ILIT PLANNING – USES AND TAX CONSEQUENCES

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I. SCOPE OF ARTICLE AND INTRODUCTION

The irrevocable life insurance trust has always been a popular estate planning tool. In recent years, it has become even more important since, in many cases, life insurance has become one of the largest assets owned by individuals and since it has taken on investment characteristics. Outside of the business context, life insurance is popular in providing liquidity to pay death taxes and debts owed at the death of the insured and to provide for support of current family members and possibly future generations. Consequently, it is important to preserve the liquidity produced by life insurance proceeds for these purposes from estate and generation-skipping transfer (GST) taxes. Unless the policy is being held mainly for investment purposes, it is usually of limited use to the insured during his lifetime and an excellent candidate for a gift to remove it from estate taxation.

This paper will analyze one method of sheltering insurance from estate taxation and generation-skipping taxation — the irrevocable life insurance trust. The advantages as well as disadvantages will be discussed. In addition, gift, estate and GST tax problems and solutions will be reviewed. The major problem in this area is the increasing complexity and uncertainty of the tax laws in relation to irrevocable life insurance trusts — particularly in the Crummey power withdrawal area where the rules are quite often inconsistent for income, gift, estate and GST purposes. If the grantor is already using the maximum gift tax annual exclusion for nontrust gifts to the persons who are the trust beneficiaries, it could be desirable not to use trust Crummey withdrawal powers and thereby eliminate administrative and tax problems while covering the premium gifts by the grantor's unified credit. However, the gift tax unified credit is limited to $1,000,000 and the gift tax is not scheduled for repeal. The estate and GST tax repeal and sunset of the repeal add other uncertainties to this area. If the unified credit is inadequate to shelter premium transfers, other premium payment techniques may be used such as GRATS, loans, split dollar arrangements and sales to defective trusts.

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II. ADVANTAGES AND DISADVANTAGES OF AN IRREVOCABLE LIFE INSURANCE TRUST

A. ADVANTAGES

1. Estate Tax Exclusion of Insurance Proceeds. If properly drafted, the life insurance trust can be a vehicle for removing the insurance proceeds from the estates of the insured and insured's spouse for federal estate tax purposes.

2. Gift and GST Tax Leverage. Since the value of the gift for gift and GST tax purposes is normally the premium payment, there is substantial leverage in making gifts of premiums for gift tax exclusion and GST tax exemption purposes with the eventual exclusion of the full face value of the insurance policy from estate and/or GST taxation.

3. Proceeds to Pay Taxes, Debts and Administration Expenses. In a properly drafted trust, the insurance proceeds through the vehicle of loans and purchases can provide liquidity to pay the insured's debts, death taxes and administration expenses of his estate without subjecting them to estate tax.

4. Generation-Skipping Transfer Tax Avoidance. Through the judicious use of the GST exemption, the insurance proceeds can avoid taxation at the levels of future generations up to the rule against perpetuity, if any (the dynasty trust).

5. Creditor and Divorce Protection. An irrevocable life insurance trust can provide protection from the claims of the grantor's future creditors and, through the use of spendthrift and other provisions, protect the proceeds from claims of creditors or divorced spouses of the beneficiaries.

6. Flexibility. Life insurance trusts present flexibility and opportunities for sophisticated estate planning techniques and for taking care of the needs of the insured's family.

   a. Beneficiaries can be given special powers to appoint property to family members or charity during lifetime and/or at death.

   b. The beneficiary can be given withdraw powers up to 5% of trust principal without transfer tax problems.

   c. Independent trust committee or advisors can be given powers which would be tax sensitive for the beneficiary or grantor – change grantor trust status, terminate the trust, change trustees, keep trust in compliance with state trust law or federal tax laws, etc.

   d. Beneficiary (or trust committee) can change trustees.

   e. Trustee or trust committee can be given power to change trust situs.

   f. Flexible distribution and investment provisions such as total return trusts, power of adjustment by trustee between income and principal, and choice of investment advisors.

B. DISADVANTAGES

1. Irrevocability. In order to accomplish the tax and other advantages, the life insurance trust must be irrevocable and the insured must not have direct or indirect access to the incidents of ownership of the policy. Consequently, the insured cannot benefit from the cash value of the policy or from pledging it to secure his debts. The trust instrument cannot be changed in case future developments make change desirable. However, flexible provisions can be incorporated into the original instrument which can anticipate some of these future changes. If the irrevocable trust becomes undesirable, the insured can purchase the policy from the trustee and convey it to a new irrevocable life insurance trust. *See* PLR 8951056. Of course, the transfer to the new trust will be subject to the three year rule of IRC Section 2035. If the new irrevocable life insurance trust falls into one of the exceptions to the transfer for value rule (e.g., partner of insured), it can directly purchase the policy from the old trust without IRC Section 2035 problems.

2. Tax Complexities. There are tremendous complexities concerning life insurance trusts under all of the tax laws — income, gift, estate and GST. Furthermore, in many areas, the law is not clear as to the results of certain provisions contained in an irrevocable life insurance trust. It is possible that advantages obtained in one tax discipline will result in unintended disadvantages in other tax disciplines.

3. Administrative Difficulties. Because of the legal complexities involved, the legal fees in setting up a life insurance trust can be significant. If Crummey powers are used, administrative difficulties involving funneling premium payments through a trustee bank account and annual notice letters are present.

III. INCOME TAX CONSEQUENCES — THE GRANTOR TRUST RULES

A. UNFUNDED TRUSTS

The typical life insurance trust is unfunded and produces no income. Therefore, in the usual case, it is of no consequence to determine whether the trust is a separate income tax entity or whether the grantor or others (if substantial owners) would have the income, deductions, and credits of the trust attributable to them under the grantor trust rules of IRC Sections 671 through 679. However, once the insured dies and death proceeds are received from the insurance carrier, lapsed Crummey powers during insured's lifetime can cause problems to the beneficiary/powerholders as discussed later.

B. FUNDED TRUSTS

Clearly, the grantor trust rules must be considered in cases where the life insurance trust is funded.

1. Reasons for Funding. Funding usually occurs when an existing trust owning other assets purchases a policy to avoid gift, estate and GST tax problems involved with the creation of a new trust. In other cases, the existing irrevocable non-insurance trust is the only source of cash flow to purchase the policy. Sometimes a life insurance trust is "front end loaded" to pay future premiums since the appreciation within the trust of the front end load will not be an additional gift to the trust.

2. Different Marginal Tax Brackets. Although the compression of trust income tax brackets (in 2006, the 35% bracket is reached at $10,050 of taxable income)

has removed much of the incentive to shelter income in an irrevocable trust, it is still important to determine whether the trust income is taxable to the trust, the original grantor or the Crummey powerholders or a combination of them. Some lowering of total income tax may still be possible depending upon the relative marginal income tax brackets of all these taxpayers.

3. No Indirect Gifts of Income Tax. If the grantor is taxed on the trust income, the trust corpus will not be reduced and payment of the tax by the grantor is not an additional gift to the trust. In Revenue Ruling 2004-64, 2004-2 C.B. 7, the IRS ruled that the grantor's payment of income tax on trust income attributable to him under the grantor trust rules did not constitute a gift by him to the trust. However, if the trust instrument or local law requires the trust to reimburse the grantor for the income tax, the full value of the trust's assets will be includible in the grantor's gross estate under IRC Section 2036(a)(1). Trusts created before October 4, 2004, are exempt from this adverse estate tax consequence. If the trust instrument or local law gives the trustee discretion to reimburse the grantor for such income taxes, the existence of that discretion by itself, whether or not exercised, will not cause the value of the trust's assets to be includible in the grantor's gross estate. However, inclusion in the gross estate is still possible if there is an understanding or preexisting arrangement to exercise the discretion; if the grantor is the trustee or has the power to remove the trustee and appoint himself successor; or if local law allows the grantor's creditors access to the trust estate. Note that the ruling does not have a October 4, 2004, grandfather date for discretionary reimbursement powers.

C. REASONS FOR MAKING AN IRREVOCABLE LIFE INSURANCE TRUST DEFECTIVE FOR INCOME TAX PURPOSES

1. Protect Crummey Powerholders. As explained in more detail later, the IRS takes the position that the lapse of a Crummey power makes the powerholder who is a trust beneficiary the owner for income tax purposes of a fraction of the trust assets until the termination of the trust or the death of the powerholder. PLR 8142061. IRC Section 678(a)(2).

a. However, if the original grantor of the trust has retained a power which makes the original grantor the owner under the grantor trust rules, the beneficiaries possessing Crummey withdraw powers will not be subject to the grantor trust rules. IRC Section 678(b). PLR 8517052.

b. Thus a defective trust during the original grantor's lifetime while the trust may be unfunded protects the Crummey powerholder from income tax consequences after the original grantor's death after the trust is funded. PLR 9321050.

2. Avoid Transfer for Value. Sometimes it is desirable to sell an insurance policy to a life insurance trust — *e.g.*, from an old undesirable trust to a new trust, from insured's corporation, or a split dollar rollout from employer to trust.

a. Under the transfer for value rule, if an insurance contract is transferred for value, the proceeds are taxable income to the beneficiary at the insured's death to the extent they exceed basis. IRC Section 101(a)(2).

b. There are several purchasers who are exempt from the transfer for value rules including the insured, a transferee whose basis is determined in whole or in part from the basis of the transferor, and a partner of the insured. IRC Section 101(a)(2)(B).

c. If the insured is the grantor of a defective trust, is a sale of a policy on the insured's life to the trust the same as a sale to the insured and an exemption from transfer for value? Reversing its previous no ruling position, in Revenue Ruling 2007-13, the IRS stated that such sales fall within the sale to the insured exception.

d. If the grantor sells the policy to the defective trust, the trust will have the same basis in the policy as the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184. Although there are no rulings on point, such a sale would seem to meet the transferee basis exception to the transfer for value rule. In PLR 20022819, the IRS ruled that a sale of a policy from one grantor trust to another grantor trust with the same insured/owner did not involve a transfer for value since the basis was the same for the policy under Rev. Rul. 85-13. *See also* PLR 200606027. The result should be the same under the commonality of basis exception if the insured directly sold the policy to his grantor trust.

