

**CLIENT INSTRUCTIONS FOR IRREVOCABLE LIFE INSURANCE TRUSTS,
ANNUAL EXCLUSION GIFTS & ADMINISTRATION**

In General

Life insurance ownership through an Irrevocable Life Insurance Trust (“ILIT”) can remove the death benefit from an individual’s taxable estate and leverage the use of an individual’s federal gift tax annual exclusions (when insurance premiums are funded with annual gifts). The Internal Revenue Service (“IRS”), however, continues to review ILIT implementation and administration procedures, and questionable practices result in expensive audits and litigation, as well as potentially significant adverse gift, estate and income tax consequences. The potential for ILITs to own larger policies, due to the availability of both annual exclusion gifts and larger federal gift tax exemptions (\$5,430,000 in 2015) to fund higher premiums may bring even more scrutiny. Accordingly, it is critical for our clients and ILIT Trustees to understand and follow appropriate procedures regarding the administration of their ILITs.

ILITs, Annual Exclusion Gifts & Administration

Clients often fund premiums on policies owned by ILITs by making annual exclusion gifts. Generally, the first \$14,000 of an individual’s annual gift to a donee is excluded from federal gift tax. A gift qualified for the gift tax annual exclusion only if the donee has a “present interest” in the gift (e.g., a direct gift to the donee). Gifts to trusts, including ILITs, however, do

not meet this requirement unless the trust gives the beneficiaries the power to withdraw the gift (referred to as a “Crummey withdrawal power”). The trust beneficiaries typically receive notice of gifts to the trust and their power to withdraw all or a portion of the gift, up to a designated amount (e.g., the gift tax annual exclusion amount). If the power to withdraw is not exercised within a specified period of time (e.g., 30 days), the withdrawal power lapses and the gift remains in trust to be invested and used by the Trustee as provided in the Trust document (e.g., to pay insurance premiums).

Clients and ILIT Trustees need to follow proper administrative procedures to ensure gifts to an ILIT qualify for the gift tax annual exclusion. Without proper administration, otherwise tax-free gifts to an ILIT can easily become taxable gifts. In addition, annual exclusion gifts to typical ILITs will not simultaneously qualify for the annual exclusion from the federal generation-skipping transfer (“GST”) tax (if applicable to the client matter). Furthermore, the failure to follow appropriate implementation procedures, including properly transferring a policy to or having a policy acquired by an ILIT could result in income or estate taxation of the policy death benefits paid to the ILIT, thereby forfeiting the ILIT’s tax-planning benefits.

Procedures for ILIT Funding & Administration

The IRS continues to scrutinize ILITs, including the administration of gifts to ILITs, the source of funds used to make gifts and whether such gifts qualify for the gift tax annual exclusion. Clients and ILIT Trustees who, with our support and the support of their other

professional advisors, implement and adhere to a set of procedures in the administration of their ILITs generally will place themselves in the best position to defend against possible IRS challenges.

After the ILIT agreement has been fully signed, witnessed and notarized by the Grantor and the Trustee of the ILIT, the following steps should be taken:

1. **Obtain Taxpayer Identification Number (“TIN”).** After the ILIT agreement is signed by the Grantor and Trustee(s), witnessed and notarized, the Trustee will need to obtain a TIN for the ILIT, which will be used to (a) apply for new life insurance policies in the ILIT’s name or to transfer one or more existing policies to the ILIT, (b) open accounts in the ILIT’s name; and (c) file fiduciary income tax returns (Form 1041) for the ILIT if it generates sufficient income. *The Trustee can arrange with the client’s CPA to obtain the TIN for the ILIT.*

2. **Establish Checking Account for the ILIT.** After the ILIT agreement is executed and the TIN obtained, the ILIT Trustee should open a checking account in the ILIT’s name. The ILIT Trustee should be the sole signatory on the account. We recommend simply leaving \$100.00 or some other minimum amount required by the financial institution in this account so that the account will be available for all future Trust transactions.

