CUMMINGS & LOCKWOOD LLC

ADMINISTRATION OF IRREVOCABLE INSURANCE TRUSTS

A Private Clients Group White Paper

This memorandum is designed to outline some of the basic administrative steps to be followed by the Trustee of an irrevocable insurance trust. When properly implemented and administered, such a trust will prevent the imposition of estate tax on any life insurance policies owned by the trust, both at the insured's death and at the death of the insured's surviving spouse. If you have established or are acting as Trustee of an insurance trust, we recommend that you follow the procedures outlined below to maximize the effectiveness of the trust:

INITIAL STEPS

1. Transfer insurance policies and designate trust as beneficiary

At the time the insurance trust documents are executed, the insured generally also signs the forms necessary to transfer ownership of the selected insurance policies to the trust. The Trustee then signs the forms necessary to designate the trust as the beneficiary of those policies. The desired end result is that the insurance trust both owns the life insurance policies and is named as beneficiary of those policies.

The forms needed to change owner and beneficiary in this manner are available from the appropriate insurance companies or, in the case of insurance policies issued through a corporation (such as group life insurance), through the insured's employee benefits office. If you have any difficulty in obtaining the necessary forms, please contact us.

If the insured desires, he or she can obtain the forms before the date that is set for signature of the Trust Agreement and forward them to us for completion.

It is preferable to forward these forms in blank so that we may complete them properly. However, if the insured's employer or any insurance company insists on completing the forms, the forms should be completed to name the insurance trust as owner and beneficiary of the policy. We recommend that you refer to the trust using the format detailed in Section 5 of this memorandum.

Occasionally, time pressures result in creation of the trust before all the insurance company forms are available. Please keep in mind that only those insurance policies transferred to an insurance trust more than three years prior to the death of the insured will achieve the intended exemption from estate tax. This three year "waiting period" does not start until the formal transfer of ownership to the trust has been completed. Accordingly, properly and promptly transferring ownership of the insurance policies to the insurance trust is extremely important.

If a new insurance policy is to be obtained either in connection with the creation of the trust or at some later time, the trust itself generally should be the initial applicant for, owner, and beneficiary of the new policy. Beyond eliminating the need to transfer ownership of the policy to the trust, this approach will prevent the insurance proceeds from ever being considered a part of the insured's estate, even if he or she dies within three years after the trust purchases the new insurance.

2. Notify insurance company of trustee's address

The Trustee should notify each insurance company of the Trustee's mailing address and request that future premium notices be sent to the Trustee.

3. Open trust checking account

Unless the trust holds only employer-provided insurance (see section 14) or other insurance with respect to which the Trustee will not be required to pay premiums and will not receive dividends, the Trustee may wish to open a checking account in the name of the trust. This account can then used as the basic trust management vehicle. The Trustee can deposit any future cash gifts to the trust into the checking account and can pay insurance premiums and other trust expenses from the account. In this way, the Trustee will preserve a permanent record of trust transactions for possible submission to the IRS.

If there are two or more Trustees, the account can be structured so that only one Trustee's signature is required on checks.

If the Trustee wishes to avoid establishing a separate trust checking account, then he or she may employ the alternate approach detailed in Section 6.

4. Verify insurance company records

Approximately three months after the creation of the trust and the transfer of the insurance policies to the Trustee, the Trustee should request written verification from each insurance company that its records reflect that: (1) the trust is the sole owner of each policy issued by it transferred to the trust, and (2) the trust is designated as sole beneficiary of each policy and will receive the proceeds in a single payment.

5. Legal title of the trust

Where it is necessary to identify the trust (as, for example, on a checking account, or as owner/beneficiary of the insurance policies owned by the trust), the following style may be followed:

> Mary Jones, Trustee, and her successors in trust, of the John Jones
>
> 2021 Irrevocable Insurance Trust under Agreement dated
>
> January 1, 2021.