D. DON'T MAKE TRUST DEFECTIVE WITH THESE GRANTOR TRUST POWERS. The following powers which would make the grantor of a life insurance trust the owner of the trust assets for income tax purposes under the grantor trust rules are generally not found in irrevocable life insurance trusts since the presence of such powers would destroy the main purpose of preventing inclusion of the insurance proceeds in the grantor's gross estate for federal estate tax purposes.

1. <u>Reversionary Interest</u>. Retention of reversionary interest in excess of five percent except in certain cases where the reversion is limited to the death of a trust beneficiary before 21 years of age if he or she is a minor descendant of the grantor. IRC Section 673. Estate tax problem under IRC Section 2037.

2. <u>Control of Beneficial Enjoyment</u>. Retention of certain powers to control the beneficial enjoyment of trust property without the approval or consent of an adverse party. IRC Section 674. Estate tax problem under IRC Section 2036(a)(2).

3. <u>Certain Administrative Powers</u>. Retention of certain administrative powers over trust property including dealing without adequate consideration, borrowing without adequate interest or security, and voting certain stock and investment trust assets in a nonfiduciary capacity. IRC Section 675. Estate tax problems under IRC Section 2036.

4. <u>Power to Revoke</u>. Retention of the power to revoke the trust. IRC Section 676. Estate tax problems under IRC Section 2038.

5. <u>Retention of Income</u>. Trust income <u>may be</u> distributed or held for future distribution to the grantor without the approval or consent of an adverse party except, in the case of income which may be used to discharge the grantor's legal obligation of support of someone other than the grantor's spouse, the grantor trust rules apply only if

such income is actually used to discharge such legal obligation. IRC Section 677(a)(1-2) and (b). Estate tax problems under IRC Section 2036(a)(1).

E. GRANTOR TRUST POWERS WHICH MIGHT NOT CAUSE ESTATE TAX PROBLEMS. Although most grantor trust powers have adverse estate tax consequences, there are four grantor trust powers commonly used which, if properly structured, probably avoid estate taxes.

1. Premium Payment on Insurance on Life of Grantor or Grantor's Spouse. There is a grantor trust to the extent trust income is applied or may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse as long as the policy is not irrevocably payable to a charity and the application of income does not depend upon approval of an adverse party. IRC Section 677(a)(3).

a. This grantor trust trigger should be used in conjunction with another trigger. Although the statute clearly provides grantor trust status is available if income "may" be used to pay premiums, there are some cases predating IRC Section 677(a)(3) which indicate that the status is not available if the trust has no income as would be the case if the only trust asset is the life insurance policy or if income is in excess of the premium. *See* Howard M. Zaritsky, Tax Planning for Family Wealth Transfers, ¶ 12.07[3][a][v], Warren Gorham & Lamont of RIA (4th Ed. 2002); Howard M. Zaritsky, 858-2d T.M., Grantor Trusts: Sections 671-679, at A-80.

b. The IRS has privately ruled that transfer for value rules of IRC Section 101(a)(2) did not apply to the sale of an insurance policy from one trust to another trust based on the insured grantor's representation that he was the owner of both trusts under IRC Section 677(a)(3) and at least one trust appeared to have no income since the insured planned to make annual gifts which in part would pay premiums. However, the ruling stated that no opinion was expressed or implied whether the insured should be treated as owner of the trust under IRC Sections 671-679. PLR 200228019.

2. Grantor's Spouse is Trust Beneficiary. If the grantor's spouse is a mandatory or possible (at the discretion of a non-adverse trustee) income beneficiary of a funded irrevocable life insurance trust, then the income of the trust will be taxable to the grantor under IRC Section 677(a)(1-2). Estate tax caution: make sure that the spouse is not also a grantor because of gifts of community property funds to the trust or the lapse of Crummey withdrawal powers in excess of $5,000 or 5% to avoid a partial inclusion of trust assets in the spouse's gross estate under IRC Section 2036(a)(1). Also, if the grantor's spouse predeceases or divorces the grantor, the grantor trust status could terminate prematurely unless some other grantor trust trigger is included.

3. Non-Adverse Person Ability to Add Beneficiaries. A trust is a grantor trust if a non-adverse person has the power to add beneficiaries of the trust other than after-born or after-adopted children. IRC Section 674(c). Normally, this power is given to an independent trustee or independent committee and often is restricted to the addition of a charitable beneficiary.

4. Power to Substitute Property of Equivalent Value. Under IRC Section 675(4), if any person has a nonfiduciary power exercisable without the consent of a fiduciary, to reacquire the trust corpus by substituting other property of equivalent value, the trust is a grantor trust.

a. IRS has no ruling position. Even though the trust contains such a nonfiduciary power of substitution, the IRS considers it to be question of fact whether such a power is exercisable in a fiduciary or nonfiduciary capacity. PLR 9437022. PLR 9437023. PLR 9713017.

b. From an estate tax viewpoint, the Tax Court has ruled that the power of the insured-grantor of a trust to substitute life insurance policies of equal value for those owned by the trust did not cause estate tax inclusion under IRC Sections 2038 and 2042. Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), *acq. in result* 1977-2 C.B. 1. However, the power in that case was possessed by the insured in accordance with fiduciary standards. Would the Tax Court decision have been the same if a non-fiduciary power is involved as is necessary for the income tax consequences of a grantor trust?

c. IRS private letter rulings on the estate tax issues are not totally clear where the grantor has the power to substitute property of equivalent value. In PLR 9413045, the IRS refused to rule whether such a power created a grantor trust under IRC Section 675 but concluded that there was no estate tax inclusion under IRC Sections 2036, 2038 and 2042 citing the Jordahl case with emphasis upon the fiduciary capacity language in that decision. In PLR 9227013, there is no discussion of the fiduciary issue but the IRS concluded that the grantor's power created a grantor trust under IRC Section 675 and no estate tax inclusion under IRC Section 2038 citing the Jordahl decision without mention of the fiduciary aspects. In PLR 200606006 and PLR 200604028, the IRS ruled that a grantor power held in a fiduciary capacity to substitute property of equivalent value did not trigger estate tax inclusion under IRC Sections 2033, 2036, 2038, or 2039. The IRS cited Jordahl and concluded that the trust was a grantor trust under IRC Section 677 because the grantor's spouse was an income beneficiary.

d. Perhaps the estate tax inclusion can be avoided by giving the substitution power to someone other than the grantor, presumably someone who is not adverse. IRC Section 675 states that "any person" can have the power although it may be difficult to understand how a non-grantor can "reacquire" trust corpus. Nevertheless, the IRS in several private letter rulings has approved grantor trust status when someone other than the grantor had the substitution power. PLR 9026036. PLR 9037011. PLR 9247024.

e. Although not involving a trust, and without deciding whether survivor benefits under no-fault insurance policy constituted life insurance, the IRS has ruled that the power to substitute, for a state required no-fault insurance policy, a policy with identical survivor's benefits did not constitute an incident of ownership under IRC Section 2042. Rev. Rul. 82-5, 1982-1 C.B. 131.

F. ACCIDENTAL FUNDING. Avoid accidental funding of an otherwise dry life insurance trust by not placing separate policies on different insureds in the same trust.

G. CRUMMEY POWERS — DEFECTIVE TRUSTS

1. Reason for the Power. The Crummey withdrawal power is a very popular device for qualifying gifts to an irrevocable trust for the gift tax annual exclusion. However, the existence of a Crummey withdrawal power will have an income tax impact on the beneficiary possessing the power, and such beneficiary may have a continuing income tax impact after the lapse of the power.

2. Crummey Withdrawal Powers Before Lapse. The annual withdrawal right of a beneficiary constitutes "a power exercisable solely by himself to vest the corpus...in himself" which makes him an owner for grantor trust purposes of that portion of the trust. IRC Section 678(a)(1). PLR 8142061. PLR 8308033. PLR 8521060. PLR 8701007. PLR 8805032. PLR 200022035. This is true even though the beneficiary is a minor without a legally appointed guardian. Rev. Rul. 81-6, 1981-1 C.B. 385.

a. During the tax year that the withdrawal power exists, the beneficiary will include a pro rata portion of all income, deductions, and credits of the trust equal to a fraction, the numerator of which is the dollar amount subject to withdrawal and the denominator of which is the fair market value of the trust property at the date the withdrawal becomes effective. Reg. Section 1.671-3(a)(3).

b. Since the withdrawal power is normally for only a portion of the taxable year, the fraction of the income, deductions, and credits of the trust will be further reduced by the portion of the year during which the withdrawal power was not effective. PLR 8142061. However, see Kraus v. Commissioner, 56 T.C. 1242 (1971), where the court, without discussion, only included in the gross income of the grantor that income of the trust received during the calendar year prior to its ceasing to be a grantor trust.

c. Example pursuant to PLR 8142061: the beneficiary has a one month right to withdraw $5,000 from a trust with a corpus worth $50,000 on the date the withdrawal power becomes effective. The beneficiary will be entitled to 1/120th of each item of the trust income, deduction, and credit ($5,000 ÷ $50,000 x 1 ÷ 12).

