IRREVOCABLE INSURANCE TRUST PLANNING AND ADMINISTRATION FOR THE NEW TAX AGE

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INTRODUCTION

Insurance. The word itself evokes different reactions. The range of emotions expands when we mention life insurance. And if we add the word trust–life insurance trust–clients may stop listening altogether. But now is exactly the time to be thinking of planning with an irrevocable life insurance trust.

Life insurance is a cornerstone of risk management and business succession, tax, wealth, and estate planning. Its place in clients' overall planning varies. Life insurance may provide simple income replacement for a growing family dependent upon the earning capacity of an early-career parent. Or it may be the source of funding a buy-sell agreement for a business enterprise. Insurance is also a resource for liquidity to fund anticipated estate tax liability and is used in charitable gift planning. Knowledgeable insurance professionals provide valuable guidance on the type of insurance to meet a client's goals while tax and legal advisors provide advice on how to own and transfer the benefit of insurance to meet client goals with minimal tax burdens.

This article discusses the types of life insurance, the purposes of life insurance in a client's wealth and estate plan, the income tax and creditor protection associated with life insurance, and the design and administration of irrevocable insurance trusts to own and administer life insurance, all of which is of growing relevance in the current environment of increasing income tax rates, decreasing estate tax exclusions, and potential changes in the taxation of appreciated assets at death. Additional advanced split-dollar life insurance planning is also discussed.

Protect and preserve wealth

As the tide of increasing estate tax exclusion levels turns (which we expect it to do by 2022) more estates will become taxable. In 2019 (the last year for which data is available) when the estate tax exclusion was $10 million, adjusted for inflation, the IRS reported 2,570 taxable estate tax returns filed. This is more than twice the number of estate tax returns filed in 2016, the final year of the $5 million, adjusted for inflation, exclusion amount. In 2009, 14,713 taxable returns were filed under the $3.5 million exclusion amount (up from $2 million in 2008). Whether the current $11.7 million exclusion reverts to $5 million adjusted for inflation, $3.5 million not adjusted for inflation, or some other lower-than-current level, more estates will owe estate tax. Life insurance is a source of liquidity in taxable estates. Life insurance held in a well-designed and administered irrevocable life insurance trust can be excluded from the taxable estate and provide overall liquidity to the family balance sheet.

Year	Exclusion Amount	Taxable Estate Tax Returns
2019	$10 million, adjusted for inflation	2,570
2016	$5 million, adjusted for inflation	5,219
2009	$3.5 million	14,713

Leverage planning

In the midst of the flurry of tax proposals, we have yet to see a proposal that would do away with the annual gift exclusion ($15,000 in 2021) in its entirety. The annual exclusion has been part of the Internal Revenue Code (Code) for decades and we expect it to remain, although some of the details may change. Leveraging the annual gift tax exclusion will become more important as the lifetime exclusion decreases. The annual gift tax exclusion, applied to cover annual premium payments in an irrevocable life insurance trust, is an effective means of leverage, so long as the total premiums paid do not exceed the benefits paid on the policy.

Simplicity

Do we really mean simplicity? Yes, in a sense. In order for an irrevocable insurance trust to work to remove assets from the insured's estate, attention needs to be paid to the administration of the trust during the insured's lifetime. This work of the trustee comes with associated duties and liabilities. In Illinois and certain other states, state law has been modernized to simplify a trustee's investment duties and minimize the associated liabilities of a trustee during the time the policy is held in trust and the insured settlor of the trust is still living. In Illinois, for example, during the settlor insured's lifetime, the trustee may hold an insurance policy in trust: (i) without determining that the policy is a proper investment for the trust; (ii) without diversifying the investments of the trust; and (iii) without monitoring the financial and physical condition of the insured. These are important considerations for both individual and professional trustees given the unique attributes of life insurance as an asset of an irrevocable trust.

Types of life insurance and ownership

Consideration should be given to the type of insurance used to fund an irrevocable insurance trust and there are many types to choose from: term, group term, whole life, universal life, variable life, survivorship, split-dollar, and private placement life insurance. Following is high level primer on the types of insurance.

Term life insurance is purely insurance; premiums are based on the actuarial assessment of the incidence of death and the benefit is the death benefit. There is no internal accumulation of tax-protected savings. The term is for a number of years or to a specified age. Premiums are typically structured to stay level to a certain age or increase annually. Term insurance is relatively inexpensive at younger ages and is often used for income replacement and debt payment at death. Premiums at advanced ages often become prohibitive and policies are often allowed to lapse if they have not previously been converted to "permanent" cash value insurance. The value of term life insurance during the life of the insured is simply the unearned premium. Thus, there is little or no cost associated with transferring an existing term insurance policy to a trust.

Group term insurance is offered by employers, professional organizations, alumni groups, and other groups with a pool of insured persons. There are a number of unique issues which arise in connection with the transfer of a group term insurance policy to an irrevocable insurance trust.

The planner must first ascertain whether the master policy permits assignment. Consideration must then be given to the three-year look back period under Code section 2035(d). If the insured assigns his group term coverage to an irrevocable insurance trust more than three years prior to his death, the payment of each annual premium will not be treated as a new transfer of insurance coverage under Code section 2035.[1] If the employer, however, changes insurance carriers after the original assignment of the group term coverage to the irrevocable insurance trust, the planner should determine whether there has been any change in the scope of the insurance coverage provided. If the new arrangement is identical in all relevant aspects to the previous arrangement with the employer, the three-year look back period will not begin again.[2]

If, however, there is a significant change in the scope of the group term insurance coverage provided by the new carrier, the IRS is likely to take the position that the three-year look back period begins to run from the date of the change in the coverage (or the date of an assignment of the new policy to the irrevocable insurance trust) instead of from the date of the original assignment, even if the original assignment purported to include an assignment of any substitute coverage provided by the employer.[3]

Each premium payment made by the employer constitutes an indirect transfer by the employee to the trust. Such indirect transfers are generally thought to be gifts of a present interest if the trust includes a *Crummey* power with respect not only to the premium payments but to the underlying policy as well.[4] There are some inconsistent private letter rulings in this area, but the generally accepted view is that the gifts will qualify as present interests if the *Crummey* power is drafted properly.[5] The cautious planner may choose to transfer a savings bond or other asset to the trust to give more substance to the right of withdrawal. If group term insurance insuring the life of a majority shareholder is transferred to an irrevocable insurance trust the planner must determine whether the insured will be deemed to have retained incidents of ownership over the policy.

Permanent life insurance provides permanent death benefit coverage (provided premiums are paid). It does not have a set term, as in the case of term insurance. There are various types of permanent insurance: whole life, universal life, variable universal life, etc. In addition to the death benefit, permanent life insurance has a savings or investment component, with the benefit of the favored income tax treatment of the build-up inside an insurance policy. The owner may borrow against the policy.