3. **Acquisition of Life Insurance by the ILIT.** If *new* coverage is being acquired on the client’s life, the ILIT Trustee should submit the insurance application and designate the ILIT as the original owner and beneficiary. In this case, the insurance proceeds will immediately pass to the ILIT, estate tax free, on the client’s death.

If the client intends to transfer an *existing* policy to the ILIT, it is important to determine who owns the policy prior to the transfer. If the client and his/her spouse own the policy, and the spouse will be the beneficiary of the ILIT, then the spouse must first transfer all of his/her interest in the policy to the client. After confirming that the client is the sole owner of the policy, *the client and the ILIT Trustee will need to complete change of ownership and change of beneficiary forms, naming the ILIT as the owner and beneficiary of the policy.* These forms should be submitted to the insurance company as soon after the ILIT's creation as possible. After the documents are submitted, and periodically thereafter, the ILIT Trustee should obtain written verification of the ILIT's ownership and beneficiary designation and retain the verification with the ILIT's records.

Please note that if the client dies within 3 years of making a gift of an existing policy to the ILIT, the proceeds will be included in his/her estate for estate tax purposes.

4. **Retention of Original Life Insurance Contracts by ILIT Trustee.** The ILIT Trustee should obtain and hold the original contract for each insurance policy owned by the ILIT in a safe place with the ILIT's records. This will add weight to the fact that the client has transferred all of his/her interest in the policy to the ILIT.

5. **Premium Notices.** Arrangements should be made with the insurance company for premium notices to be sent to **BOTH** the client and the ILIT Trustee.

6. **Designation of Policy Owner/Beneficiary**

(a) If a *new* life insurance policy on the Grantor's life is being issued, then the initial application for life insurance should designate:

“[INSERT TRUSTEE'S NAME], Trustee

or any Successor Trustee of [INSERT NAME OF TRUST] dated _____”

as **BOTH** owner and beneficiary of the policy from its inception. If an initial premium payment is required, the Trustee should make this payment rather than the insured. The funds should be contributed to the Trust's checking account, as described below.

(b) If an *existing* life insurance policy is being transferred to the Trust, then obtain **BOTH** change of ownership (assignment of ownership) forms and change of beneficiary forms for each insurance company involved in the policy transfers and use the designation set forth in Step 6(a) above as **BOTH** owner and beneficiary.

7. **Client Gifts to ILITs for Premium Payments.** When funding premiums on an ILIT policy using annual exclusion gifts, the client should **NOT** pay the insurance premium directly. Instead, *the client should issue a check payable to the ILIT Trustee for deposit into the ILIT's account.*

- If the client and his/her spouse are both Grantors of the ILIT (i.e., it holds a survivorship life insurance policy), checks to the ILIT may be issued from an

account jointly owned by the Grantors. *If the client is the sole Grantor of the ILIT, checks to the ILIT should be issued from his/her individual account as opposed to a joint account, particularly if the other account holder is a beneficiary of the ILIT.* Otherwise, the beneficiary may be deemed to have made a gift to the ILIT in which he/she has a beneficial interest, causing a portion of the ILIT assets to be included in his/her estate.

- *Gifts to the ILIT that are intended to be used for the payment of premiums should be made sufficiently in advance of the premium due date* so that (a) the funds can remain in the ILIT during the withdrawal period specified in the ILIT; and the ILIT Trustee will have enough time following the withdrawal period to send the premium payment to the insurance company by the due date. *We recommend that the gifts to the ILIT be made least sixty (60) days prior to the expiration of the applicable grace period, if possible.*
- If the client makes a gift by *electronic funds transfer* to the ILIT account, then the client should formally document the gift by executing a “gift letter” to the ILIT, which describes the value and type of gift. Receipt of the gift should be acknowledged by the ILIT Trustee by countersigning the letter. The original letter should be retained by the ILIT Trustee with the ILIT’s records, with a copy returned to the client for his/her records. Clients making gifts by check should also consider using a gift letter to document the gift for the ILIT’s records.

8. **Deposit Check into ILIT Account.** Upon receipt of the check, the ILIT Trustee should immediately deposit the check into the ILIT's checking account.