3. Lapsed Crummey Powers. Does the annual lapse of the beneficiary's general power of appointment create any further income tax problems for the beneficiary under the grantor trust rules?

a. IRC Section 678(a)(2) states that a person is deemed to be the permanent "owner" under the grantor trust rules of any portion of a trust over which such person has "released" a "power exercisable solely by himself to vest corpus or the income therefrom in himself" to the extent such person would be the owner under IRC Sections 671-677 if he or she were the original grantor. For example, if the lapse of a Crummey power is a "release" and the beneficiary is eligible to receive trust income without the consent of an adverse party, said

beneficiary would be taxed on the income produced by the lapsed portion of the trust assets under IRC Sections 678(a)(2) and 677(a).

b. The IRS has taken the position that the beneficiary who let a power lapse will be taxed on a pro rata part of trust income (value of the aggregate "lapsed" property over all trust property) each year even though such income is not distributed. PLR 8142061. PLR 8342088. PLR 8517052. PLR 8521060. PLR 8545076. PLR 8701007. PLR 8805032. PLR 200022035.

c. The IRS has reached the same conclusion in a series of private rulings that a Crummey trust may be an S corporation shareholder if all of the transfers to the trust do not exceed the withdrawal power, the donor did not restrict the withdrawal power, and the grantor of the trust is not considered to be the owner because of the grantor trust rules. PLR 8805032. PLR 8809043. PLR 9009010. PLR 9226037. PLR 9311021. PLR 9448018. PLR 9450014. PLR 9504024. These rulings are based on the premise that the beneficiary's withdrawal power makes him or her the owner under the grantor trust rules of IRC Section 678(a)(2). *See*, Karr, "Grantor Trusts With Withdrawal Powers Add Flexibility in S Corp Owner's Estate Planning," 15 Estate Planning 266 (Sept/Oct 1988).

d. It is not clear whether the IRS position is correct in classifying a lapse of a Crummey power as a "release" under IRC Section 678(a)(2).

(1) Literally, the word "release" connotes a positive action by the powerholder to reduce or modify the power.

(2) A lapse on the other hand, requires no action by the powerholder.

(3) Congress found it necessary to expressly state that the lapse of a general power of appointment shall be considered a release of such power for estate and gift tax purposes. IRC Sections 2041(b)(2) and 2514(e). The failure of Congress to so state for income tax purposes might be an indication that Congress did not intend for a "lapse" to be considered a "release" for the grantor trust rules.

e. Unlike the $5,000 and 5% exception for lapsed powers for gift and estate tax purposes, there is no such exception for lapsed powers under the grantor trust rules. See PLR 200022035.

f. Furthermore, if the IRS position is correct, a larger share of annual trust income would be taxed to the beneficiary as the lapses of the Crummey power accumulate. *See*, Whitty, "Crummey Trust Computations", 9 Probate & Property 35 (Jan/Feb 1995). PLR 200022035 stated that the annual increase of trust corpus owned by a powerholder because of the lapse of a power is the product of the amount he or she could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which the powerholder is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made.

g. Even if the life insurance trust is not funded, IRC Section 678 could cause problems for a beneficiary who has allowed Crummey powers to lapse if the trust would continue in existence after the death of the insured and the proceeds are invested to produce taxable income.

h. Furthermore, the problem is enhanced for the beneficiary who has allowed Crummey powers to lapse if the income is payable to someone else (*e.g.* the non-insured non-grantor parent) since he or she will have taxable income under the grantor trust rules but no access to the income to help pay the income taxes.

4. Different Result if the Grantor Is the "Owner" — Defective Trusts. If the original grantor of the life insurance trust has retained a power which makes the grantor the owner under the grantor trust rules of IRC Sections 671-677, the beneficiaries possessing the Crummey withdrawal powers will not be subject to the grantor trust rules.

a. IRC Section 678(b) states that the beneficiary will not be treated as the owner under IRC Section 678(a) in regard to a power over income if the original grantor is already treated as the owner under the grantor trust rules.

b. Defects which will make the grantor the income tax owner, hopefully, without estate tax consequences, include independent person has power to add a beneficiary other than an afterborn or after-adopted child (IRC Section 674(c)), trust income may be used to pay premiums on insurance on life of grantor or grantor's spouse (IRC Section 677(a)(3)) and grantor has nonfiduciary power to acquire trust assets in exchange for property of equivalent value (IRC Section 675(4)(c)).

c. Even though the beneficiary's withdrawal powers are over corpus and do not literally fall within the IRC Section 678(b) exception, the Congressional Committee Report indicates that the exception applies to the grantor's power over both the income and the corpus. HR Rep. No. 1337, 83rd Cong., 2nd Sess. 340 (1954). *Also see* PLR 200603040 and PLR 9309023.

d. The IRS has acknowledged that the grantor being treated as the owner under the grantor trust rules overrides any income tax consequences to the Crummey powerholder. PLR 8517052. PLR 8521060. PLR 8701007. PLR 8805032. PLR 200606006. PLR 200604028.

e. In the case of a funded irrevocable life insurance trust, it might not be desirable to use IRC Section 678(b) by making the original grantor the owner because of the current income tax consequences to the grantor. However, if the original grantor has sufficient cash flow, the grantor's payment of the taxes on the income of the trust under the grantor trust rules would prevent diminution of the trust without constituting an additional gift by the grantor. Rev. Rul. 2004-64, 2004-2 C.B. 7.

f. However, in the case of an unfunded life insurance trust which produces no income, there would be no adverse income tax consequences to the grantor because of IRC Section 678(b).

g. Caution: If the grantor is otherwise the owner of the trust under the grantor trust rules, does IRC Section 678(b) permanently exempt the Crummey power beneficiary from being the owner under IRC Section 678(a) or only as long as the original grantor is alive?

(1) If IRC Section 678(b) merely suspends IRC Section 678(a) during the insured grantor's lifetime, then the lapsed Crummey powers will still cause an income tax problem to the powerholder when the insured dies and the insurance proceeds are invested by the trustee.

(2) The IRS has privately ruled that, when the original grantor is otherwise the owner of the trust under the grantor trust rules, the Crummey powerholder is prevented from being a owner under the grantor trust rules, both before and after the death of the real grantor pursuant to IRC Section 678(b). PLR 9321050 reversing PLR 9026036.

5. Pertinent Articles. Gissel, "Insurance and Other Irrevocable Trusts in 1996: How Crummey Can They Be After the Final GST Regulations?", Advanced ALI-ABA course of study, Planning Techniques for Large Estates (1996). Westfall, "Lapsed Powers of Withdrawal and the Income Tax", 39 Tax Law Review 63 (1983). Dye, "Several Routes Exist to Avoid IRS' Income Tax Roadblock to Use of Crummey Trust Provisions," 10 Estate Planning 222 (July 1983). Early, "Income Taxation of Lapsed Withdrawal Powers: Analyzing Their Current Status," 62 Journal of Taxation 198 (April, 1985). Adams & Abendroth, "Beware the Consequences of Powers of Withdrawal," 127 Trusts & Estates 37 (May, 1988).

IV. GIFT TAX CONSEQUENCES

A. ADVANTAGE OF LEVERAGE. The inherent advantage of gifts of life insurance is that the value of the property transfer is modest (value of the policy at date of gift plus subsequent premium gifts) often within the gift tax annual exclusion while the value at death of the insured (hopefully exempt from estate tax) is large. The built-in appreciation at death makes life insurance policies ideal candidates for gifts.

B. VALUE OF LIFE INSURANCE POLICY GIFTS. The general rule is the replacement value of the policy at the date of gift. Reg. Sec. 25.2512-6(a).

1. Value of Brand New Cash Value Policy — initial premium payment. Reg. Sec. 25.2512-6(a).

2. Existing Single Premium or Paid Up Policy — amount insurer would charge for the same policy on the life of a person of the age of the insured at date of gift. Reg. Sec. 25.2512-6(a), Ex. 3. However, if the cash value of the policy was substantially higher than the replacement premium, the cash value will be the gift value. Rev. Rul. 78-137, 1978-1 C.B. 280.

3. Existing Cash Value Policy — replacement cost will normally be the interpolated terminal reserve at the date of gift plus the proportionate part of the gross premium paid before the date of gift which covers the period extending beyond that date. Reg. Sec. 25.2512-6(a), Ex. 4.

4. Existing Term Policy — the portion of the last premium which covers the period beyond the date of gift.

5. Group Term Insurance — the value of the initial gift would also be the unused premium paid for the period beyond the date of gift.

a. The gift of a group policy on a premium due date has no ascertainable value. Rev. Rul. 76-490, 1976-2 C.B. 300.

b. For a group term policy qualified under IRC Section 79, the donor has the option of measuring the gift by the Table I value (without the $50,000 coverage exclusion) set out in Reg. Section l.79-3(d)(2) unless the donor is a key employee and the plan discriminates in favor of key employees. Rev. Rul. 84-147, 1984-2 C.B. 201. The alternative Table I rules are useful when it is difficult to determine the individual insured's portion of the premium payment under a large group plan.

6. Split Dollar Insurance Policy.

a. Grandfathered Arrangements: For split dollar arrangements entered into before September 18, 2003, and not materially modified after September 17, 2003, the value of a gifted insurance policy subject to a split dollar arrangement is the same as the valuation of a brand new whole life policy or an existing whole life policy, as the case may be, reduced by the employer's ownership interest in the policy at the date of transfer. Rev. Rul. 81-198, 1981-2 C.B. 188.

b. Economic Benefit Regime and Loan Regime Arrangements: For split dollar arrangements entered into or materially modified after September 17, 2003, the economic benefit regime applies if the employer, donor or other person is the owner (with an endorsement of death benefit to the trustee of the irrevocable trust) and the loan regime applies if the trustee is the owner (and the employer or corporation has a collateral assignment). Reg. Section 1.61-22(d) through (g). Reg. Section 1.7872-15(b)(1). Although the final regulations do not expressly discuss the gift tax consequences of a transfer of a policy under the economic benefit regime or the loan regime, the preamble to the final regulation states that the "gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles notwithstanding who is treated as the owner of the life insurance contract under the final regulations." The preamble then cites Rev. Rul. 81-198, 1981-2 C.B. 188. Consequently, new split dollar arrangements for gift tax purposes will continue to be valued in the same manner as a brand new policy or an existing policy, as the case may be, less the employer's ownership or collateral assignment interest in the policy at the date of transfer.

7. Special Circumstances. Remember that general rule is replacement cost and other factors may increase the value of the policy — insured now uninsurable, rated or near death. *See* Estate of Pritchard v. Commissioner, 4 T.C. 204 (1944). In that context, replacement costs and other factors may increase the value of the policy. Also, if the policy is eligible for sale in the growing life settlement market (generally for persons

over 65 years of age), the value may be equal to a percentage of the face amount well in excess of interpolated terminal reserve.