Second-to-die life insurance is, as the name clearly indicates, insurance payable on the life of the second of two insureds to die. Second-to-die insurance policies are particularly useful for married couples funding an irrevocable insurance trust to replace wealth expected to be lost due to the payment of estate taxes at the death of the surviving spouse, or to fund ongoing expenses with vacation property passing to children.

Split-dollar life insurance, discussed in greater detail below, is an arrangement where the payment of premiums on permanent life insurance and the benefit at death are, as the name indicates, split. For example, an employer may pay premiums on the life of an employee with death benefits in excess of premium reimbursement to the employer payable to the employee's beneficiaries. Private split-dollar insurance is a similar split between individuals (or an irrevocable life insurance trust).

Private placement life insurance (PPLI) is a variable universal life insurance policy that is offered by an insurance carrier. It is not registered with the SEC, but is compliant with IRS insurance regulations. It is designed to maximize the investment aspect of a life insurance policy minimizing the amount of death benefit coverage. Some asset protection may be provided for the cash value, depending on the applicable state law. PPLI is available in either individual or survivorship arrangements. The insured is typically either the client or the client's child. Ownership is commonly through a trust.

Use of life insurance in business, wealth, and tax planning

Life insurance serves many purposes in financial and estate planning. Common uses include:

- Income replacement and debt payment in the event of the death of an individual providing support to others;
- Funding contractual obligations upon the death of the insured, such as a purchase obligation under a buy-sell agreement in a closely held business; and
- Providing liquidity for payment of estate taxes following death in an estate with a concentration of illiquid assets.

Creditor protections considerations

Life insurance proceeds are creditor-protected in many states. Under Illinois law, for example, life insurance proceeds payable to the:

> wife or husband of the insured, or to a child, parent or other person dependent upon the insured, whether the power to change the beneficiary is reserved to the insured or not, and whether the insured or his estate is a contingent beneficiary or not, shall be exempt from execution, attachment, garnishment or other process, for the debts or liabilities of the insured.[6]

No mention is made of insurance payable to a trust for the benefit of a spouse or other dependents although there is case law indicating that insurance so payable will not be subject to the claims of creditors unless the trust instrument directs otherwise.[7] The claims of creditors may generally be circumvented with the use of an irrevocable insurance trust, provided the transfer of the policy does not operate to defraud creditors. Such protection should not be limited to circumstances where the surviving spouse or other dependents are the beneficiaries of the policy.

Alternatives to irrevocable insurance trusts

The irrevocable insurance trust may not be the right solution for all clients. An outright gift of an insurance policy is often an appealing alternative. Another alternative is to have children purchase a policy on the life of a parent with their own funds or with cash gifts from the parent. Some planners promote the use of a partnership as an alternative to an irrevocable insurance trust. If a family limited partnership is used to own life insurance, the insured may act as a managing partner but should only own a minimal equity interest in the partnership and the insurance proceeds must be payable to the partnership to avoid incidence of ownership problems. The insured may not retain the right to change the beneficiary of the policy.[8] Insurance proceeds made payable to a partnership of which the insured decedent was a partner will be reflected when valuing the decedent's interest in the partnership.[9]

INCOME, GIFT, AND ESTATE TAXATION OF LIFE INSURANCE

Income tax

Subject to numerous exceptions, gross income does not include amounts received under a life insurance contract, if paid by reason of the death of the insured.[10]

Transfer for value is one such exception. In the case of a transfer for valuable consideration, by assignment or otherwise, of a life insurance contract or any interest in a life insurance contract, the amount excluded from gross income is limited to the actual amount of the value of the consideration and the premiums and other amounts later paid by the transferee.[11] There are exceptions to the exception for transfers: (i) to the insured; (ii) to a partner of the insured; (iii) to a partnership in which the insured is a partner; or (iv) to a corporation in which the insured is a shareholder or officer.[12]

Code section 1035 provides that no gain or loss is recognized on certain exchanges of insurance policies (life insurance and qualified long-term care insurance).

Irrevocable life insurance trusts are typically grantor trusts for income tax purposes during the life of the insured. Code section 677(a)(3) provides that the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Gift tax

Transfers during life for less than full and adequate consideration are gifts. Thus, the transfer of ownership (without retained incidents of ownership) of an existing policy of life insurance by the owner to another individual or to an irrevocable life insurance trust is a gift. The amount of the gift is the value of the policy at the time of the gift. If, however, the policy is initially purchased by the trust, there is no gift of the policy. The gift is of the funds contributed to the trust to purchase the policy. Ongoing contributions to an irrevocable insurance trust for premium payments are gifts.

Annual exclusion gifts can be used to minimize the gift tax cost of annual premium payments. Use of a *Crummey* right of withdrawal will qualify gifts to an irrevocable insurance trust as gifts of a present interest qualifying for the annual gift tax (but not generation-skipping tax) exclusion. See the discussion below for additional details.

In order to utilize gift splitting under Code section 2513, the subject gift must be made to a person other than the spouse. If the spouse has an interest in the irrevocable insurance trust that cannot be segregated from that of other beneficiaries (e.g., discretionary income and principal to spouse and children) gift splitting will not be available.[13]

Estate tax

The date-of-death value of insurance owned by a decedent on the life of another is included in the gross estate under the umbrella provisions of Code section 2031. Insurance on the life of a decedent (i) in which the decedent possessed incidence of ownership at the time of death, exercisable alone or with another person, regardless of whom payable to, or (ii) payable to the estate of the decedent (regardless of who owned the policy) is included in the gross estate at its value by reason of the death.[14]

Incidents of ownership include those held individually and in other capacities, such as a trustee. Examples of incidents of ownership include, but are not limited to:

- The right of the insured or his estate to the economic benefits of the insurance;
- The power to change the beneficiary;
- The power to surrender or cancel the policy;
- The power to assign the policy or to revoke an assignment;
- The power to pledge the policy for a loan; and
- The power to obtain from the insurer a loan against the surrender value of the policy.[15]

Insurance on the life of a decedent owned by the decedent and transferred within three years of the date of death will be drawn back into the estate of the decedent under Code section2035(d). Thus, it is preferable to fund an irrevocable life insurance trust with cash and have the trustee of the trust purchase the life insurance, rather than have the insured purchase the policy and gift it to the trust.

Company-owned life insurance on the life of a controlling shareholder payable to the corporation is not attributed to the shareholder (by operation of indirect incidents of ownership).[16] However, the value of the shareholder's stock in the company will encompass the value of the proceeds payable to the company.[17] If the proceeds are not payable to the corporation and the shareholder has ownership of 50 percent or more of the voting power of the corporation, the corporation's incidents of ownership will be attributed to the shareholder for purposes of Code section 2042(2) estate tax inclusion.[18]

IRREVOCABLE INSURANCE TRUST DESIGN

The irrevocable insurance trust is a basic estate planning tool which can be used to remove insurance proceeds from the estate of the decedent, to provide liquidity for the payment of estate taxes, to replace wealth lost due to the payment of estate taxes or a charitable remainder gift, to leverage use of the annual gift exclusion and generation-skipping transfer (GST) tax zero-inclusion ratio, and to insulate insurance proceeds from the claims of creditors.

