather than to the trust itself.

Following your death, the trustee will collect the proceeds of life insurance policies that are payable to the trust, and will invest those proceeds and begin generating significant income. Of course, the trustee will be required to file income tax returns to report that income. We recommend that the trustee retain an accountant to prepare those returns.

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