9. **Notify Beneficiaries of Withdrawal Rights.** Immediately upon receipt of the check (or other addition to the ILIT, including any existing policies transferred to the ILIT), the ILIT Trustee **MUST** notify the beneficiaries of the gift and their withdrawal rights, preferably by certified mail, return receipt requested (as proof of notice). In most cases, this will be the spouse, children and grandchildren of the insured. If the beneficiary is a minor or incapacitated, the notice should be sent to his or her parent, guardian or other person specified in the ILIT. The ILIT Trustee will need to review the ILIT agreement to determine which beneficiaries have withdrawal rights and will receive notices.

- When a notice is required, it should provide each beneficiary with (a) the amount subject to the withdrawal right, (b) date of the contribution, (c) the expiration date for the withdrawal right, and (d) the manner in which the withdrawal right may be exercised. Duplicate copies should be sent to each designated beneficiary, who should then sign and date both copies to acknowledge receipt. The beneficiary should keep one copy and return the other copy to the ILIT Trustee to be retained with the ILIT's records.
- This procedure should be followed with respect to each and every addition to the ILIT. The Trustee should be instructed to comply with this notice procedure on a regular basis. The purpose of this notice procedure is to make sure that the

amounts transferred by the Grantor-insured to the Trust will qualify for the Grantor's gift tax annual exclusion. This amount is currently \$14,000 per year and, if the Grantor and his or her spouse elect to "gift split", the amount will be \$28,000 per year. The ILIT Trustee should be instructed to strictly comply with this notice procedure for the annual exclusion to be available.

- *A form of notice is attached hereto and should be used with respect to each contribution to the ILIT.* The ILIT Trustee must fill in the amount of the total contribution to the ILIT and the date of the contribution in the blanks provided in the second sentence of the second paragraph of the notice. This number should be divided by the number of beneficiaries of the ILIT that have this withdrawal power. The result of this division should be set forth in the third sentence of the second paragraph. For example, assume that \$10,000 is contributed to the ILIT. This dollar amount should be set forth in the second sentence. If there are two children and two grandchildren of the Grantor given the power to withdraw, the amount of \$2,500 (\$10,000 divided by 4 powerholders) should be inserted in the third sentence of the second paragraph.

10. Payment of Premium. Upon expiration of the specified withdrawal period, the ILIT Trustee should issue a check from the ILIT's checking account to pay the policy premium and send it to the insurance company in time for payment to be received by the due date (thereby exercising his/her discretionary authority to make such payments under the terms of the ILIT).

11. **WARNING: NO SHORTCUTS!!!** Do **NOT** take shortcuts to save time by having premium payments made directly by either the client or the client's business entities on client's behalf. The direct payment by the client/client's business entities could cause the ILIT technique (excluding insurance proceeds from the client's estate) to fail.

12. **Provide Information to Client's CPA.** The client should provide his/her CPA with the following information at the end of each year:

- Information regarding the ILIT's bank account, including bank statements, so that the CPA can determine whether the ILIT must file federal and/or state income tax returns (income tax returns generally are not required during the client's lifetime if the ILIT only owns life insurance policies); and
- Details of the client's annual gifts, including gifts to the ILIT (both direct and any indirect gifts due to premiums paid by another, such as the client's employer). The CPA will use this information to determine whether the client must file federal gift tax returns (Form 709) to report taxable gifts (i.e., gifts that exceed the federal gift tax annual exclusion).
- For most ILITs, the proper allocation (or non-allocation) of federal GST tax exemption will require the filing of annual federal gift tax returns, even if all gifts to the ILIT qualify for the federal gift tax annual exclusion.

Accordingly, the CPA will need the above information to determine whether

to file a gift tax return that makes an election regarding the allocation or non-allocation of the client's federal GST tax exemption for gifts to the ILIT.

13. Review Policies. The client and ILIT Trustee should review each insurance policy owned by the ILIT with the insurance agent and other advisors on a regular basis to monitor policy performance, and the impact of any current or potential changes in market and economic factors, product options and the insured's health condition.