Funding premium payments

Use of a *Crummey* right of withdrawal will qualify gifts to an irrevocable insurance trust as gifts of a present interest qualifying for the annual gift tax (but not GST) exclusion. If rights of withdrawal exceed the $5,000/5 percent section 2041 safe harbor for lapsing powers, consideration must be given to the gift and estate tax implications of the lapse to the power holders. The lapse of an “excess” right of withdrawal will constitute a taxable transfer unless: (i) the power holder is the only beneficiary of the trust and the beneficiary’s interest in the trust is vested; (ii) the *Crummey* power holder has a general testamentary power of appointment over the trust assets which renders the lapse of the right of withdrawal an incomplete transfer, at least until the death of the power holder; or (iii) the *Crummey* power “hangs” beyond the initial withdrawal period.[19]

Hanging powers, however, have been subject to scrutiny by the IRS, particularly where the power is only operative if the lapse would otherwise constitute a taxable gift.[20]

The lapse of an unprotected excess right of withdrawal will cause inclusion of a part of the trust in the gross estate of the power holder.[21] In addition, the lapse of a right of withdrawal in excess of the $5,000/5 percent ceiling will cause the power holder under a GST trust to become the transferor for purposes of allocation of the GST exemption.[22] If GST exemption of the donor was allocated to the trust at least part of such allocation will have been wasted and the trust will have multiple transferors (the donor and the power holder) for GST purposes.

The number of annual exclusions available is a function of the number of *Crummey* power holders. The IRS will continue to challenge the validity of *Crummey* powers held by persons who are only nominal beneficiaries under a trust.[23] If multiple *Crummey* power holders are required for annual exclusion purposes, such power holders should be given a substantial interest in the trust.

In the unforeseen circumstance that the trust is included in the gross estate of the decedent (for instance, if an existing policy is transferred to the trust and the settlor/insured does not survive three years), the trust can include a contingent QTIP marital trust.

The trustee may not be required to use insurance proceeds to pay estate taxes but may be authorized to enter into transactions with the executor to loan insurance proceeds to the executor or to purchase assets from the executor.[24]

The trust should include some sort of bail-out provision. Possible options are: (i) to give the trustee (who is not a beneficiary) the option to terminate the trust if it is no longer prudent to administer the trust; or (ii) to give the trustee discretion to distribute trust income and principal to the trust beneficiaries. The trustee’s discretionary distribution rights should not impair the exercise of a power holder’s right of withdrawal.[25]

Valuing the policy

The value of a paid-up whole life policy for gift tax purposes will be the replacement cost on the date of the gift.[26] If premiums are still being paid on a whole life policy, the value of the policy for gift tax purposes will be the interpolated terminal reserve plus the unexpired portion of the last premium prior to the gift.[27] The only value in term insurance other than group term insurance is the amount of any unearned premium. Group term insurance under a plan that is not discriminatory is valued using Table I in Treasury regulation section 1.79-3T. For key employees in a discriminatory plan, the value used is actual cost.

Second-to-die policies

The cost of second-to-die coverage will be less than that of comparable single life coverage and the insurance proceeds will be available when, and not before, they are needed to replace wealth loss due to the payment of estate taxes. Unless both spouses die during the three-year look back period, a second-to-die policy transferred to an irrevocable insurance trust will not be drawn back into either spouse's gross estate. If both spouses die within the three-year look back period and the transferor spouse is the second to die, the policy proceeds will be brought back into the gross estate of the transferor spouse. When the first spouse dies, premiums will increase significantly and gift-splitting will no longer be possible.[28]

Before a second-to-die policy is added to an existing trust, the trust should be reviewed to determine whether, given the terms of the trust, policy proceeds will escape taxation in the estate of both husband and wife. Additions to grandfathered GST irrevocable insurance trusts may taint the trust.

Drafting the irrevocable insurance trust intended to hold a second-to-die policy will differ in some respects from the drafting of an insurance trust intended to hold a single life policy. Neither spouse should be a beneficiary, a *Crummey* power holder, or a trustee of an irrevocable insurance trust intended to hold a second-to-die policy.[29] In addition, the use of contingent QTIP marital deduction language in the event the policy is included in the estate of the first to die should be scrutinized. If a marital deduction is allowed at the first death, Code section 2044 will bring the policy into the estate of the second to die at its full-face value. If the policy is brought back into the estate of the first to die, it may be more desirable to pay estate tax on its then-greatly reduced value and keep open the possibility of exclusion of the policy proceeds from the estate of the second to die. As is the case with irrevocable insurance trusts, for any type of insurance the trustee should be authorized (but not required) to purchase life insurance, including a second-to-die policy.

An irrevocable insurance trust funded with a second-to-die policy may be used in connection with a charitable remainder trust under which a married couple are the term holders. Income tax savings arising from the charitable remainder trust and the increased cash flow from the charitable remainder may be applied to premium payments on a second-to-die insurance policy. At the death of the surviving spouse, the remainder charitable interest of the trust will pass to the designated charity; an estate tax charitable deduction will be taken with respect to the charitable gift; and the proceeds of the irrevocable insurance trust will be available for the designated beneficiaries free of estate tax.

Trustee

The choice of trustee of a trust, including the trustee of an irrevocable insurance trust, is an important aspect of both the design and administration of the trust. The significance of the selection is, however, often underestimated. After all, how difficult can it be to administer a trust holding a life insurance policy? As the following discussion highlights, administration of an irrevocable insurance trust to achieve the settlor's objectives requires regular attention to the details of administration. The settlor should not act as trustee. Corporate fiduciaries may also act as trustee, although many will not accept appointment as trustee of a stand-alone irrevocable insurance trust, absent other wealth management relationships with the settlor and/or the settlor's family.

The trustee should exercise due care in selecting the insurance carrier and maintaining the required *Crummey* notice records. The trust instrument should include language authorizing the trustee to purchase insurance and exonerating the trustee from liability for purchasing and holding insurance. The planner should disclaim any liability regarding policy selection and should consider the use of an outside consultant to review a policy.

Some states include statutory authority to limit the duties and liability of the trustee of an irrevocable life insurance trust. In Illinois, for example, section 913 of the Illinois Trust Code provides as follows:

> (a) Notwithstanding any other provision, the duties of a trustee with respect to acquiring or retaining as a trust asset a contract of insurance upon the life of the settlor, upon the lives of the settlor and the settlor's spouse, or upon the life

of any person for which the trustee has an insurable interest in accordance with Section 113, do not include any of the following duties:

(1) to determine whether any contract of life insurance in the trust, or to be acquired by the trust, is or remains a proper investment, including, without limitation, with respect to:

(A) the type of insurance contract;

(B) the quality of the insurance contract;

(C) the quality of the insurance company; or

(D) the investments held within the insurance contract;

(2) to diversify the investment among different policies or insurers, among available asset classes, or within an insurance contract;

(3) to inquire about or investigate into the health or financial condition of an insured;

(4) to prevent the lapse of a life insurance contract if the trust does not receive contributions or hold other readily marketable assets to pay the life insurance contract premiums; or

(5) to exercise any policy options, rights, or privileges available under any contract of life insurance in the trust, including any right to borrow the cash value or reserve of the policy, acquire a paid-up policy, or convert to a different policy.

