IRREVOCABLE INSURANCE TRUSTS

I. Insurance is purchased to provide additional liquidity upon the death of the insured. The liquid cash can be used:

A. To pay estate taxes;

B. To provide for the financial needs of the insured's dependendents;

C. To multiply the effect of annual gifting;

D. Other? (Buy-Sell arrangements, etc.)

II. To avoid increasing the insured's estate by the amount of the life insurance proceeds, the insured should not have any "incidents of ownership" over the insurance policy. Therefore, the insurance policy can be owned by:

A. Business partners (Buy-Sell Agreements);

B. Corporation (unless controlled by insured);

C. Children or other intended beneficiaries;

D. Irrevocable Trust.

III. By using a trust as the owner and beneficiary of the insurance policy, the trustor can have more control over the eventual use of the policy proceeds, than if the proceeds were to go directly to the heirs.

A. The trustor can give explicit instructions regarding the intended use of the policy proceeds.

B. The trustee makes sure that the Trustors intent is followed.

C. The problems of placing large sums of cash in the hands of financially irresponsible beneficiaries are avoided.

IV. Even if the proceeds are included in the trustor's estate, no estate taxes will be due if all the proceeds go to the surviving spouse so that the unlimited marital deduction can be used to reduce the estate by the amount of the proceeds. However, the proceeds will be taxable in the survivor's estate. If the survivor's estate is expected to exceed $600,000, then the use of an insurance trust is appropriate to avoid increasing either spouse's taxable estate. If a living trust is used to make full use of both spouses' $600,000 exemption, then insurance proceeds do not create a problem, unless the estate is expected to exceed $1,200,000.

If the estate will exceed $1,200,000, then extate taxes can be saved by holding insurance in

an irrevocable trust. Furthermore, if an estate exceeds $1,200,000, then life insurance provides a ready source of cash to pay the estate taxes which will be due, so that a liquidation of the estate's assets at fire sale prices to pay the taxes is unnecessary. The trust can transfer cash to the estate by:

A. Loaning money to the estate at the market interest rate;

B. Purchasing assets from the estate, which will then be held and managed for the benefit of the beneficiaries.

C. The trust should not be required to pay the Trustor's estate taxes or other debts, or its assets may be included in the Trustor's estate.

V. FUNDING THE TRUST. Transfers by the Trustor to the trust are gifts. Each person is allowed to make gifts of up to $10,000 per person per year, which are exempt from gift tax, provided they are gifts of a "present interest". Normally, a gift to a trust is not a gift of a present interest and is not exempt from gift taxes.

A. "Crummey Powers". The "Crummey" case held that a gift to a trust is a present interest if the beneficiary has the right to withdraw the gift from the trust for a limited period of time. Thirty days is sufficient time for the beneficiary to exercise this power.

B. "$5000 or 5%". The Crummey power is a general power of appointment over amount gifted to the trust. If a beneficiary allows his Crummey power right of withdrawal to expire, his general power of appointment has lapsed. To the extent this exceeds the greater of $5,000 or 5% of the assets from which the right of withdrawal could have been satisfied ("5x5"), the beneficiary is deemed to have made a gift to the trust. The annual exclusion does not apply to this gift and so a gift tax return would be required.

C. Sole Beneficiary. If the assets over which the beneficiary had a right of withdrawal can only be used for that beneficiary's benefit and the beneficiary has a either a limited or general power to appoint those assets in the beneficiary's will, then the beneficiary has not made a gift by relinquishing the Crummey right of withdrawal, so no gift tax return is required. This can be accomplished by dividing the trust into separate shares for each beneficiary from the outset.

D. Hanging Powers. It may be desirable to keep all the trust assets in a single pot so that the trustee can direct them toward the beneficiary with the greatest needs. If this is done, however, then a beneficiary makes a taxable gift upon releasing the Crummey power if it exceeds the "5x5" limit. Parents may wish to use their combined ability to gift $20,000 per year to each child in order to rapidly fund the trust. To avoid a taxable gift, they may allow the beneficiary's right of withdrawal to "hang" to the extent it exceeds "5x5". The beneficiary's right of withdrawal only expires in an amount equal to the "5x5" each year so there is no taxable gift.

Therefore, in the early years of funding a policy the total amount subject to a right of withdrawal grows. Then after contributions to the trust cease, the right of withdrawal expires a little bit each year. If the contributions are used to purchase term insurance, this strategy may not work, since there are actually no assets over which the beneficiary can exercise the hanging power of

withdrawal. It is an "aggresive" strategy.

E. Minor Children. Minor beneficiaries rights of withdrawal are exercised by the non-insured parent or legal guardian. Therefore, if the parents are creating the trust for their children, it is unlikely that the Crummey power will be exercised as long as the children are minors.