8. Potential Impact of New Regulations and Revenue Procedure 2005-25. In 2004, the IRS issued a proposed regulation for valuing life insurance policies with regard to qualified plans, transfers governed by IRC Section 83, and IRC Section 79 policies with permanent benefits. The IRS finalized the regulation on August 29, 2005. *See* T.D. 9223, 2005-39 I.R.B. 591 (Sept. 26, 2005). Although there are no amendments to the gift tax regulations on valuation of insurance policies, both the preamble to the proposed regulation and the background section of Revenue Procedure 2005-25, 2005-1 C.B. 962, make statements implying that the new definition of fair market value also may apply to gifts of insurance policies when the premium payments greatly exceed the cash value. Revenue Procedure 2005-25 gives a safe harbor definition of fair market value for income tax purposes that is the greater of (1) the interpolated terminal reserve plus the unused premiums and the anticipated dividends, or (2) the "PERC" (a figure based upon premiums, earnings, and reasonable charges) multiplied by the average surrender factor.

C. FUTURE PREMIUM PAYMENTS

1. Continued Premium Payments Are Gifts. If the donor continues to pay premiums (directly or indirectly) on policies owned by the life insurance trust, there are additional gifts in the amount of such payments. Reg. Sec. 25.2511.1(h)(8).

2. Future Group Term Premium Gifts.

a. There is an imputed gift by the employee to the trust every time the employer makes a group term premium payment on a policy owned by the trust. Rev. Rul. 79-47, 1979-1 C.B. 312.

b. As noted earlier, the value of the imputed gift is the actual cost of the coverage for the employee or the Table I value of the coverage if the policy qualifies under IRC Section 79 and is not discriminatory for a key employee insured. Rev. Rul. 84-147, 1984-2 C.B. 201.

c. For tax years beginning after 1988, TAMRA required the IRS to change Table I to provide for 5-year age brackets beyond the previous statutory ceiling of age 63 for Table I. IRC Section 79(c). IRS has already so adjusted Table I with a top age bracket of 70 and older. Reg. Sec. l.79-3(d)(2). It is possible that the IRS could establish rates for 5-year brackets beyond 70 in future revisions of Table I. Unless group term insurance lapses shortly after retirement, it may not be a good candidate for gift to a life insurance trust because of the escalation in Table I gifts during retirement.

3. Future Split Dollar Premium Gifts.

a. Grandfathered Arrangements: For split dollar arrangements entered into prior to September 18, 2003, and which are not materially modified after September 17, 2003, there is an imputed gift by the employee to the trust every time the employer (and the employee in a contributory plan) makes a premium payment on a split dollar policy even though the split dollar arrangement is directly between the employer and a third party (*e.g.*, trustee). Rev. Rul. 78-420, 1978-2 C.B. 67 (Situation 2 - wife third party). Rev. Rul. 2003-105,

2003-2 C.B. 696. The value of the imputed gift is the economic benefit received by the employee from the employer each year under the split dollar contract plus any premiums paid by the employee. Rev. Rul. 81-198, 1981-2 C.B. 188. Examples of economic benefits.

(1) Lower of Table 2001 or the insurer's yearly renewable term rate for initial issue term insurance for the portion of the policy coverage not owned by the employer. Rev. Rul. 66-110, 1966-1 C.B. 12, modified by Notice 2002-8, 2002-1 C.B. 398.

(2) Policy dividends not benefiting the employer. Rev. Rul. 66-110, *supra*.

(3) If the employer's investment is limited to employer premium payments, is the excess build up of cash value (less accumulated employee premium payments) owned by the trustee (so-called equity split dollar) an additional economic benefit to the employee and an additional gift to the trust? *See* PLR 7916029 and PLR 8310027. In Notice 2001-10, 2001-1 C.B. 459, the IRS concluded that the equity was taxable under IRC Section 83 but left to future guidance whether taxable annually or at rollout from split dollar arrangement. Notice 2002-8 revoked the 2001 Notice but did not take a position on equity taxation. However, the 2002 Notice defers taxation of equity to rollout, if there is any taxation at all. Although Notice 2002-8 was silent, comments in the preamble to the proposed regulations interpreting recently enacted IRC Section 409A (addressing certain nonqualified deferred compensation arrangements) imply that the equity is an IRC Section 83 economic benefit. Prop. Treas. Reg. Section 1.409A-1, 70 Fed. Reg. 57930, 57941 (Oct. 4, 2005).

(4) For split dollar arrangements entered into on or after the new regulations were finalized on September 18, 2003, new rules will apply but the above discussion will still apply to split dollar arrangements entered into before the new regulations are effective. Rev. Rul. 2003-105, 2003-2 C.B. 696.

b. Economic Benefit Regime: For split dollar arrangements entered into or materially modified on or after September 18, 2003, where the employer, corporation or donor is the owner of the policy with an endorsement of insurance coverage to the life insurance trust (or where the trustee is the owner of a non-equity policy with a collateral assignment of the entire cash value to the employer, corporation or donor), any economic benefit from the split dollar arrangement will be treated as provided from the owner to the non-owner (e.g., life insurance trust). Reg. Section 1.61-22(d)(1). The tax treatment of the economic benefit will depend upon the relationship between the owner and the non-owner – employee (compensation), shareholder (dividend), private split dollar (gift). If a third party is involved, there could be two tax consequences (with regard to a split dollar arrangement between employer and life insurance trusts, compensation to the employee and gift by the employee to the trust).

There are three possible economic benefits to the non-owner under the economic benefit regime pursuant to Reg. Section 1.61-22(d)(2):

(1) The cost of current life insurance protection (Table 2001 or the term premium of the insurance carrier if lower). Notice 2002-8.

(2) The amount of policy cash value to which the non-owner has current access (to the extent that such amount has not been taxed to the non-owner in a prior taxable year). Thus, any equity buildup in the insurance policy will be currently taxed to the employee and be a gift from the employee to the trust if the trust has current access to the equity cash value.

(3) The value of any other economic benefit to the extent not taken into account by the non-owner in a prior year – amounts actually received as dividends, withdrawals, partial surrenders, and specified policy loans. Reg. Section 1.61-22(e)(1).

c. Split Dollar Loan Regime: For split dollar arrangements entered into or materially modified on or after September 18, 2003, where the trustee is the owner of the policy with the employer, corporation or donor loaning the premiums to the trust with a collateral assignment against the policy, the income and gift tax rules of IRC Section 7872 will apply. Reg. Section 1.7872-15(e)(1). There are two ways in which the interest on the premium loan may result in gifts.

(1) If the trust does not pay the applicable federal interest rate, the foregone interest would be a gift from the donor or employee to the trust with income tax consequences to the donor or employee. The amount of the income and gift depends on whether the loan is a demand loan, a term loan, or a hybrid loan under the regulations.

(2) If the trustee pays the applicable federal interest rate without gift tax consequences under IRC Section 7872, unless the trustee has other funds in the trust, the donor may have to give the interest to the trustee to make the payment.

D. GIFT TAX ANNUAL EXCLUSION

1. Date of Gift by Check. If a gift check is delivered at the end of one calendar year but clears the bank in the next calendar year, in which year is the gift completed for gift tax annual exclusion purposes? After a series of cases which were inconsistent among themselves and with prior IRS guidance as to whether the relation-back doctrine applied to non-charitable beneficiaries, the IRS issued Rev. Rul. 96-56, 1996-2 C.B. 161 which allows the relation-back doctrine for non-charitable beneficiaries in certain limited circumstances. The ruling states that the check to a non-charitable beneficiary will be considered completed on the earlier of:

a. The date on which the donor has so parted with dominion and control under local law as to leave in the donor no power to change his disposition, or

b. The date on which the donee deposits the check or presents the check for payment if it is established that:

(1) The check was paid by the drawee bank when first presented to the drawee bank for payment.

(2) The donor was alive when the check was paid by the drawee bank.

(3) The donor intended to make the gift.

(4) Delivery of the check by the donor was unconditional.

(5) The check was deposited, cashed, or presented in the calendar year for which the completed gift treatment is sought and within the reasonable time of issuance.

Thus a year end gift by check to a trustee should be either in the form of a certified or cashier's check or deposited by the trustee before year end.

2. Present Interest v. Future Interest Gifts. The first $12,000 ($24,000 if community funds or if a split-gift of separate funds is elected under IRC Section 2513) of present interest gifts to each donee during the calendar year is excluded from the gift tax. IRC Section 2503(b). The gift tax annual exclusion is indexed with the cost of living in $1,000 increments.

a. A present interest is an "unrestricted right of the immediate use, possession or enjoyment of property or income from property". Reg. Sec. 25.2503-3(b).

b. A future interest gift is not entitled to a gift tax annual exclusion — "interests or estates, whether vested or contingent, . . . which are limited to commence in use, possession or enjoyment at some future date or time". Reg. Sec. 25.2503-3(a).

3. Gifts to Typical Life Insurance and Other Complex Trusts are Future Interests. A gift (either of a policy or a premium payment) to the usual life insurance trust or a gift to the usual complex trust is not a present interest gift. Reg. Sec. 25.2503-3(c), Exs. (l) and (2).

4. Exception: Crummey Withdrawal Powers. See Article IIIE *infra.*

E. CRUMMEY WITHDRAWAL POWERS

1. Crummey Power Can Create Present Interest Gift. If the trust beneficiary can withdraw trust property equal to the value of the gifts to the trust during the calendar year, such gifts will qualify as present interest gifts even if the power to withdraw lapses unexercised. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). Rev. Rul. 73-405, 1973-2 C.B. 321.

2. IRS Requirement of Notice to Beneficiary of Withdrawal Power and of Gifts

a. Notice of Power. The IRS requires notice to the beneficiary of the existence of the Crummey power on the grounds that the powers are illusory without notice. Rev. Rul. 81-7, 1981-1 C.B. 474.

b. Notice of Gift. Likewise, the IRS requires notice to the beneficiary of the gifts to the trust which are subject to the power. PLR 8030085. PLR 8006048.

c. Is Notice Necessary?

