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IRREVOCABLE INSURANCE TRUSTS

I. GENERAL DESCRIPTION OF IRREVOCABLE LIFE INSURANCE TRUST:

An Irrevocable Insurance Trust avoids probate and provides all of the desirable advantages that revocable trusts do to protect the interests of beneficiaries and carry out the Grantor's directions. This type of trust has the extra advantage of potential estate tax savings but the creator has a loss of control over the insurance policy and may have a possible gift tax cost.

Generally, the Grantor contributes funds to the insurance trust and the trustee (someone other than the Grantor) pays the premiums on a new insurance policy. Thus, the Grantor or creator of the trust never owns the insurance policy. Instead it is purchased directly by the Irrevocable Insurance Trust by the Trustee. The Trustee cannot be the Grantor, but should be someone else. Sometimes, the Trust can be funded, this means that the Grantor transfers property to the trust along with an insurance policy and those resources and their earnings are used to pay the premiums on an ongoing basis. Oftentimes, the trust is unfunded, and the Grantor gifts amounts necessary to pay the annual premiums. Under either scenario, the premiums are generally paid with after-tax dollars.

The main advantage of an Irrevocable Life Insurance Trust is the avoidance of Federal estate taxes, and the avoidance of probate on the proceeds. The proceeds of a life insurance policy payable after death of the insured are not included within the decedent's estate so long as:

1.1 The insured/decedent did not retain or possess an incident of ownership over the policy at the time of death; and

1.2 If an existing insurance policy has been transferred to the trust, the insured must not die within three years of that transfer, or it will be included within his or her estate.

It is important to remember that the life insurance trust is irrevocable. This means once the trust is set up, the beneficiaries cannot be changed and the Grantor or creator of the trust cannot amend it in any way. The named beneficiaries, usually the Grantor's children, will be able to use the funds for payment of estate taxes at the Grantor's death. However, they cannot be forced to do so. They may choose to use the funds to pay estate taxes within nine months from the date of death. Alternatively, the beneficiaries could decide to retain the proceeds of the insurance policy payable upon death of the insured and use them in other ways. In that event, they would still have to pay the estate taxes from the other estate assets, not held in the Irrevocable Insurance Trust.

Usually, this is an ideal scenario for beneficiaries who will inherit a family-owned business such as a construction company or car dealership. If the heirs do not have an insurance trust, they will have to pay the estate taxes within nine months of death out of the other assets of the estate. Typically, these are primarily the business itself. Thus, sometimes, a fire sale is necessitated by the death of the Grantor. An insurance trust allows them to pay the estate taxes from the life insurance policy proceeds and are not forced to sell the business within nine months of death. Often, the Grantor's children are also involved in the business on an ongoing basis, and would prefer not to sell it at all.

II. GUIDELINES FOR ONGOING MAINTENANCE OF AN IRREVOCABLE TRUST:

Here are a few guidelines for the Grantor (creator of trust) to keep in mind after signing an irrevocable trust:

2.1 Insurance Policies:

As a general rule, life insurance should not be put into an irrevocable trust that is also used for other investment assets during the Grantor's lifetime. In other words, life insurance should be kept in one or more separate trusts. This memo assumes that life insurance is not going to be an asset of the irrevocable trust; we have a separate memo for life insurance trusts.

2.2 Gifts:

Under most circumstances, anyone except a trustee, a beneficiary, or a potential beneficiary can contribute assets to the trust, but sometimes it is unwise to do so. If someone other than you, the Grantor, wants to contribute assets to the trust, let us know.

2.3 Initial Contributions:

After signing the trust, make the initial contribution of assets to the trustee. You must give up all of your rights to the trust assets. You may not retain direct or indirect control over trust assets. You should not give the trustee written instructions, especially asset management or distributions to beneficiaries; however, written clarification regarding your intent are acceptable.

2.4 Trust Obligations:

You should NEVER pay trust obligations (debts, insurance, taxes, etc.) for the trustee or allow such payments to be deducted from your personal account or from a business account.

2.5 Periodic Contributions:

You may periodically make contributions of cash or other assets to the trust, as you deem appropriate, but never direct the trustee what to do with those contributions.

A. If you want to make a contribution to cover an obligation of the trust, make the

contribution to the trustee, but do not make any notation on the check or give any written instruction that could be construed as a direction to the trustee. Remember, you cannot retain control over the trust assets. Even the appearance of control by you can create problems.