ONGOING TRUST ISSUES

6. Payment of premiums

Each time a premium payment is due with respect to life insurance owned by the insurance trust, the insured generally will make a gift to the trust (to be added to the trust checking account) sufficient to pay the premium. Because the Trustee may need to mail letters notifying the beneficiaries of this gift [see Section 8] before using the gifted funds, the insured should make this gift to the trust at least 30 days in advance of the actual premium due date.

If the Trustee wishes to avoid establishing a separate trust checking account, then an alternate approach would be as follows:

- The insured should forward a check to the Trustee, made payable to the Trustee in the amount of the premium, within a reasonable period of time (at least 30 days) in advance of the premium due date.
- The Trustee should then send notification letters [see Section 8] to each of the trust beneficiaries and hold the check during the 30-day period.
- When the premium payment is due, the Trustee should endorse the back of the check as follows:

"Pay to the order of ABC Life Insurance Company."
[Signed:] John Doe, Trustee

This approach avoids the need of opening a checking account for the trust and has been sanctioned by a number of judicial decisions.

As a final approach, which may be the only available alternative when the deadline for payment of a premium is imminent, an insured can pay a premium directly to the insurance company. In such a case, the premium payment is treated as a gift to the trust, and the Trustee should immediately send notification letters to the trust beneficiaries. Using that method may increase the likelihood that the IRS will seek to deny gift tax "annual exclusions" for the premiums paid. Nevertheless, this result is utilized by many clients and certainly should be preferable to allowing a policy to lapse for nonpayment of premiums.

7. Source of contributions to the trust

<u>If the insured's spouse is a beneficiary of the trust, *no contributions by the spouse should be made to the trust* and no premiums should be paid out of either a joint account or an account in the spouse's individual name.</u> Failure to follow this important rule could result in all or a portion of the life insurance proceeds being subject to estate taxation at the surviving spouse's death.

8. Mailing of notice letters

Generally the insurance trust agreement provides that certain trust beneficiaries have an immediate right to withdraw any gifts made to the trust. These withdrawal rights are necessary to qualify gifts to the trust for the "annual exclusion" for gift tax purposes. Specifically, using this mechanism, a donor can contribute to the trust up to $15,000 per beneficiary (other than the insured's spouse) annually (reduced by other gifts to those beneficiaries) without the imposition of any federal gift tax. If the donor's spouse consents to have the gift treated on the donor's gift tax return as made one-half by the donor's spouse, this exclusion can be increased to up to $30,000 with respect to each person (other than the insured's spouse) having a right of withdrawal.

Under most trust agreements, each beneficiary's withdrawal rights will lapse at the rate of the greater of $5,000 or 5% of the value of the trust each year, which prevents adverse gift tax consequences to the beneficiary if he or she does not exercise the withdrawal rights. The withdrawal rights may become cumulative to the extent the rights exceed such thresholds each year. The Trustee should keep careful records in order to determine the amount of withdrawal rights from time to time.

In order to qualify gifts to an insurance trust for the gift tax "annual exclusion," the trust beneficiaries must be informed of their right to make a withdrawal in the year in which the gift is made. The creation of the trust should be discussed with the trust beneficiaries who are eligible to make withdrawals, and the Trustee should send a confirming letter to each of them and retain a copy in the trust files. Although it is not required, if possible, the letter should provide the dates of all future premium payments and the amounts of the annual contributions to the trust. It is not clear under existing law whether a letter providing "one-time" notice is sufficient, or conversely whether notice must be given each time an insurance premium is paid or a contribution is made to the trust. The conservative approach thus would be to give each beneficiary notice on each occasion. In this case, the initial letter should be thorough in explaining the withdrawal rights (see Exhibit "A"), but subsequent letters can be more brief. (See Exhibit "B" for an example.) Please note that the attached letters are intended for adult beneficiaries. If there are minor beneficiaries, the letter should be addressed to that beneficiary's legal guardian, normally either of his or her parents (but not the insured).