(1) Although not the issue in the case, there is speculation in the original Crummey decision that "it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust ....they probably did not know when contributions were made to the trust or in what amounts." The Crummey court concluded that the test is not whether a beneficiary is likely to make an effective demand, but whether he or she had a legal right to make a demand which could not be resisted. Crummey v. Commissioner, 397 F.2d at 88.

(2) Although notice was not at issue (it had in fact been given), the Tax Court in Cristofani v. Commissioner quoted the above dicta from Crummey in a footnote and, citing Crummey, rejected as a test the likelihood that the beneficiary will actually receive present enjoyment of the property in favor of the "ability of the beneficiaries, in a legal sense, to exercise their right to withdraw such corpus, and the trustee's rights to legally resist the beneficiary's demand for payment." Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991). *See also* Estate of Holland v. Commissioner, 73 T.C.M. 3236 at 3237-9 (1997).

(3) Although the legal rationale of both the Crummey and Cristofani decisions could lead to a conclusion that oral or written notification is not necessary to obtain the benefit of a gift tax annual exclusion because of the existence of a Crummey withdrawal power, the cautious practitioner should still insist upon such notification in case the courts do side with the IRS or, at least, to avoid the cost of litigating this issue with the government.

d. How Long Before the Lapse of the Crummey Powers Should the Notice be Given?

(1) The beneficiary must have a reasonable opportunity after notice to exercise his or her demand right before it lapses. Rev. Rul 81-7, 1981-1 C.B. 474.

(2) The IRS has approved Crummey powers with various time limits before lapse — 90 days (PLR 8044080), 60 days (PLR 7939061), and 30 days (PLR 8143045). A 15-day notice in the Cristofani case was unchallenged by the IRS.

(3) Gifts and notices given at least 30 days before the lapse of a Crummey power clearly qualify. Any gifts and notices within 30 days might be challenged.

e. Notice Can't Be Waived. The IRS has privately ruled that the notice cannot be waived by the beneficiary. TAM 9532001.

f. Is One Notice Enough?

(1) In PLR 8121069 and PLR 8133070, the IRS approved Crummey powers for life insurance trusts which provided for one notice of a recurring date and amount of premium gift to such trust.

(2) Since 1982 the IRS will not ordinarily issue private rulings on Crummey withdrawal powers involving "super trusts" as to whether transfers to the trust qualify for gift tax annual exclusion. Rev. Proc. 2007-3, Sec. 4.01(45), 2007-1 I.R.B., January 2, 2007.

(3) Consequently, cautious practitioners will insist upon notice for each premium gift, particularly if the amount of the premium or gift varies. It is common to have one notice at beginning of the year for all premium gifts during the year.

(4) A belt and suspenders approach would include in the first notice the fact that premium gifts in specific amounts will be made around the same date or dates in the future years just in case the grantor or trustee fails to give a notice in some future year.

3. IRS Requirement of Substantial Future Economic Benefit--The Cristofani Case

a. The IRS Position Pre-Cristofani

(1) Crummey powers held by a mandatory income beneficiary or by beneficiaries who were entitled to principal distributions in accordance with an ascertainable standard qualify for the gift tax annual exclusion. PLR 9030005.

(2) Crummey powers held by persons who had no beneficial interest in the trust other than the withdrawal power (naked Crummey powers) did not qualify for the gift tax annual exclusion. TAM 8727003. TAM 9045002.

(3) Crummey powers held by remote contingent beneficiaries of the trust do not qualify for the gift tax annual exclusion. TAM 8727003. TAM 9045002.

b. The Cristofani Case

(1) The decedent executed an irrevocable trust which provided for mandatory distribution of income to her two children and for distribution of principal to her two children in accordance with ascertainable standards. Upon termination of the trust, the trust assets would be distributed to the children or, if a child was deceased, to the

deceased child's children. The two children and five grandchildren were given $10,000 Crummey withdrawal powers.

(2) The Service denied the gift tax annual exclusion for the five grandchildren. The IRS argued that the grandchildren did not have "substantial, future economic benefits" in the trust corpus and income. It also argued that the deceased never intended to benefit the grandchildren since they possessed only a contingent remainder interest in the trust and that the withdrawal powers were given to them only to obtain the benefit of the gift tax annual exclusion.

(3) The Tax Court concluded that the Crummey case does not require a beneficiary to have a vested present interest or vested remainder interest in the trust corpus or income in order for the withdrawal power to qualify for the gift tax annual exclusion. If the beneficiary has a legal right to withdraw such corpus and the trustee cannot legally resist the beneficiary's demand for payment, then gifts subject to the withdrawal power qualify the present interest for purposes of gift tax annual exclusion without regard to the likelihood that the beneficiary will actually receive present enjoyment of the property other than through the exercise of the withdrawal power.

c. IRS's Initial Reaction to Cristofani

(1) The IRS acquiesced in result indicating its disagreement with some or all of the reasons in support of the Cristofani decision. 1992-2 C.B. 1.

(2) The IRS amplified its acquiescence in a formal action on decision issued later in 1992. AOD 1992-09.

"The Service does not contest annual gift tax exclusion Crummey powers held by current income beneficiaries and persons with vested remainder interests. However, the Service will deny exclusions for powers held by individuals who either have no property interest in the trust except for Crummey powers, or hold only contingent remainder interests. To extend the gift tax benefit of Crummey powers to beneficiaries with interests more remote than current income or vested remainders would undermine significantly the unified system of estate and gift taxation which Congress intended, and would invite flagrant abuse in the future.

"Although the Service will not recommend appeal of this case, we disagree with the Tax Court's sweeping interpretation of Crummey. Accordingly, we shall litigate other cases whose facts indicate a greater abuse of the Crummey power, than those of Cristofani, preferably outside the Ninth Circuit."

d. IRS's Recent More Aggressive Response to Cristofani

(1) New Action on Decision. On July 15, 1996, the IRS issued a new action on decision relating to the Cristofani case setting out its new litigating position in connection with Crummey powers. AOD 1996-010.

After reaffirming its position that the Service will not normally contest gift tax annual exclusions for Crummey powers held by current income beneficiaries and persons with vested remainder interests having a continuing economic interest in the trust, the AOD then makes the following further statement:

"In Cristofani, the court followed Crummey and held that Crummey does not require a trust beneficiary to have a vested present interest or vested remainder interest in order to qualify for the annual gift tax exclusion; rather, it is the legal duty to withdraw that is significant. However, the Service will deny the exclusions for the Crummey powers, regardless of the powerholders' other interests in the trust, where the withdrawal rights are not in substance what they purport to be in form....If the facts and circumstances of a particular case show that there was a prearranged understanding that the withdrawal right would not be exercised or that doing so would result in adverse consequences to the holder (*e.g.* losing other rights or gifts under the trust instrument or other beneficial arrangement), the creation of the withdrawal rights is not a bona fide gift of the present interest in property. ...

"Although the Service did not appeal this case, the Service disagrees with the Tax Court's sweeping interpretation of Crummey to the extent the benefit of the annual exclusion to illusory gifts as present interests would undermine significantly the unified system of estate and gift taxation that invites flagrant abuse of the benefit which Congress intended in enacting section 2503(b). Accordingly, the Service will continue to litigate cases whose facts indicate that the substance of the transfers was merely to obtain annual exclusions and that no bona fide gift of a present interest was intended."

(2) New Acquiescence in Result. In accordance with the AOD, the IRS issued a new acquiescence in result for the Cristofani case. 1996-29 I.R.B. 4 (July, 1996).

(3) TAM 9628004. The IRS applied its new AOD in this ruling. The ruling involved two trusts created by the same donor for the benefit of one or more of his three children. One trust had 13 Crummey powerholders and the other trust had 6 Crummey powerholders. The ruling denied gift tax annual exclusions for all of the Crummey powers for a period of four years, even those possessed by the beneficiary with a vested remainder interest, because of the IRS' determination that, under all of the facts and circumstances, the donor did not intend to make bona fide gifts of present interests to any of the trust beneficiaries.

"We also considered the fact that none of the rights were ever exercised, even by those who had no other interests in the trusts, and conclude that as part of a prearranged understanding, all of the beneficiaries knew that their rights were paper rights only, or that exercising them would result in unfavorable consequences. There is no other logical reason why these

individuals would choose not to withdraw $10,000.00 a year as a gift which would not be includable in their income or subject the Donor to the gift tax."

(4) TAM 9731004. The IRS ruled that withdraw powers from trusts possessed by 16, or in some cases by 17, persons did not constitute present interest gifts except for one person for each trust who was a current income beneficiary and vested remainderman. The remaining 15 or 16 withdraw powers were possessed by certain grandchildren who were contingent remaindermen, certain children and their descendants who were remote contingent remaindermen and spouses of children who were naked powerholders.

(a) Unlike TAM 9628004 which based its denial of present interest status to the withdraw powers on several factors which showed no intent to make a gift, TAM 9731004 bases its denial solely on the fact that the powers were possessed by contingent beneficiaries and naked powerholders.

(b) "The Service generally does not contest gift tax annual exclusions for transfers subject to withdrawal powers that are held by current income beneficiaries and persons with vested remainder interests. These individuals have current or long term economic interests in the trust and in the value of the corpus. It is understandable that in weighing these interests, they decide not to exercise their withdrawal rights. However, where nominal beneficiaries enjoy only discretionary income interests, contingent rights to the remainder, or no rights whatsoever in the income or remainder, their non-exercise of the withdrawal rights indicates that there was some kind of prearranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both."

(c) "The fact that none of the withdrawal rights was ever exercised, even by those who had no other interests in the trusts, leads to the conclusion that as part of a prearranged understanding, all of the individuals (other than the primary beneficiary) knew that their rights were paper rights only, or that exercising them would result in unfavorable consequences. There is no other logical reason why these individuals would choose not to withdraw the amount specified in each trust as a gift which would neither be includable in their income nor subject the Donor to the gift tax."