B. For the same reasons, avoid making contributions when obligations are due and in the exact amount of the obligations. If your intent is to see that payments on a loan secured by trust assets are made, it is better to make contributions in excess of the debt service so that the trustee can keep an interest-bearing bank account open as well as invest in other assets, as the trustee deems appropriate.

C. Contributions can be taxable gifts. Contributions of \$10,000 or less per primary beneficiary will not be subject to gift tax. The trust can provide that contributions may be withdrawn by the primary beneficiary.

- In order to qualify for the annual gift tax exclusion, trust contributions must be subject to withdrawal by one or more beneficiaries. If the trust document does not make the contributions subject to a withdrawal right, you must give the trustee notice that you want a withdrawal right to apply.
- You may designate different beneficiaries who have the right to make the withdrawals for each contribution. A withdrawal right should not be given to a person who is not a bona fide beneficiary; the IRS may disallow the annual gift tax exclusion.
- There can be adverse tax consequences for your beneficiaries if "withdrawable" contributions exceed \$5,000 per beneficiary, so we recommend that you contact us before making such contributions.
- Even if the beneficiaries have a withdrawal right, your contributions may exceed your available annual gift tax exemption requiring you to pay gift tax or use up your gift and estate tax credit. Also, certain contributions for your grandchildren or lower generations may require you to use up your "GST Exemption" (Generation Skipping Transfer Tax) for purposes of the federal generation skipping tax. It is better to use up the GST exemption than to expose the trust to the generation-skipping tax (which is currently a 55 % flat rate), so it is important to file the appropriate gift tax return and to properly make the required election on the return. If this is not done correctly, the problem may not be discovered until it's too late to correct.
- In addition, you may specify that any contribution is not subject to this withdrawal right; however, if you do, a gift tax return (IRS Form 709) will be required for that contribution, and you will have to "spend" part of your lifetime gift and estate tax "exemption" of \$675,000 (or actually pay a gift tax if you've already used up your "exemption".)

2.6 Special Rules if Your Spouse is A Beneficiary:

If you have created an insurance trust which provides benefits to your spouse after your death, all contributions to the trust must be made from your separate property.

- If contributions of community property funds are made to an irrevocable trust and the Grantor's spouse is a beneficiary, the assets (or at least some of the assets) will be included in the spouse's estate for federal estate tax purposes.
- If you do not have separate property funds to contribute to the trust, then community funds must be converted into separate funds. For example, if you have decided to contribute \$3,000 to the irrevocable trust, you must take \$6,000 of community funds and give \$3,000 to your spouse, to be placed in a separate property account, and the remaining \$3,000 can be contributed to your irrevocable trust.
- Your spouse should not be the trustee. Pick an independent trustee.

III. TRUSTEE:

The trustee of an insurance trust should never be the insured. Instead, the insured should be sure to assign all rights to a policy (if an existing policy is transferred to the trust) in order to avoid retaining any incident of ownership which might cause the insurance proceeds to be includible in his or her estate. Alternatively, if a new insurance policy is purchased by the trustee for the trust itself, be sure that the trustee, not the insured, fills out the application and purchases the policy. The trustee of an irrevocable trust should follow these instructions:

- All transactions you make on behalf of the trust should clearly reflect that you are acting as trustee.
- All cash contributions should be deposited into a separate account established solely for the trust. The bank (or other financial institution) should be given the trust's tax identification number when the account is opened.
- Never deposit trust contributions into a personal account or make payments on behalf of the trust from a personal account.
- The primary beneficiaries of the trust will usually be given at least 30 days to withdraw their pro rata shares of contributions to the trust (up to \$10,000 each). This withdrawal right may be outlined in the trust document or in a separate document, and you should follow the instructions carefully. If contributions are subject to a withdrawal right, you must maintain liquid funds to be able to satisfy those rights until the withdrawal right lapses.
- Keep meticulous records relating to the trust's assets, income, and expenditures.

You must file a fiduciary income tax return (IRS Form 1041) unless the income from the trust assets is below the minimum amount indicated on the return.

- The trustee must act independently. If the IRS perceives that the trustee is merely an agent for the Grantor, the trust assets may be included in the Grantor's estate for federal estate tax purposes.
- This trust is written so that its assets will NOT be considered part of the Grantor's estate for federal estate tax purposes. The trustee should never pay any tax or other liability owed by the Grantor, the Grantor's estate, or the trustee of any other trust created by the Grantor. The trustee can grant loans and make purchases as permitted by the trust document.