Even though the trust beneficiaries normally will choose not to exercise their withdrawal rights, the rights are legally enforceable and must be treated as such by all the parties. For example, there must be no agreement between the grantor of the trust and the beneficiaries that the beneficiaries will not exercise their withdrawal rights. If the parties to the trust do anything to undermine the enforceability of the withdrawal rights, gift-tax benefits for contributions to the trust may be lost. In addition, trust beneficiaries who do not wish to exercise withdrawal rights should not affirmatively decline or waive those rights; they should merely allow them to expire.

9. Additional contributions to the trust

Insurance Trusts generally are designed for the primary purpose of administering life insurance. Often special dispositive and administrative provisions relating to insurance are included in the governing trust agreement. The trust, therefore, may not be a suitable vehicle for administration and disposition of assets other than insurance, at least during the insured's lifetime.

Specifically, for tax and administration reasons, an independent Trustee or co-Trustee may be needed if gifts made to the trust are larger than needed to pay premiums and other expenses. In addition, if surplus funds are invested or if the trust's checking account is an interest-bearing account, the trust may begin to collect taxable income, requiring the Trustee to obtain a tax identification number and file annual tax returns. (See Section 12.) Your Cummings & Lockwood attorney or other tax advisor should be consulted *before* making such gifts to the trust.

10. Gift tax return for persons making contributions to the trust

Generally speaking, a United States Gift Tax Return must be filed for any year in which a gift is made. However, as discussed above, gifts to an insurance trust generally are designed to qualify for the $15,000 per donee annual exclusion from gift tax. Remember that all gifts from a donor to a donee (in trust or otherwise) must be combined to determine if the $15,000 threshold has been met. Remember also that both (1) the cash value of any existing life insurance policies added to the trust, and (2) the premiums paid by an insured's employer on policies owned by the trust count as a gifts when determining the total taxable transfers to the trust for that year.

If only gifts that qualify for the annual exclusion are made in a given year, it generally is not necessary to report these gifts on a gift tax return. However, it still may be necessary to file a gift tax return if a donor wishes to allocate any of his or her lifetime exemption from the Generation-Skipping Transfer Tax (GST Tax) to any gifts made during the year. In addition, there are very highly technical default rules relating to automatic allocation of GST Tax exemption, which may require taxpayers to file gift tax returns for the sole purpose of electing not to have these automatic rules apply. Please see the following section of this memorandum for a more detailed summary of these considerations.

If the explanations contained above and in the following section of this memorandum do not clearly address the facts of your situation, you should consult your Cummings & Lockwood attorney or tax advisor about the necessity of filing gift tax returns. Such returns are due on April 15 of the year following the year in which the gift is made.

11. Allocation of Generation-Skipping Tax exemption and gift tax returns

The Generation-Skipping Transfer Tax (GST Tax) generally applies when a person makes a gift to persons two or more generations younger than the donor (for example, to grandchildren) or to trusts for their benefit. Each person has a $11,700,000 exemption from this tax, which can be used either during life or at death. The amount of the exemption is indexed for inflation. To elect to use the exemption during life, generally a Federal gift tax return must be filed to report this election.

If gifts are made to a trust which the donor intends to qualify for exemption from the GST Tax, it may be necessary to file a gift tax return to report this election. In other cases, automatic allocation default rules contained in the tax law may make it unnecessary to file such a return. Finally, in certain circumstances, these default rules may <u>automatically</u> allocate GST Tax exemption to gifts to some trusts generally not intended for GST Tax planning. In such cases, application of these default rules could result in a waste of GST Tax exemption.

Unfortunately, the default rules are too numerous and too complex to adequately summarize in this format. Accordingly, you should make certain that you discuss the need to file gift tax returns either with your Cummings

& Lockwood attorney or with a tax preparer who is aware of these automatic GST Tax allocation rules and is familiar with the intent of your estate planning.