(b) The trustee is not liable to the beneficiaries of the trust, the beneficiaries of the contract of insurance, or to any other party for loss arising from the absence of these duties regarding insurance contracts under this Section. [30]

Trust protector

The issue with irrevocable trusts is that they are irrevocable and therefore inflexible. Naming a trust protector who has limited powers to amend the administrative provisions of the trust, change the situs of the trust, and take similar action to optimize tax benefits and provide for ease of administration is a useful means of providing for flexibility.

GST tax

The irrevocable insurance trust can be used to leverage the benefit of the GST tax zero-inclusion ratio and exemption. There are a number of unique challenges to be faced when drafting the irrevocable generation-skipping insurance trust in order to maximize use of the annual gift and GST tax zero-inclusion ratio and to make the most efficient allocation of the available GST exemption. While use of a *Crummey* right of withdrawal may qualify a gift as a gift of a present interest for gift tax purposes, the *Crummey* power alone will not qualify the gift for a zero-inclusion ratio. Only transfers constituting "direct skips" to trusts with a single beneficiary having a vested interest will qualify for the zero-inclusion ratio.[31] Despite these limitations the planner has at least four GST planning options.

- Separate Grandchild's Trust: Use of the GST zero-inclusion ratio can be leveraged through the use of an irrevocable insurance trust for the sole benefit of the grandchild, provided the grandchild is the sole lifetime beneficiary of the trust, has a vested interest in the trust, and the trust will be included in the grandchild's estate. Gifts to such a trust will qualify for the annual gift and GST zero-inclusion ratio.
- Dynasty Trust: A dynasty trust in which children have no taxable interest may be used provided *Crummey* powers are limited to the $5,000/5 percent ceiling. Hanging powers are also an option but may be subject to scrutiny. Gifts to a dynasty trust may qualify for the gift tax annual exclusion but they will not qualify for the GST zero-inclusion ratio. GST exemption must be allocated to a dynasty trust each time a premium is paid (unless the automatic allocation of exemption rules apply).
- Separate Children's Trust: A less appealing alternative is to create separate trusts for each child (possibly under a single instrument), which will be taxable in the estate of the child but will also benefit the grandchildren. Estate tax will be due at the death of the child, but the more onerous GST tax will be avoided.

- Allocation of Exemption: A generation-skipping trust that does not qualify for the annual exemption for gift or GST zero-inclusion ratio is another possibility. Part of the donor's gift tax unified credit and GST exemption must be applied to the trust with each premium payment (unless the automatic allocation of exemption rules apply).

IRREVOCABLE INSURANCE TRUST ADMINISTRATION

For the most part, irrevocable life insurance trusts are not complicated in terms of drafting, but the administration stage is where things often fall apart. The key is to have a clear plan as to *who* is administering the trust. Is it:

- The drafting attorney as individual trustee? This is probably the best solution, in terms of knowledge/expertise. But can the attorney get adequately compensated for this? And will the firm (and/or professional responsibility insurance carrier) allow it?
- Family member/friend as individual trustee? Can, and will, they do it? Unless they are very organized, proactive, and knowledgeable, probably not.
- A corporate trustee? BMO does them, but only for clients with whom we have a larger relationship. Again, there is the question of being paid. Where do the fees come from (especially in the case of an irrevocable life insurance trust holding one or more policies but no cash)?

Initial steps

- Funding: There are two potential funding options with potentially different tax outcomes. Option one is to transfer or assign ownership of an existing life insurance policy. The settlor/insured must complete the transfer form and ensure that the change confirmation comes to both the settlor/insured and the trustee. Once the transfer is complete, the trustee will change the beneficiary designation. Option two is to purchase a new life insurance policy owned by the trust. The trustee should complete the requisite paperwork and limit the involvement of the settlor/insured.
- Obtain Tax ID number for trust, for purposes of opening a bank account. While the irrevocable life insurance trust is a grantor trust and you will not be filing income tax returns, this is the cleaner method. From a practical point of view, most retail bank personnel don't understand why you would be opening an account with someone else's SSN.
- Open trust checking account. For good irrevocable life insurance trust "hygiene," contributions by the settlor/insured should be deposited here. The trustee should be the only signatory and the account should not bear interest.
- Obtain contact information for all beneficiaries and keep this information with the trust records. For beneficiaries who are minors, obtain dates of birth. Give initial notice to all beneficiaries in accordance with the governing trust code. For discussion, we will look to the Illinois Trust Code (ITC) (based on the Uniform Trust Code). Note that irrevocable life insurance trusts are subject to the ITC just like other trusts. For trusts that became irrevocable after January 1, 2020, there are specific duties to inform and account under section 813.1 of the ITC. More specifically, within 90 days of the trust's creation, notice has to be given to each qualified beneficiary of the trust's existence, the beneficiary's right to request a complete copy of the trust instrument, and whether the beneficiary has a right to receive or request trust accountings.[32] Initial notice should include the trustee's name, address, and telephone number.[33]

Ongoing administration

- Dealing with policy premiums and notice: The policy premium notice is received by the trustee and forwarded to the settlor/insured. The settlor contributes money to the irrevocable life insurance trust (deposited into the trust checking account) sufficient to pay the policy premium and any costs/expenses. The trustee gives written notice to beneficiaries entitled under the trust agreement (and time for them to exercise their right of withdrawal—many prefer at least 30 days and maybe even 60). This notice can be combined with the annual trust accounting required to be furnished at least annually under the ITC.[34]

- A related point regarding notice: be aware of changes in the beneficiary status or number (births, deaths, becoming an adult, or becoming disabled) which impact the annual notice and the "initial" notice under ITC 3/813.1(b). Consider whether to require each beneficiary to acknowledge receipt of each year's notice in writing. Assuming no withdrawal, the trustee pays the policy premium. Consider a tickler system to avoid fire drills (with at least one date three months before the premium payment is due).?
- Tracking receipts and disbursements: Keep tidy records/files with policy documents, bank statements, copies of notice, and the like.
- Policy Review: There are pretty extensive limitations on trustee duties and liability with respect to life insurance under the Illinois Prudent Investor Law.[35] Nevertheless, most corporate trustees will: (i) review each policy annually for performance; (ii) secure illustrations annually or biannually; and (iii) monitor policies for conversation opportunities.

Overlap with settlor/insured

If you are the drafting attorney, you may be wearing two hats: attorney for the settlor/insured and attorney for the trustee. While the focus of this article is on administration of the irrevocable life insurance trust, there are some things that you will want to be aware of, mostly related to gift tax implications for the settlor/insured

- Initial Gift Tax Return if existing policy is being assigned (with value based on Form 712);
- Annual Gift Tax Returns;
- Allocating GST exemption;
- Gift-splitting; and
- Gifts in excess of annual exclusion amount.