(5) Estate of Kohlsaat v. Commissioner, 73 T.C.M. 2732 (1997). The Tax Court rejected the new IRS position.

(a) Mrs. Kohlsaat established a trust providing for mandatory income and discretionary principal payments to her two children each of whom possessed special powers of appointment in

favor of the child's descendants. In default of the exercise of the special power, the trust principal of one child would pass to that child's descendants per stirpes and, in the case of the other child, in trust for the life of the spouse of the second deceased child and then to such child's descendants per stirpes. Crummey notice letters were timely sent to Mrs. Kohlsaat's two children, daughter-in-law and 15 grandchildren and great grandchildren, who did not exercise their withdrawal rights.

(b) The IRS allowed the gift tax annual exclusion for the two children but denied it for the other 16 power holders on the grounds that their withdrawal rights were a illusory.

(c) The IRS cited the same authority cited in AOD 1996-010. The IRS produced no evidence as to any overt attempt to dissuade a beneficiary from exercising a right of withdrawal. In essence, the IRS is taking the position that there is a presumption that the withdrawal power is illusory if the beneficiaries have no current income or vested reminder interest and do not exercise the power to withdraw.

(d) The Tax Court stated that the fact that none of the beneficiaries exercised their withdrawal powers does not imply that the beneficiaries had agreed not to do so and the court refused to infer such an understanding. The court noted that the evidence did not establish an understanding that the contingent beneficiaries would not exercise their rights and, in fact, several credible reasons were offered by the trust beneficiaries as to why they did not exercise the rights.

(e) Fiore and Deener, "How to Deal Effectively With Expanded IRS Attacks on Crummey/Cristofani Trusts," 22 ACTEC Notes 216 (Winter, 1996).

(6) Estate of Holland v. Commissioner, 73 T.C.M. 3236 (1997).

(a) Decedent's mother set up a separate trust for each of the decedent's eight grandchildren and gave them (or their guardians) a Crummey withdraw power through the end of the year.

(b) Decedent made $10,000 gifts to each trust for four years.

(c) Although the grandchildren were vested beneficiaries, the IRS argued no effective withdraw power because of an agreement or understanding that the power would not be exercised.

(d) IRS evidence of agreement — family discussed how the beneficiaries would use the gifts prior to decedent's transfers and then pooled the gifts to buy a CD.

(e) The Tax Court disagreed. No evidence demand right was limited by informal agreement. No evidence decedent would not make gift to donee who did not agree in joint investment.

e. Bottom Line: Until the courts finally determine the issues raised in the IRS renewed attack on Crummey withdrawal powers, the following should be considered:

(1) Despite the Cristofani and Kohlsaat decisions, a cautious practitioner should still seek to give a Crummey powerholder a current interest in the income and principal of the trust, or a vested remainder interest.

(2) Timely notice to the powerholders of the withdrawal rights and gifts to the trust should be strictly followed.

(3) Drafters of the trust documents should consider expressly requiring the trustee or some other individual to give notice to the powerholders of the right to withdraw and of additions to the trust. Although incorporating the withdrawal power in the trust instrument, some drafters have hesitated in placing the responsibility of giving notice on a particular person in case such person didn't give notice but the beneficiary had actual notice. Perhaps this concern could be met by stating that the trustee has the primary responsibility of giving the notice but that notice may be given by other persons.

(4) There should be no attempt to dissuade any beneficiary from exercising his or her withdrawal powers.

(5) If the prospective grantor does not want to grant a current income and principal interest or a vested remainder interest in the trust to a potential powerholder, such powerholder should at least be given a contingent remainder interest in order to fall within the facts of Cristofani and Kohlsaat. If the grantor is not willing to give a contingent remainder interest, then he should give at least a discretionary income and principal interest. Although the IRS will not accept such interest, perhaps a court would.

(6) Drafters should avoid withdrawal powers possessed by naked powerholders.

4. Gift Tax Consequences for Powerholder — Should the Withdrawal Power for Each Beneficiary Be Limited By the "5 and 5" Exception?

a. The Gift Tax Annual Exclusion is $12,000 Per Donee. However, if there are more than one donor to a trust, there would be a multiple of $12,000 exclusions, one for each donor, e.g., $24,000 if the donation to the trust is

community property or separate property of one spouse and there is an IRC Section 2513 split gift election. The Taxpayer Relief Act of 1997 indexes the annual exclusion for cost-of-living in $1,000 increments. IRC Section 2503(b)(2).

b. Withdrawal Power Is General Power of Appointment. The withdrawal rights are general powers of appointment possessed by the beneficiary and the annual lapse of such powers will be treated as gifts to the other beneficiaries of the trust which would not qualify for the gift tax annual exclusion. IRC Section 2514(b). PLR 9804047. There is a similar estate tax problem for the beneficiary discussed infra.

c. The 5 and 5 Exception. However, if the Crummey power for each beneficiary does not exceed the greater of $5,000 or 5% ("5 and 5 exception") of the value of the trust property subject to the power, the lapse of the power will result in no gift by the beneficiary. IRC Section 2514(e).

(1) The IRS has acknowledged that the 5 and 5 exception does prevent a gift when a Crummey power lapses. PLR 7939061. PLR 7947066. PLR 8003033. PLR 8003152.

(2) However, since August 16, 1982, the IRS no longer issues rulings concerning the application of the 5 and 5 exception to the lapse of Crummey withdrawal powers for gift tax purposes for life insurance trusts defective under the income tax rules. Rev. Proc. 2007-3, Sec. 4.01(46), 2007-1 I.R.B., January 2, 2007. As a practical matter, the IRS almost never issues a ruling on a life insurance trust including those which are not defective for income tax purposes.

(3) If the Crummey withdrawal power exceeds the 5 and 5 exception, only the lapse in excess of the exception will be treated as a gift by the beneficiary.

d. Only One 5 and 5 Exception Each Year. There is only one 5 and 5 exception each year for each beneficiary who lets his or her Crummey withdrawal powers lapse. Rev. Rul. 85-88, 1985-2 C.B. 201.

(1) If a person is a beneficiary of separate trusts created for his or her benefit by his or her mother, father and grandparents, such person apparently has one $5,000 exception for all of the trusts combined each year although each trust may provide for a separate $5,000 Crummey power. The facts of Rev. Rul. 85-88 involve two identical trusts created by the same grantor but the language of the revenue ruling would not appear to restrict the aggregating of multiple withdrawal powers for 5 and 5 purposes to that situation. *Also see* GCM 3937 and PLR 903005.

(2) Each trust for a beneficiary has only one 5% exception no matter how many powers might lapse as to such trust in a calendar year with the 5% based on the maximum amount subject to the designee's power on the date of lapse of any such power during the calendar year.

e. <u>$12,000 versus $5,000 Dilemma</u>. The dilemma for the grantor of an irrevocable life insurance trust — shelter the full $12,000 ($24,000 if community property gift involved) of annual gifts from becoming taxable gifts or limit the shelter to the 5 and 5 exception to protect the beneficiary? There are several solutions whereby the grantor may take the full $12,000 exclusion without gift tax consequences to the beneficiary.

(1) <u>Special Power Solution</u>: The beneficiary's gift tax exposure can be eliminated by giving him or her a special power of appointment over his or her trust property. Reg. Sec. 25.2511-2(b). PLR 8229097. This solution would work if the trust only had one beneficiary with a withdrawal power but would be very hard to draft if there are multiple beneficiaries with withdrawal powers in a single trust situation.

(2) <u>General Power Solution</u>: The beneficiary's gift tax exposure can also be eliminated by giving him or her a general power of appointment or by making the beneficiary's estate the ultimate trust beneficiary. PLR 8517052. PLR 8545076. PLR 8142061. However, in such a case, all trust assets will be includable in the beneficiary's estate at his or her death. Once again, this is useful where there is one beneficiary with a withdrawal power but it would be difficult to draft a general power of appointment for multiple beneficiaries with withdrawal powers in a single trust.

(3) <u>Hanging Power Solution</u>: Another possible solution is the "hanging power". Only the amount of the withdrawal power up to the 5 and 5 ceiling lapses in any one year and the excess carries over to the next year. The carryover power will lapse in subsequent years to the extent gifts in those years are less than the 5 and 5 ceiling.

(a) If the powerholder should die prior to the termination of the trust, the hanging power in existence at the date of his death will be included in his or her estate for federal estate tax purposes.

(b) If the holder of the hanging power is not the beneficiary of the trust assets upon termination of the trust (e.g., child and grandchildren have <u>Crummey</u> hanging powers over the same trust but the trust terminates in favor of the child after the death of the insured parent), then the gift is merely postponed for the unlapsed hanging power until the termination of the trust unless the powerholder will receive a distribution at least equal to the hanging power which might have GST tax or other consequences. A solution may be to delay the termination of the trust after the death of the insured until all hanging powers have lapsed. The lapse may be accelerated with regard to a 5% power because of the larger amount of trust property available for withdrawal after the receipt of the insurance proceeds at the death of the insured.

(c) The hanging power is most useful where the premium gifts are of short duration (e.g., a limited pay or disappearing premium policy) or the trust will continue for a substantial time after the death of the insured (e.g., lifetime of the powerholder) so that there will be time to work away the hanging power when there will be no additional gifts to the trust.

(d) In 1989, the IRS ruled that a certain hanging power was invalid and did not prevent the lapse of a Crummey power in excess of $5,000. TAM 8901004. The power involved in the ruling stated that, if the lapse of the withdrawal power would be deemed to be a taxable gift for federal gift tax purposes, then the withdrawal power would not lapse but would continue until it could lapse in a subsequent year without the result of being a taxable gift.

(i) Citing Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944), the IRS concluded that the hanging power was a condition subsequent and void as contrary to public policy since the gift by the powerholder to the trust would be voided to the extent a court determined that it was otherwise a taxable gift.