12. Trust income tax returns

An insurance trust generally will be treated as a "grantor trust" for income tax purposes, which means that the grantor (and not the trust itself) is liable for the payment of tax on any income generated by the trust. Among other reasons, a trust is a "grantor trust" when (1) trust income may be used to pay the premium on insurance policies on the grantor-insured's life, or (2) the terms of the trust permit trust income to be distributed to the grantor's spouse. Because most insurance trusts are funded only with insurance, generally no income, deductions, or credit will be generated, and thus the trust will not have any filing requirements. However, if assets are added to the trust that produce items of income, deduction or credit, these items will have to be reflected on the income tax return of the grantor. The Trustee should then consult his tax advisor to discuss filing requirements.

13. Loans against insurance policies held in the trust

Insurance policies transferred to an irrevocable trust may be subject to outstanding loans. Also, the Trustee generally is authorized by the trust agreement to borrow funds from the insurance company and to pledge the trust policies as security. This technique can be used to pay all or part of the premiums due on certain types of policies.

14. Special characteristics of employer-provided life insurance

If the premiums on any insurance policies held in the trust are paid by the insured's employer ("group life insurance"), in part or in whole, the IRS has taken the position that while employment continues such payments are considered (1) *taxable income* to the employee, limited in the case of group life insurance to the premium attributable to coverage in excess of $50,000, and (2) as *gifts* by the employee to the trust owning the policy. Depending on the terms of the governing trust, Treasury rulings indicate that the $15,000 annual gift tax exclusion may be available for such "gifts" to the trust.

The desirability of continuing the group insurance policies and the trust after retirement of the insured requires consideration before his or her retirement.

15. Termination of the trust

Many insurance trust agreements contain provisions that permit the termination of the trust and distribution of the policies during the insured's lifetime. If such termination becomes advisable, please consult counsel. *This opportunity MUST be reviewed shortly before retirement in the case of group life insurance policies.*

16. Death of the insured

Upon receipt of notice of the death of the insured, the Trustee should request appropriate claim forms from the insurance company. Claim forms are often available on-line as well. Payment of the proceeds normally takes several weeks. When the proceeds are collected, the complexities of administering the trust will be substantially increased, both with respect to investment responsibility and record keeping. The Trustee should consult with counsel at that time.

When the insurance claim is filed, the Trustee should request that the insurance company forward directly to the insured's Executor a Treasury Department "Form 712" for each policy collected. Form 712 is a statement of the policy's value that the Executor must submit to the IRS (attached to the U.S. Estate Tax Return), whether or not the policy proceeds are taxable.

The trust agreement may provide for the appointment of a co-Trustee at the death of the insured. If so, the co-Trustee should be notified immediately of the insured's death, and a meeting should be arranged among the

Trustees and their counsel to discuss further administration of the trust.

Revised January 2021

This document is intended to convey to you the principal characteristics of Administration of Irrevocable Insurance Trusts as they apply to common situations. For this reason we have deliberately simplified technical aspects of the law in the interest of clear communication. Under no circumstances should you or your other advisors rely solely on the contents of this document for technical advice nor should you reach any decisions with respect to this topic without further discussion and consultation with a Cummings & Lockwood attorney.

In accordance with IRS Circular 230, we are required to disclose that: (i) this memorandum was not intended or written by us to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer; (ii) this memorandum was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the memorandum; and (iii) each taxpayer should seek advice on his or her particular circumstances from an independent tax advisor.

EXHIBIT A

{Trustee}
{Trustee's address}

{DATE}

{Beneficiary}
{Address of Beneficiary}

Re: *{Trust}* dated *{date of Trust}*

Dear *{Beneficiary}*:

On *{date of Trust}*, your *{relation of Grantor(s) to beneficiary}* signed an irrevocable Trust that designates *{Trustee(s)}*, and me as Trustees. As more fully explained below, under the Trust you have the absolute right to withdraw part or all of the property contributed to the Trust. The purpose of this letter is to notify you of your withdrawal right and the mechanics of exercising it. A copy of the withdrawal power is enclosed for your review.