When the policy "matures" (i.e., the settlor/insured dies), you will need to work with the family or advisors of the settlor/insured to obtain a death certificate, complete and submit the claim form in order to collect the proceeds, and administer the proceeds as provided in the trust agreement. Be aware of three common problems in irrevocable life insurance trust administration: (i) incorrect *Crummey* power provisions; (ii) notice not given; and (iii) GST exemption allocation issues.

ADVANCED PLANNING: SPLIT-DOLLAR LIFE INSURANCE

Split-dollar insurance is simply permanent insurance the ownership and benefits of which are split, typically between a corporation and an employee. Split-dollar insurance is often used to provide a valuable benefit to a key employee at a relatively low cost to the employer. Split-dollar insurance may also be used in conjunction with an irrevocable insurance trust to provide estate liquidity and to replace wealth lost due to the payment of estate taxes. The gift tax costs of establishing and maintaining an irrevocable insurance trust using split-dollar insurance are significantly less than the costs associated with other types of permanent insurance. The lower of the insurer's current published premium rates for one-year term insurance available to all standard risks and the ''PS 58'' value of the premiums (not the actual premium costs) is used to value the economic benefit to the employee and any imputed gifts. When a split-dollar arrangement is used in connection with a second-to-die policy in an irrevocable insurance trust gift tax costs can be reduced even further.

Issue checklist

Split-dollar arrangements involve a myriad of tax (income, gift, and estate) and corporate issues. The following is a summary checklist of many, but not necessarily all, of the issues the planner must consider when implementing a split-dollar arrangement.

- Policy selection: Does the policy suit the needs of the insured and the employer? Is the issuer financially sound? Is the policy a ''modified endowment contract''?

- Plan structure: What method will be used to establish the plan? How will premiums be split? What are the income tax consequences of the premium split? How will death benefits be split? Will the employee, the employee's spouse, or an irrevocable trust own the employee's interest?
- Outside agreement: How will the plan be administered? How and when will the plan be terminated? How will the termination/roll-out be financed? Is the outside agreement subject to ERISA?
- Income, gift, and estate tax issues: Will premium payments constitute taxable income to the employee? Will the employer be able to deduct premium payments? What are the income tax consequences of the increase in cash value of the policy and the termination of the split-dollar arrangement? Will the policy proceeds be subject to income tax, including corporate alternate minimum tax? Will the policy proceeds affect the value of the corporate stock or be included in the estate of the insured?
- Corporate issues: What resolutions are required? Does the arrangement constitute an unsecured loan? Does state law prohibit loans to shareholders and officers?

Documenting the split-dollar arrangement

There are four ways to document a split-dollar arrangement: (i) the endorsement method; (ii) the collateral assignment method; (iii) the split ownership method; and (iv) the sole ownership method.

Under the endorsement method, the employer owns the policy. Pursuant to an endorsement to the policy, the employee (or his transferee) is given the right to name the beneficiary of the policy proceeds in excess of the employer's share of the proceeds. The portion of the policy proceeds subject to the employee's control is referred to as the "at risk" or "protection" portion. Under the endorsement method, the employer maintains control over all but the at-risk portion of the policy. The employee cannot assign the policy itself to a third party. The endorsement method should be used only on a very selective basis due to the significant income tax issues that arise when the split-dollar plan established under the endorsement method is terminated and employee's interest in the policy is "rolled out" to the employee.

Under the collateral assignment method, the employee (or his transferee) owns the policy and selects the beneficiaries. The employer "lends" the premium amounts to the employee and the "loan" is secured by a collateral assignment to the employer of the cash value and death benefits under the policy. Under the collateral assignment method, the employee has control over the policy and may assign the policy, subject to the collateral assignment, to a third party such as an irrevocable insurance trust.

Under the split ownership method, the employee insured (or his transferee) is the basic owner of the policy. The interests in the policy are then split either by operation of an absolute assignment or an endorsement. Under the absolute assignment method, the employee assigns ownership rights in a portion of the policy value equal to the employer's premium payments to the employer. The employee (or his transferee) retains all other ownership rights. Split ownership is not commonly used in employer-employee split-dollar arrangements but it is more common in private split-dollar arrangements.

Under the sole ownership or unsecured method, the employee (or his transferee) owns the policy. The employer has no ownership rights and no secured interest in the policy. At the death of the employee, under the terms of an outside agreement, the employer is reimbursed for premium payments from the death benefit. There is, however, very little IRS precedent regarding split-dollar arrangements under the sole ownership method. In addition, use of the sole ownership method raises a number of corporate issues insofar as the corporation is, in effect, making an unsecured loan to the employee/shareholder.[36]

Premium splits

There are four common means of splitting the premium obligation: (i) the employer pays all plan; (ii) the PS 58 offset plan; (iii) the conventional plan; and (iv) the tailored or level amount plan.

Under the employer pay all plan the employer pays the entire premium. The economic benefit of the premium payments to the employee is measured according to the lower of the one-year term rates from the PS 58 table and the insurer's published one-year term rates for standard risks. Such economic benefit constitutes taxable income to the employee.[37]

Under the PS 58 plan, the employee contributes the lesser of the PS 58 cost of the insurance or the net premium due. Because the employee pays the PS 58 cost of the insurance, the premium payment does not give rise to taxable income to the employee. It is the PS 58 plan that is used most commonly in conjunction with an irrevocable insurance trust. The employee contributes the PS 58 amount to the trust each year, subject to a *Crummey* right of withdrawal. Once the *Crummey* withdrawal period lapses the trustee makes the premium payment.

Under the conventional or classical plan, the employer pays the part of the annual premium equal to the lesser of the annual increase in the cash value of the policy and the net premium due. Because the employee is required to pay a large portion of the initial premiums in the early years of the policy, this plan is seldom used.

The tailored or level amount plan is a modification of the conventional plan. The amount of the employee contribution to the premium payment is leveled across a number of years to minimize the large front-end contributions required under the conventional plan.

Income tax consequences of split-dollar arrangements

The income tax consequences of each plan are a function of the character of the benefits for the employee. The following basic principles govern the income taxation of employer-employee split-dollar arrangements:

- A split-dollar arrangement constitutes an economic benefit provided by the employer to the employee, not an interest-free loan;
- Because the employer is either a direct or indirect beneficiary of the policy, the employer may not deduct any part of the premium payments, not even the PS 58 portion of premiums paid by the employer which constitute taxable income to the employee;
- The measure of the economic benefit to the employee is the PS 58 value in the case of a single life policy and the U38 value in the case of a second-to-die policy while both insureds are alive;
- The employee's contribution to the premiums will reduce the economic benefit to him reportable as taxable income; and
- The employer and the employee's beneficiary will receive the death benefit free of income tax provided the transfer for value rules under Code section 101(a) do not apply.[38]

The cited rulings were all issued in connection with split-dollar arrangements established under the endorsement or the collateral assignment method. The split ownership method is just a variation of the endorsement and collateral assignment methods. The sole ownership method, however, differs substantively from both the endorsement and the collateral assignment methods in that there is no split of interests under the insurance policy itself. Reliance upon the cited ruling as precedent for the treatment of sole ownership plans must, therefore, be qualified. There are currently no published rulings regarding the tax treatment of sole ownership arrangements.