F. Adult Children. Adult children should be made aware of the purpose of the trust and the dismay it would cause the Trustor if they were to exercise their Crummey power, which might cause the Trustor to cease making contributions to the trust and to reduce other distributions which the beneficiary otherwise stands to receive from the Trustor's estate. This should discourage beneficiaries from excercising the Crummey powers.

G. Cristofani. In the recent Cristofani case, the Tax Court approved the use of Crummey powers for numerous contingent beneficiaries, in order to multiply the annual exclusions available to fund the trust. The Trustors's children were the primary trust beneficiaries. If they were to die, then various uncles and aunts and the grandchildren would succeed them. These contingent beneficiaries were also given Crummey powers. This substantially increased the annual exclusions available to the Trustor and the amount which could be gifted tax free to the trust. This IRS is still fighting this strategy, however.

H. Surviving Spouse as Beneficiary. If a spouse is to be a beneficiary of the trust, then that spouse must not also be a grantor of the trust or the policy proceeds will be included in their estate. If community property funds are used to fund the trust, then both spouses are grantors. Only the separate property of the insured should be used to fund such a trust, so that the uninsured spouse is not a grantor. Each spouse should establish a separate property bank account. Community funds should then be divided equally between the separate property accounts. The insured spouse should then use funds from their separate property account to make gifts to the trust.

I. Notice of Crummey Power. After a trustee receives a contribution to the trust, he should deposit the amount in the trust bank account and give written notice to the beneficiaries of the Crummey power to withdraw the funds. After the withdrawal period has expired, the trustee may use the funds to pay insurance premiums.

VI. PURCHASING THE POLICY - 3 YEAR RULE. If the owner of a life insurance policy dies within three years after giving the policy away, then it will be pulled back into the owner's estate. Therefore, the insured should avoid purchasing a life insurance policy and then contributing it to an irrevocable trust. Instead, the insured should first create the trust and fund it using the Crummey power provisions to avoid gift taxes. After the withdrawal period has expired, then the trustee should use the trust funds to purchase the policy. However, the trustee should not be required by the terms of the trust to purchase life insurance. It should merely be an understood option.

VII. TAX RETURNS. Under both California and federal law, no tax returns are required for the trust unless it has a certain amount of income. Until the death of the insured, a trust is unlikely to have enough income to pay for the preparation of a tax return. Therefore, it is advisable to deposit contributions to the trust into non-interest bearing accounts to avoid the possibility of earning just enough income to require the filing of a return. The allowable income limits are as follows:

A. Federal:

B. California:

VIII. TRUSTEE. The insured trustor should not act as the trustee since this would be an incident of ownership causing the insurance proceeds to be taxed in his estate.

IX. GENERATION-SKIPPING TRANSFER TAX AVOIDANCE. For large estates, the irrevocable insurance trust can be a powerful tool for maximizing gifts to third and fourth generations. If a Generation Skipping Transfer ("GST") Tax exemption applies to all assets contributed to a trust, then the assets of that trust will be exempt from GST Taxes. Therefore, the assets can grow over the lifetimes of several generations without being subjected to a 50% estate tax at each succeeding generation.

A. Limit-Life in Being Plus 21 Years. Trusts are prohibited from existing for longer than the life of a person living at the creation of the trust plus 21 years. However, a class of persons may be used, such as "all the descendants of the Trustors living on the date the trust is created." This should be sufficient for the assets to pass to the great grandchildren and avoid two generations of estate taxes.

B. Creditor Protection. Typically, assets of an irrevocable trust are exempt from the claims of the beneficiaries creditors. Therefore, the amounts in the trust can be kept available to meet the needs of the beneficiaries, while being protected from creditors and estate taxes, as long as they remain in the trust.

C. Crummey Power Unavailable. Gifts to a trust are not exempt for GST Tax purposes unless it is certain that they will be taxed in the estate of the person with the Crummey Power. This defeats the purpose of a GST avoiding trust. Therefore, if GST avoidance is a major goal of a trust, then the Crummey power may not be relied on to exempt gifts to the trust from GST Taxes, although it may still be used to obtain the gift tax exemption. In order to make the gifts exempt for GST Taxes, a portion of the Trustor's $1,000,000 lifetime GST exemption should be applied to the gift. To do this, a gift tax return should be filed, even though no taxes are due because the gift is exempt from gift taxes. To make sure the beneficiaries are not considered grantors of the trust, their Crummey withdrawal rights should not exceed the 5x5 limit, otherwise the beneficiary will have to use up some of their $1,000,000 GST exemption as well.