While the above steps may seem overly technical and laborious, the potential tax ramifications for overlooking minor details could be severe. In most cases, the issues will not arise until after the client's death, when beneficiaries who have never been involved in the administration process will want to understand why ILIT assets that were anticipated to be estate tax free may now incur estate tax at the maximum 40% federal rate. *Family members who are appointed as ILIT Trustees need significant guidance and should closely follow these procedures.*

Corrective Actions

Lapses or oversights in administration can occur even with the best-managed ILITs. In such situations, clients should consider taking appropriate corrective action:

- If it is discovered that a policy intended to be transferred to the ILIT was not, immediate action should be taken to transfer the policy and to name the ILIT as the policy beneficiary (subject to confirmation of the potential gift and GST tax consequences).

- If the client forgets to make a gift to the ILIT and instead pays a premium directly to the insurance company, the gift may still qualify for the gift tax annual exclusion. To bolster this position, however, upon being informed of such payment, the ILIT Trustee should immediately send confirmatory notices to the beneficiaries to substantiate that the trust beneficiaries were aware of and did not intend to exercise their withdrawal rights over the transfer. Efforts should be made going forward to have future premium payments made by the ILIT Trustee, following the steps set out above.
- If the ILIT Trustee fails to send the required withdrawal notices to the beneficiaries, the ILIT Trustee should, immediately upon discovering the oversight, send confirmatory notices similar to the above. Efforts should be made going forward to send the withdrawal notices to the beneficiaries on a timely basis.
- If the client has been making gifts to the ILIT from a joint account and the other account holder is a beneficiary of the ILIT, actions should be taken, if possible, to confirm funds originally came from the client and not the beneficiary. Going forward, gifts should be made only from an account in the client's name.
- If prior gifts to the ILIT exceeded the annual gift tax exclusion or were taxable gifts, or if the client's GST tax exemption was not properly allocated, the client's CPA should be notified immediately and gift and GST tax returns filed as appropriate.

Special Situations

- As noted above, if a policy on the Grantor’s life is owned by the spouse of the Grantor-insured, then it is necessary to initially transfer the policy from the spouse back to the Grantor-insured and thereafter have the Grantor-insured transfer it to the ILIT. A direct transfer to the ILIT from the Grantor’s spouse could provide disadvantageous estate tax results if the spouse is also a beneficiary of the ILIT.
- If a company is paying the premium for the life insurance policy through group life insurance coverage, the payment procedures set forth herein cannot necessarily be followed. Accordingly, the premium payment could be considered payments made by the Grantor-insured thereby producing possible adverse estate tax consequences if the insured dies within the 3-year period after the policy is initially transferred to the ILIT.
- If the company is paying the premium under a special fringe benefit program and it is not necessarily a group program, then it would be better to have the company give the amount of the premium to the insured as compensation directly, rather than indirectly through premium payments, and the insured and ILIT Trustee would follow the steps outlined in Steps 7 – 10 of the immediately preceding section (e.g., Grantor-insured transfers the funds to the ILIT, ILIT Trustee deposits the funds into the ILIT checking account, the ILIT Trustee gives notice to the beneficiaries regarding their withdrawal rights and the ILIT Trustee then pays the premium to the insurance company).
- If any of the insurance policies are being handled on a “split dollar” basis, the client should consult with us so that we can as to the appropriate procedure. This must be handled on a case-by-case basis.

- If any of the existing life insurance policies have cash surrender value, this is a special issue that cannot be dealt with here with simple rules. The client should consult us or his/her CPA to consider possibly “stripping” these policies of their cash surrender value prior to transfers. Otherwise, the client could have unexpected tax.
- As a general matter, the ILIT technique provides excellent tax planning opportunities with respect to the GST tax by enabling the Grantor to leverage his or her GST exemption (currently \$5,430,000). However, to obtain these tax benefits, several technicalities involving the exclusion and the proper allocation of the GST exemption need to be carefully observed. Because of the complexity of the rules, the client should consult us to make sure that the maximum GST benefits are achieved.