Equity split-dollar refers to an arrangement where the employer's interest in the underlying insurance policy is limited to the right to reimbursement for premium payments from death benefits. The income tax treatment of the increasing cash surrender value of the policy, in excess of premiums paid by the employee (an economic benefit) is not clear. The excess cash value may constitute a taxable economic benefit when the policy is surrendered (Section 72 theory), when the policy is no longer subject to a substantial risk of forfeiture (Section 83 theory), or as it accrues (Revenue Ruling 66-110 theory). Revenue Ruling 66-110 provides that if an employee receives additional benefits (such as policy dividends used to purchase paid up additions) the value of such benefits must be included in the employee's gross income. The planner should advise the client that there is no clear authority regarding the income tax treatment of the increasing cash surrender value.

The termination of a split-dollar plan is frequently referred to as a "rollout"—the interest of the employer in the policy is rolled out to the employee. Split-dollar arrangements are commonly terminated when the employee leaves the company or when the economic benefit constituting taxable income to the employee becomes prohibitive. In order to keep the policy in effect, the employee will have to reimburse the employer for the premium payments paid by the employer. The roll-out of a split-dollar arrangement will often include the removal of the "substantial risk of forfeiture" of the employee's interest in the policy. Such removal may cause the cash value of the policy at the termination of the arrangement (in excess of the sum of the employee's contributions to policy and the employer's investment in the policy) to be taxed to the employee as current income.[39] In addition, the termination of a split-dollar arrangement may result in Code section 7702(f)(7) income taxation at the time of the roll-out and in section 101(a) transfer for value problems at the death of the insured.

Under Code section 7702(f)(7), if there is a cash distribution from a policy within 15 years after the policy has been issued, along with a reduction in death benefits, the cash distribution up to the statutory recapture ceiling will be deemed income to the distributee.

Income tax issues regarding transfers for value

In the case of a transfer for valuable consideration, however, the amount excluded from gross income is limited to the amount of the consideration actually paid and the premiums paid following the transfer.[40] There is an exception to the transfer for value rule where the transfer is to the insured, to a partner of the insured, or to a corporation in which the insured is a shareholder or officer.[41] A transfer to the employee's spouse will be an exempt transfer under Code section 1041. In addition, the transfer for value rule will not be violated where the transferee receives a carryover basis in the policy or the interest in the policy from the transferor.

Transfer for value issues typically arise when the split-dollar arrangement is established and when the employer's interest in the policy is rolled out to the employee. Transfer for value issues under a split-dollar arrangement are a function of the method used to establish the arrangement. These problems are particularly onerous if the endorsement method is used to establish the split-dollar arrangement because the employer is the basic owner of the policy. The transfer of the employee's interest to a non-exempt transferee such as an irrevocable insurance trust when the policy is rolled out will constitute a transfer for value. If the collateral assignment method is used to establish the split-dollar arrangement there should not be a transfer for value problem when the split-dollar arrangement is established or when the policy is rolled out. The collateral assignment of a policy as a security interest does not constitute a transfer for valuable consideration.[42] If a collateral assignment does not constitute a transfer for value, the release of a collateral assignment at the time of a roll-out should not constitute a transfer for value. Note, however, that the cited regulation does not refer specifically to releases. If the split ownership method is used, transfer for value issues may arise both when the split-dollar arrangement is established and when the policy is rolled out to the employee. If the sole ownership method is used, there should be no transfer for value problems when the split-dollar arrangement is established or when the employee reimburses the employer for the premiums because there is no split in the actual ownership of the policy. Note once again, however, that none of the Revenue Rulings issued to date regarding the income, estate, and gift tax treatment of split-dollar arrangements have dealt with arrangements under the sole ownership method.

Special rules apply to the income taxation of modified endowment policies.[43] If a modified endowment policy is to be used in a split-dollar arrangement, the income tax consequences of the termination of such an arrangement must be considered.

Any increase in the annual cash value in excess of premium payments in which the employer has an interest or the death benefit is in excess of cash value received by the employer on a corporate-owned (endorsement method) policy will be a corporate AMT adjustment.[44]

Gift tax issues

If a third party owns the employee interest under a split-dollar arrangement, the value of the economic benefit of the annual premium payments will be a deemed gift to the owner of the interest.[45] If the employee's spouse is the owner of the employee's interest, the gift will not generate any gift tax liability due to the unlimited marital deduction. If an irrevocable trust with *Crummey* powers owns the policy, part or all of the deemed gift should qualify for the annual gift tax exclusion, provided the *Crummey* powers holders have a substantive right of withdrawal. If the employee transfers his interest in a policy subject to a split-dollar arrangement, the gift will be valued in accordance with Revenue Rule 81-198.

Estate tax issues

Transfers of the employee's interest in a policy under a split-dollar arrangement will be subject to the three-year look back rule for estate tax inclusion under Code section 2035. The three-year rule will not apply if a third party (e.g., the employee's spouse or the trustee of an irrevocable insurance trust) applies for the policy and no interest in the policy is thereafter transferred to the employee. Depending on the method used to establish a split-dollar arrangement, it may be difficult to avoid both the transfer for value income tax rules and the three-year look back rules when the policy is rolled out. If the employee retains any incidence of ownership in the policy, the employee's portion of the death benefits will be included in his estate under Code section 2042. Special issues regarding attribution of incidents of ownership arise with majority shareholders. These issues will be discussed in the section below regarding majority shareholders.

Split-dollar arrangements and majority shareholders

Corporate ownership of insurance in a closely-held business presents significant valuation and attribution issues. When valuing stock of a closely-held business for federal estate tax purposes, consideration is to be given to nonoperating assets, including the proceeds of life insurance payable to or for the benefit of the company.[46] If an insured is the sole or controlling shareholder of a corporation with incidents of ownership in a policy, such incidents of ownership will not be attributed to the shareholder to the extent that the policy proceeds are payable to the corporation. If, however, an insured is the sole or controlling shareholder of a corporation with incidents of ownership in a policy, such incidents of ownership will be attributed to the insured to the extent policy proceeds are payable to a beneficiary other than the corporation. If, for example, the decedent is the controlling shareholder in a corporation and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse or to an irrevocable insurance trust, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under Code section 2042.[47] Note that when considering the majority shareholder issue, the planner must look not only to the stock ownership at the inception of the split-dollar arrangement but also to the likely ownership at the death of the shareholder.