(ii) Rather than conditioning the hanging power upon whether the lapse would be a taxable gift, most practitioners now draft hanging power to expressly state that the power will not lapse to the extent it exceeds the 5 and 5 exception without mentioning gift tax consequences. Although the IRS has not formally or privately ruled upon such a condition precedent hanging power, representatives of the IRS have informally acknowledged that such power should work.

5. Is the Annual Exclusion Available if There are Multiple Crummey Powers for Beneficiaries of a Single Trust?

a. The exclusion is available only if the trust beneficiary is assured of receiving some amount of trust corpus should he make a demand. Rev. Rul. 80-261, 1980-2 C.B. 279. If $5,000 is given to a trust which has two beneficiaries with maximum withdrawal powers of $5,000, neither beneficiary is assured of receiving any funds since the one beneficiary might beat the other to the punch in making a demand.

b. Solution: If the gift is less than the aggregate withdrawal powers, the trust agreement should specify that each beneficiary may withdraw only a pro rata share of the gift. Rev. Rul. 80-261, *supra*.

c. Solution: The trust agreement can establish a separate trust for each beneficiary with only that beneficiary having the withdrawal powers over his

or her trust. Gifts to the trustee will be applied on a pro rata basis among the trusts.

6. Is the Exclusion Available if the Only Asset in an Irrevocable Life Insurance Trust is the Policy? If the only asset in the trust is an insurance policy that has no cash value (*e.g.,* split dollar, group term or regular term insurance) or has cash surrender value less than the annual exclusion, the Crummey language might not preserve the annual exclusion since there is no asset against which the beneficiary could exercise his or her power of appointment.

a. Solution: Funnel the Premium Payments Through the Trust. The donor makes a gift to the trustee, the trustee holds the money for reasonable time after notice to beneficiaries, then trustee pays the premium (or the Table 2001 or carrier term rate in the case of an economic benefit regime split dollar policy). PLR 8015128. PLR 8134135. Where an employer pay-all split dollar or a group term policy is involved, this solution is not possible.

b. Solution: Power to Withdraw Insurance Policy. In situations involving group term policies, the IRS has ruled that the annual exclusion applies where the beneficiary could withdraw the policy in kind under a Crummey power. PLR 8006109. PLR 8021058. PLR 8111123. There is concern that this may work only when the policy has a value at least equal to the withdraw power.

c. Solution: Cash Side Fund or Liquid Seed. The IRS has also ruled that the power to withdraw cash or other assets included in a trust with a group term policy qualifies for the annual exclusion. PLR 8103074. PLR 8006109. PLR 8111123. Thus a donor of an employer pay-all economic benefit regime split dollar policy or a group term policy could place a side fund of cash in the trust which would exceed the annual gift for future years and preserve the annual exclusion under the Crummey power which allows the beneficiary to withdraw the cash. Of course, this would result in a larger gift to the trust the first year.

7. Miscellaneous Crummey Power Considerations

a. ”Revocable” Crummey Powers. The gift tax annual exclusion is unaffected by a trust agreement provision which allows the donor to exclude any person with a withdrawal power from exercising that power as to any property subsequently added to the trust by the donor. TAM 8901004. This is a useful power to protect against an “ingrate” beneficiary who might otherwise exercise his power.

b. Imputed Premium Gifts. In the case of an employer pay-all economic benefit regime split dollar or a group term policy held in trust, the trust agreement should make it clear that the withdrawal power is triggered by indirect or imputed gifts to the trust caused by the employer’s premium payments. *See* PLR 8103074, PLR 8138102 and PLR 8138170.

c. Avoid Intervening Trustee Powers. If the trustee has the power to defeat the beneficiary’s withdrawal power by making distributions to other beneficiaries, the value of the withdrawal power is not ascertainable and no annual exclusion will be allowed. TAM 8107009.

d. Amendable Crummey Powers. Because of the uncertainty surrounding Crummey withdrawal powers, some practitioners provide in their life insurance trusts for an independent person to have the power to amend the Crummey withdrawal provision so that gifts to the trust will qualify for the gift tax annual exclusion in case there are future changes necessitated by law, regulations, rulings or court decisions. There are no authorities concerning such an amending power.

e. Avoid Reciprocal Crummey Powers. When business partners created separate trusts for their children each of which provided for withdrawal powers for the other partner and both sets of children, the reciprocal withdrawal powers did not constitute gifts to the other partners subject to the gift tax annual exclusions since they were in consideration of each other. Rev. Rul. 85-24, 1985-1 C.B. 329. Thus when the powers in favor of the partners lapsed, the grantor of the trust made an additional gift to his child of the amount subject to such powers.

8. IRS No Ruling Attitude

a. As mentioned earlier, the IRS has refused to render rulings on Crummey withdrawal powers for "super trusts" as to whether the transfer of property to the super trust qualifies as a present interest under IRC Section 2503(b) or as to whether the 5 and 5 exception of IRC Section 2514(e) applies to the lapse of withdraw powers by beneficiaries of the super trust. Rev. Proc. 2007-3, Section 4.01(45) and (46), 2007-1 I.R.B., January 2, 2007. The essential elements of a super trust are as follows: (a) consists substantially of insurance policies on the life of the grantor or the grantor's spouse, (b) the trustee has the power to apply trust income or corpus to pay premiums on such policies, (c) the trustee has the power to make loans to or purchase assets from the grantor's estate, (d) the trust beneficiaries possess Crummey withdrawal powers, and (e) it is a grantor trust.

b. Although the revenue procedure only applies to defective trusts, since the moratorium was imposed in 1982, there have been very few rulings involving Crummey withdrawals for any life insurance trust. However, the IRS continues to issue published and private rulings concerning non-insurance trusts. Many practitioners think that the IRS is reassessing its position concerning all Crummey life insurance trusts or may be trying to limit the use of withdrawal powers by creating an aura of uncertainty through a no ruling policy.

V. ESTATE TAX CONSEQUENCES

A. THE THREE YEAR RULE AND SECTION 2035

1. Statutory Language

"a. Inclusion of Certain Property in Gross Estate. — If --

"(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any

property, during the 3-year period ending on the date of decedent's death, and

"(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section . . . 2042, if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included."

2. Insured Transferred Existing Policy, Continues to Pay the Premiums and Dies Within Three Years of Transfer

a. If the insured is an owner of a policy on his life and transfers it within three years of his death and continues to pay the premiums on the policy directly or indirectly, the proceeds of the policy are includable in his gross estate.

b. If the transferred policy was owned as community property by the insured and his or her spouse, only one-half of the proceeds would be includable in the insured's estate should the insured die within three years of the transfer. Estate of Hass v. Commissioner, 51 T.C.M. 453 (1986). Estate of Barrata-Lorton v. Commissioner, 49 T.C.M. 770 (1985). Estate of Schnack v. Commissioner, 848 F.2d 933 (9th Cir. 1988).

c. Presumably, the same result would occur if insured possessed incidents of ownership as trustee of a trust of which the insured was either a beneficiary or the grantor, resigned as trustee and died within three years of the resignation. *See* PLR 9434028.

3. Insured Transfers Policy, Trustee Pays the Premium and Insured Dies Within Three Years of Transfer

a. The Tax Court has held that, where the insured died within three years after the transfer of an existing insurance policy to his son, the proportionate part of the proceeds of the policy attributable to the son's premium payments after the transfer will be excluded from the decedent's estate under IRC Section 2035. Estate of Silverman v. Commissioner, 61 T.C. 338 (1973), *aff'd on another issue*, 521 F.2d 574 (2nd Cir. 1975), *acq. in result*, 1978-1 C.B. 2. Thus, under the Silverman rationale, if the insured paid 55 premiums before the transfer and the donee paid seven premiums after the transfer, only 88% of the proceeds would be subject to the three-year rule.

b. Although the proration of proceeds was not at issue in the appeal of the Silverman case, the Second Circuit decision states that the court was uneasy about the basis for excluding a portion of the proceeds from IRC Section 2035 because of the donee's premium payments and offered a gratuitous observation supporting a contrary result. 521 F.2d at 577-578.

c. Despite the Second Circuit's dicta, the IRS has acquiesced in the Silverman decision. 1978-1 C.B. 2. The IRS has also cited Silverman with approval. PLR 7907011. PLR 8724104.

d. The Tax Court has held that the Silverman ratio adjustment was not repealed by ERTA. Estate of Friedberg v. Commissioner, 63 T.C.M. 3080 (1992).

e. Thus, if at all possible, the donee of an existing insurance policy (if the insured is the donor) should pay the premiums for the next three years with funds received from someone other than the insured.

4. Insured Transfers Existing Policy, Continues to Pay Premiums, But Dies More Than Three Years After the Transfer

a. Initially, the IRS took the position that the decedent's gross estate would include a proportionate share of the proceeds, measured by the ratio of premiums paid within the three-year period to the total premiums paid.

b. After that position was rejected by the Fifth Circuit in First National Bank of Midland v. United States, 423 F.2d 1286 (1970), the IRS reversed its position concluding that payment, by the insured, of premiums on a whole-life insurance policy on his life that had been owned by another for more than three years prior to his death, is not a transfer of an interest in the policy.

c. Thus, if all incidents of ownership were transferred more than three years before death, IRC Section 2035 will be inapplicable. There is no reverse Silverman situation.

5. Trustee Purchases the Policy, the Insured is the Direct or Indirect Source of Premium Payments and Insured Dies Within Three Years

a. Pre-ERTA Law. For insureds dying before 1982, several courts included insurance proceeds in the insured's gross estate when he died within three years of purchase of the policy under two constructive ownership theories — a "beamed transfer" theory where the insured paid the first premium or under an "agency transfer" theory where the third party policy owner paid the premiums with funds provided by the insured. Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972). Detroit Bank & Trust Co. v. United States, 467 F.2d 964 (6th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973). First National Bank of Oregon v. United States, 488 F.2d 575 (9th Cir. 1973).

b. Post-ERTA Judicial Position. Because of the amendment to Section 2035 by ERTA effective January 1, 1982, the Tax Court and the Fifth, Sixth and Tenth Circuits took the position that beamed transfer and agency transfer theories no longer apply for decedents dying after 1981 where a third party at all times possessed incidents of ownership in the policy on the decedent's life even though the insured was the source of the premium payments. Estate of Leder v. Commissioner, 893 F.2d 237 (10th Cir. 1989). Estate of Headrick v. Commissioner, 918 F.2d 1263 (6th Cir. 1990). Estate of Perry v. Commissioner, 927 F.2d 209 (5th Cir. 1991).

c. Post-ERTA IRS Position

(1) Until 1991, the IRS opposed the positions taken in the Leder, Headrick and Perry cases and took the position that the beamed

transfer and agency transfer theories still applied to post-1981 deaths. TAM 8509005. TAM 8252016. PLR 9030005. PLR 9037012.