The Agreement gives each of the members of a class composed of *{class of beneficiaries}* the right to withdraw a portion of a donor's aggregate annual gifts, the exact amount of which is determined by dividing the total gifts for the year by the number of persons in the class who are eligible to make a withdrawal. The maximum amount that may be withdrawn, however, may not exceed the maximum annual exclusion available for federal gift tax purposes.

Recently, your *{relation of Grantor(s) to beneficiary}* made a gift to the Trust by assigning policies of life insurance to the Trust and by paying the premiums on such policies or by contributing cash, and you are entitled to exercise your withdrawal right with regard to this gift.

In subsequent years, your *{relation of Grantor(s) to beneficiary}* intend(s) to make additional gifts to cover the premiums due on the life insurance policies, either by paying the premiums or by contributing cash to the Trust to be used by the Trustees to pay the premiums. *{If possible, provide the insurance carrier and policy number, the dates of future premium payments and the amounts of annual contributions to the trust.}*

These gifts will entitle you to exercise your withdrawal rights in subsequent years.

In order to exercise your right of withdrawal with regard to the recent gift or the gifts which your *{relation of Grantor(s) to beneficiary}* intend(s) to make in future years, on or before December 31 of the applicable calendar year you must give the Trustees written notice that you intend to exercise it. The notice should state the calendar year involved and should indicate whether you are exercising your right of withdrawal to the fullest possible extent or to some lesser extent. It is not necessary for you to know the amount or the timing of gifts to the Trust in order to exercise your withdrawal right. The notice can be given to the Trustees at any time (before or after the date of a gift) during a calendar year. For example, you may notify a Trustee on January 1 that you intend to exercise your right of withdrawal as to all amounts subject to it during that calendar year, and that notice will be effective as to all gifts made during the course of the year.

At the end of each calendar year, if you have not exercised your withdrawal right, the withdrawal right will be reduced by an amount equal to the greater of $5,000 or 5% of the value of the trust on December 31. The only exception to this rule is for withdrawal rights arising in connection with gifts made during the month of December. The withdrawal right applicable to gifts made during December is not reduced until December 31 of the following calendar year.

As Trustee of the *{Trust}*, I will do my best to answer any questions you may have regarding gifts to the Trust and your rights under the Trust Agreement. I am certain that your *{relation of Grantor(s) to beneficiary}* will also be happy to answer questions regarding the Trust. If you wish to exercise your withdrawal right, the written notice should be sent to *{Trustees}, {address of Trustee}*.

For my records, I would appreciate your acknowledging that you received and understand this notification by dating and signing the attached copy of this letter and returning it to me in the envelope provided.

Very truly yours,
{Trustee}, Trustee

Enclosures

Received and understood by:
{Beneficiary}

____

____
Date

EXHIBIT B

{Trustee}
{Trustee's address}

{DATE}

{Beneficiary}
{Address of Beneficiary}

Re: *{Trust}* dated *{date of Trust}*

Dear *{Beneficiary}*:

During *{current year}*, your *{relationship of Grantor(s) to beneficiary}* made a gift to the {*Trust}{by assigning policies of life insurance to the Trust and}* by paying the premiums on such policies or by contributing cash, and you are entitled to exercise your withdrawal right with regard to this gift. If you do not exercise your right of withdrawal on or before December 31, *{current year}*, the right will lapse to the extent provided in the trust agreement.

If you would like to exercise this right of withdrawal, you will need to sign a written request and send it to me, as Trustee. To determine the exact amount covered by your withdrawal right or for more information about the right, please contact me.

For my records, I would appreciate your acknowledging that you have received and understand this notification by dating and signing the attached copy of this letter and returning it to me.

Sincerely,

{Trustee}, Trustee

Enclosures

Received and understood by:
{Beneficiary}

____

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Date