In order to avoid attribution of the incidents of ownership problems under a split-dollar arrangement involving a majority shareholder, the rights of the corporation in the policy must be severely limited or eliminated altogether. The corporation may not have the right to surrender the policy or any other power to affect the balance of the proceeds.[48] In addition, the corporation may not have the right to borrow against the cash value in the policy.[49] Use of the sole ownership method of establishing a split-dollar arrangement for a majority shareholder avoids the problem of attributed incidence of ownership but raises corporate issues regarding the authority of a corporation to make what is in effect an unsecured loan to a majority shareholder.

Split-dollar insurance in S corporations

Income of an S corporation is taxed whether it is distributed or not; the money used to pay nondeductible insurance premiums will, therefore, be included in the taxable income of the S corporation shareholder. If the premium payments under a split-dollar arrangement constitute PS 58 economic benefit income to the insured who is also a shareholder, the same premium payment dollars will be taxed twice without any offsetting corporate deduction. This result can be avoided by using the PS 58 plan for splitting premiums.

Other types of split-dollar arrangements

Split-dollar arrangements between family members are referred to as private split-dollar arrangements. Private split-dollar arrangements will be subject to the below-market loan income and gift tax rules under Code section 7872. Private split-dollar arrangements with irrevocable insurance trusts are not always effective for removing proceeds from the estate of the insured.[50] Reverse split-dollar arrangements switch the interests of the employer and the employee under a traditional split-dollar arrangement. At the termination of the plan, the employer transfers the at-risk portion to the employee. Reverse split-dollar is used for retirement planning.

CONCLUSION

As the estate tax exclusion amount moved upwards in recent years, planning with irrevocable insurance trusts was on the decline. But the upward trend in the exclusion is expected to stop and the exclusion is expected to revert to lower-than-current levels. Now is the time to not only refresh planning for life insurance, but to anticipate the matters associated with administration. When planning is done with administration in mind, including the selection of the trustee and the record-keeping for the trust, the end result for the client and her family is optimal.

Notes

1 Rev. Rul. 82-13, 1982-1 C.B. 132; PLR 8724014.

2 Rev. Rul. 89-231, 1972-2 C.B. 323.

3 American National Bank and Trust Co. of Rockford, Ill. v. U.S., 832 F.2d 1032 (7th Cir. 1987); distinguished by Cunningham v. Guardian Life Ins. Co. of America, No. Civ. A. 99-337, 2000 WL 1820080, at 3-4 (E.D. Ky. 2000).

4 Rev. Rul. 79-47, 1979-1 C.B. 312; PLR 8006109.

5 PLR 8103074; PLR 812067; PLR 8021058.

6 215 ILCS 5/238.

7 Gurnett v. Mutual Life Ins., Co., 191 N.E. 250 (1934) (case decided before statute enacted, extends protection both to trusts and to beneficiaries outside the designated class).

8 Treas. Reg. § 20.2042-l(c)(6), Watson v. Comm'r, 36 T.C.M. 1084 (1977); Rev. Rul. 83-147, 1983-2 C.B. 158.

9 Estate of Atkins v. Comm'r, 2 T.C. 332 (1943).

10 I.R.C. §101(a)(1).

11 I.R.C. §101(a)(2).

12 I.R.C. §102(a)(2)(B).

13 PLR 200422051; PLR 200201002.

14 I.R.C. § 2042.

15 HR Rep. No. 2333, 77th Cong., 1st Sess. (1942), reprinted in 1942- CB 372, 491.

16 Treas. Reg. § 20.2042-1(c)(2).

17 Treas. Reg. § 20.2031-2(f).

18 Treas. Reg. § 20.2042-1(c).

19 PLR 8142061; PLR 8229097; PLR 8022048.

20 PLR 8901004; Commissioner v. Procter, 142 F.2d 834 (4th Cir. 1944), cert denied, 323 US 756 (1944), distinguished by Knight v. C.I.R, 115 T.C. No. 36 (2000).

21 I.R.C. § 2041(b)(2).

22 Treas. Reg. § 26.2652-1(a)(1).

23 Action on Decision 1992-09, 1992-12 IRB 4 (4-5-92) Estate of Crisofani v. Commissioner, 97 T.C. 74 (1991).

24 I.R.C. § 2042(a); Treas. Reg. § 20.2042-l(b)(l); Old Colony Trust Co. v. Commissioner, 39 BTA 871 (1939), acq. 1939-2 CB 27.

25 PLR 8121051.

26 Treas. Reg. § 25.2512-6(a) (Ex. 3); see also Rev. Rul. 78-137.

27 Treas. Reg. §25.2512-6(a) (Ex. 4).

28 I.R.C. §§ 2035(d)(2), 2042.

29 I.R.C. §§ 2036(a) and 2042.

30 760 ILCS 3/913 (Life Insurance).

31 I.R.C. § 2642(c).

32 760 ILCS 3/813.1(b)(1).

33 Id.

34 760 ILCS 3/813.1(b)(2) and (3).

35 See 760 ILCS 3/913(a) and (b).

36 See Rev. Rul. 64-328, 1964-2 C.B. 11, which held in part that a split-dollar arrangement does not constitute an interest free loan, pertains to collateral assignment and endorsement method split-dollar arrangements and not to sole ownership arrangements.

37 Rev. Rul. 64-328, 1964- 2 C.B. 11; Rev. 55-747, 1955-2 C.B. 228, Rev. Rul. 66-110, 1966-2 C.B. 105.

38 Rev. Rul. 64-328, 1964-2 C.B. 11; Rev. Rul. 66-110, 1966-2 C.B. 105; Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 55-747, 1955-2 C.B. 228.

39 PLR 7916029; PLR 8310027. IRC § 83.

40 I.R.C. § 101(a)(2).

41 I.R.C. § 101(a)(2)(B).

42 Treas. Reg. § 1.101-1(b)(4).

43 I.R.C. § 72(e)(3)(A) and (v).

44 I.R.C. § 56(g).

45 Rev. Rul. 78-420, 1978-2 C.B. 67.

46 Treas. Reg. § 20.2031-2(f)(2); See, e.g., Crosley Est. v. Comr., 47 T.C. 310 (1966), acq., 1967-2 C.B. 1.

47 Treas. Reg. § 20.2042-l(c)(6); Rev. Rul. 76-274, 1976-2 C.B. 278.

48 Rev. Rul. 76-274, 1976-2 C.B. 278.

49 PLR 9037012; Rev. Rul. 82-145, 1982-2 C.B. 213.

50 Rev. Rul. 79-129, 1979-1 C.B. 306; Rev. Rul. 81-164, 1981-1 C.B. 458.

OPERATION OF [______________] INSURANCE TRUST

DURING LIFETIME OF [______________]

Nature of Trust. The [__________] Insurance Trust (the "Trust") is an irrevocable trust designed to own life insurance insuring the life of [________________________]. The Trust was established under a trust agreement dated [______________], 20____, (the "Trust Agreement"). The Trust is not designed to hold joint and survivor (second to die) life insurance.

Trust Bank Account. The Trustee should establish and maintain a Trust checking or money market account in the following name:

[______________________________________] Insurance Trust

u/a/d [__________________________], 20____, [______________], Trustee

Only the Trustee is authorized to sign on the account unless the Trustee designates an agent (not the insured or grantor). The Trustee's mailing address should be used for the account. When signing checks, the Trustee should sign as follows: "[________________________], Trustee."

The federal employer identification number for the Trust, which is used for banking and tax purposes, is [____].

Purchase and Transfer of Insurance Policies to The Trust. Existing life insurance policies owned by [________] insuring his life should be assigned to the Trust. All new life insurance policies insuring the life of [________] should be acquired in the name of the Trustee. The Trust should be both owner and beneficiary of all such policies and all incidents of policy ownership should be vested in the Trust. The Trustee should keep all insurance policies in their possession.

To assign existing policies to the Trust, the Trustee or the insurance agent for the Grantor will have to secure the following forms from each insurance company:

a. Change of ownership form to be signed by [________________];

b. Change of beneficiary form to be signed by [________________], as Trustee; and

c. Form 712 reporting the value of the policy at the time of the transfer to the Trust.

For any new life insurance policies acquired by the Trust, the ownership form and beneficiary designation should be issued in the following name (or a similar designation):

[____________________________________] Insurance Trust

u/a/d [________________________], 20____, [_____________], Trustee

Payment of Premiums. The Trustee, as owner of the policies which have been acquired by or assigned to the Trust, has the responsibility of making all premium payments from Trust assets. The Trustee should make premium payments from the bank account which the Trustee has established in the name of the Trust. The Trustee should establish a calendar docket system which lists the dates upon which all premium payments are due and their amounts.

The primary source of funds to pay premiums will be gifts by the Grantor. [____________________], on an annual or semi-annual basis, may gift to the Trust sufficient cash from his personal bank account in order for the Trustee to have the cash with which to pay the premiums which are due each year. We recommend that gifts be made at least 40 days prior to a premium due date.

If it is desired to minimize the Trustee's duties, the Trustee should request from the insurance companies that the premiums be paid annually and coordinate multiple policies so that they have approximately the same premium payment date. This will ease the burden of the calendaring requirements and the notice requirement described below. Typically, annual premiums are slightly less expensive than semi-annual or quarterly premium payments.

Withdrawal Rights. Article I of the Trust Agreement first gives [___________________] the right to withdraw the greater of $5,000 or 5% of the gifts to the trust each calendar year. Article I of the Trust Agreement then gives each of the children the right to withdraw a pro rata share of the gifts to the trust in excess if that which [_____________] has the right to withdraw, up to a maximum of $30,000 per child in each calendar year (assuming [_____________] agrees to split the gifts for gift tax purposes).

The right to withdraw extends for 30 days from the date the beneficiaries receive the notice of the gift to the Trust. If no withdrawal is made by a beneficiary, each beneficiary's right lapses as to the greater of $5,000 or 5% of the value of the Trust. Any amount of the withdrawal right in excess of the greater of the $5,000 or 5% of the trust estate will carry over and become available for withdrawal in the next calendar year.

The right of withdrawal provided in the Trust Agreement is given to the beneficiaries in an attempt to secure for the Grantor of the Trust an annual exclusion from gift tax on any gifts made to the Trust, while providing the Trustee with the cash from which to pay premium payments. Otherwise, gifts to the Trust would be gifts of a future interest and would not qualify for the annual gift tax exclusion. The gifts to the Trust will reduce the availability of other annual exclusion gifts the Grantor may wish to make. If the Trustee follows the notification procedures (discussed below), the annual exclusion from gift tax should be available based upon the Ninth Circuit case of Crummey v. Commissioner and I.R.C. Section 2503(b) and IRS interpretations.

Notice to Beneficiaries. Section 1.6 of the Trust Agreement requires the Trustee to notify each beneficiary that funds are available for withdrawal by the beneficiary from the Trust each time a gift is made. If a beneficiary is a minor, the notice should be directed to the child's parent or guardian, even if it is the parent of the child who is making the gift. The notification is required by IRS interpretation. A sample notification letter is attached. The Trustee should keep a copy of each notification letter sent to a beneficiary.

Gift Tax Returns. If gifts to a beneficiary (either directly, through the Trust or through any other trust) in any one calendar year are made in excess of $15,000 ($30,000 if [____________________] consents to split the gifts), then the excess is a taxable gift. Taxable gifts reduce the donor's federal applicable exclusion amount. Once the applicable exclusion amount is used, the applicable gift tax rate is 45%.

Gift tax returns must be filed timely for all gifts in excess of $15,000 given to any one individual in any one year, taking into account transfers made not only into this Trust, but also into any other trusts for the benefit of that beneficiary or to the beneficiary outright. These must be filed at the same time as the Grantor's income tax return, generally by the 15th day of April (plus extensions) of the year following the year in which the gift (or gifts) are made. Your accountant should be notified of all gifts so that he may prepare the gift tax returns.

In addition, it may be beneficial to allocate generation-skipping transfer tax exemption to the gifts you make, which should be done on the federal gift tax return.

Income Tax Returns. Because this Trust is a "grantor type" trust, the Grantor, during his lifetime, will be treated as the owner of the Trust for purposes of reporting income or losses from the Trust. Any income earned by the Trust and any expenses or losses incurred by the Trust will be reflected on the Grantor's individual income tax returns. (Any interest paid by the Trust on premium loans may be consumer interest and its deductibility limited.) The Trust may be required to file a separate federal fiduciary income tax return (no state return is required for Illinois) during the life of the insured, reporting that the Trust is a grantor trust and that "all income and losses are attributable to the Grantor, pursuant to Sections 671-677 of the Internal Revenue Code."

[________________________], 20____

EXHIBIT A

SAMPLE LETTER: NOTICE TO BENEFICIARY

[__________], Trustee
[______________] Insurance Trust
[_________________________]
[______________], [____] [__________]
______________________________________, 20____

[____________], individually
[_________________________]
[______________], [____] [__________]

[____________]
as Parent on behalf of __________________
[_________________________]
[______________], [____] [__________]

Re: [______________] Insurance Trust

Dear Beneficiaries:

You are a beneficiary of the [______________] Insurance Trust that was created by [____________] on [________, 20____] (the "Trust"). One of the purposes of the Trust is to own life insurance. Pursuant to the terms of the Trust Agreement, you have the right to request in writing the withdrawal of your share of any gifts made to the Trust.

This year, the Trust has received qualifying gifts of $______________, of which $____________ is subject to your right of withdrawal. This right of withdrawal will lapse. If you wish to exercise this right to withdraw, please notify me in writing. If you do not wish to exercise the withdrawal right and would prefer to have the share of the gift remain in the Trust, you do not need to do anything.

It is anticipated that a similar gift will be made each year to the Trust in order to pay the premium on the life insurance policy owned by the Trust. You will have similar rights of withdrawal with respect to such gifts.

Please contact me if you have any questions.
Sincerely,

[______________], Trustee