(2) Because of the three adverse appellate opinions, the IRS chief counsel has recommended acquiescence in the Headrick decision. AOD 1991-12. The AOD concludes with the following remark: "We will no longer litigate this issue."

(3) Citing Perry, Headrick and Leder, the IRS has ruled that IRC Section 2035 is inapplicable where the insured signed the application for the policy and paid all of the premiums but designated her sons as the initial owners and beneficiaries since, under state law, the insured never possessed an incident of ownership in the policy which was transferred within three years of death. TAM 9323002.

6. Avoid the Transfer Problem for an Existing Policy Owned By the Insured By Bona Fide Sale of the Policy.

a. An exception to the three-year rule is a "bona fide sale" for adequate and full consideration in money or money's worth." IRC Section 2035(b)(1). Thus, a transfer of an insurance policy by a bona fide sale, even within three years of the insured's death, is not subject to IRC Section 2035.

b. The problem with a sale of an insurance policy is the "transfer for value rule" of IRC Section 101(a)(2). With certain exceptions, if an insurance policy is sold for valuable consideration, the proceeds of the policy upon the death of the insured will be includable in the gross income of the beneficiary to the extent they exceed the premiums and other consideration paid by the transferee of the policy.

c. One of the exceptions to the transfer for value rule is where the insurance policy "has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to such basis ... in the hands of the transferor." IRC Section 1041(a) states that "no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse." IRC Section 1041(b)(2) goes on to state that the transfer of property between spouses shall be deemed to be a gift and the "basis of the transferee in the property shall be the adjusted basis of the transferor."

(1) Consequently, the sale of an insurance policy by an insured to his or her spouse for adequate and full consideration would seem to be an exception to the transfer for value rule because of the application of IRC Section 1041.

(2) In order to remove the insurance proceeds from the estates of both spouses, the non-insured spouse should transfer the policy immediately after the purchase to their children or to an irrevocable trust for the benefit of their children. This would immediately remove the proceeds from both estates even if the non-insured spouse died within three years of the transfer since IRC Section 2035 only applies to transfer of insurance policies by the insured.

(3) In order to avoid an argument of indirect gift and step transaction, the non-insured spouse would have to use his or her funds (not derived from a gift from the insured) to purchase the policy.

(4) The problem with this solution is that the non-insured spouse cannot be the beneficiary of the insurance policy or a beneficiary of the life insurance trust such spouse created without including the insurance and proceeds in the estate of the non-insured spouse.

d. If a trust is a grantor trust for income tax purposes with the insured as grantor, presumably a sale to the trust by the insured also would be excepted from the transfer for value rule. If a grantor sells property to a grantor trust, the trust will have the same basis in the property as the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184. Thus, the sale of the policy by the insured to the insured's grantor trust also should qualify for the commonality of basis exception. *See* I.R.C. Section 101(a)(2)(B); *see also* PLR 200228019 (ruing that the sale of a policy from one grantor trust to another grantor trust with the same grantor was excepted from the transfer for value rule); *see also* PLR 200606027.

e. Another exception to the transfer for value rule would apply if the trust were a partner in a legitimate partnership with the insured. IRC Section 101(a)(2)(A). An important issue in this context is what exactly constitutes "adequate and full" consideration for the transfer of the policy? Is it interpolated terminal reserve plus unused premium, the value established by the life settlement market, or fair market value defined in Rev. Proc. 2005-25, 2005-1 C.B. 962? *See* discussion at IVB8 *supra*.

B. LIFE INSURANCE TRUSTS AND SECTION 2042. Insurance proceeds are includable in the gross estate of the insured only to the extent receivable by his or her executor or to the extent he or she possesses an "incident of ownership," exercisable either alone or in conjunction with any other person. IRC Section 2042.

1. Receivable By the Executor. Normally, in the typical irrevocable life insurance trust, this is no problem since the insured and his estate are not beneficiaries of the trust. However, if the trust is subject to a legal obligation to pay the insured's taxes, debts or other charges enforceable against the estate, the proceeds are includable in the insured's gross estate. Reg. Section 20.2042-l(b)(l). If, on the other hand, the trustee is merely authorized to loan money to the estate of the insured (for adequate security and interest) or to purchase assets from the insured's estate (at fair market value), the insurance proceeds are not includable in the decedent's estate even though the funds from the loan or the sale are used by the executor to pay the decedent's debts and taxes.

2. Incidents of Ownership. In the typical irrevocable life insurance trust, the insured-decedent does not directly possess any incident of ownership over the insurance policy owned by the trustee which would result in an inclusion in his gross estate under IRC Section 2042(2). However, the incident of ownership problem is quite often present where the insured is indirectly the possessor of an incident of ownership which will be discussed later in this outline.

a. Regulation Definition. An incident of ownership is a right of the insured or his estate to the economic benefits of the policy including the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to borrow against the policy or a reversionary interest in the policy exceeding 5%. Reg. Section 20.2042-l(c)(2) and (3).

b. Settlement Options and Beneficiary Change Veto. The power to elect a settlement option is an incident of ownership. In Re Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973). *Contra*, Estate of Connelly v. United States, 551 F.2d 545 (3rd Cir. 1977). The IRS sides with Lumpkin. Rev. Rul. 81-128, 1981-1 CB 469. The power of the insured to veto a change of beneficiary by the owner of the policy is also an incident of ownership. Schwager v. Commissioner, 64 T.C. 781 (1975).

c. Is the Contractual Right of the Insured to Purchase the Policy From a Third Party Owner an Incident of Ownership?

(1) Yes, where the insured had the right to purchase the policy from his employer if his employer decided to surrender the policy. Rev. Rul. 79-46, 1979-1 C.B. 303. The Tax Court has reached a different result. Estate of Smith v. Commissioner, 73 T.C. 307 (1979), *acq. in result* 1981-1 C.B. 2. The IRS has agreed that the shareholder/employee's contractual right to purchase the employer's interest in the policy is not an incident of ownership if it could be exercised only if preceded by a fact of independent significance such as the sale of his stock upon termination of employment. PLR 8049002.

(2) However, a retained right to purchase policy by insured in his sole discretion is an incident of ownership. TAM 9128008.

(3) Where the grantor of a trust possessed the power to substitute property of equal value for trust corpus which included insurance policies, the trust assets were not includable in the grantor's estate under IRC Sections 2038(a)(2) or 2042(2). Estate of Jordahl, 65 T.C. 92 (1975), *acq. in result*, 1977-1 C.B. l.

(4) If the sole right to a group term insurance policy possessed by the insured-employee is the right to convert the policy upon termination of employment or the right to cancel the insurance coverage by terminating his employment, an incident of ownership is not involved. Estate of Smead, 78 T.C. 43 (1982), *acq. in result*, 1984 2 C.B. 2. Rev. Rul. 84-130, 1984-2 C.B. 194. Rev. Rul. 72-307, 1972-1 C.B. 307.

d. Divorce of Spouse-Beneficiary. Where the beneficial rights of the spouse of the insured-grantor in a life insurance trust were subject to termination in case of divorce, the decedent-insured did not possess an incident of ownership to change beneficiaries since a divorce is an act of independent significance, TAM 8819001.

3. Incidents of Ownership by Insured as Trustee

a. IRS Position. After years of unsuccessfully asserting (except in the 5th Circuit) that the insured as trustee in all cases possessed incidents of ownership under IRC Section 2042(2), the IRS position now is that an insured-trustee will have incidents of ownership over the policy in trust only if one of the following is present (Rev. Rul. 84-179, 1984-2 C.B. 195).

(1) The insured-trustee could have exercised trust powers over the policy for his benefit (without regard to how those powers were acquired and without consideration of whether the insured transferred property to the trust) or

(2) The insured has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust or

(3) The devolution of trust powers to the insured-trustee by a third person is part of a prearranged plan involving participation of the insured (*e.g.*, the insured is the indirect grantor).

b. Most Courts Agree. Because of the following court decisions, the IRS issued Rev. Rul. 84-179. Estate of Skifter v. Commissioner, 468 F.2d 699 (2nd Cir. 1972). Estate of Connelly v. United States, 551 F.2d 545 (3rd Cir. 1977). Estate of Fruehauf v. Commissioner, 427 F.2d 80 (6th Cir. 1970). Hunter v. United States, 624 F.2d 833 (8th Cir. 1980). Gesner v. United States, 600 F.2d 1349 (Ct. Cl. 1979). However, the Fifth Circuit had sided with the old IRS position that the insured trustee possessed incidents of ownership in all cases. Rose v. United States, 511 F.2d 259 (1975). Terriberry v. United States, 517 F.2d 286 (1975).

c. Bottom Line. Although it is possible for the insured to be trustee if he or she is not the grantor or beneficiary (*e.g.*, policies owned by deceased noninsured spouse are left in testamentary trust with insured as trustee for adult children for whom insured has no legal obligation of support), the safest course of action is to avoid having the insured be trustee of a trust owning a policy on his or her life in all cases.

4. Incidents of Ownership and Insured's Power to Remove Trustee

a. Grantor Insured Can Remove and Replace with Someone Else - in Gross Estate. When the insured transferred a policy on his life to an irrevocable trust and the trust agreement gave the insured the power to remove the trustee without cause and appoint anyone other than himself as trustee, the insured will be deemed to possess the trustee's incidents of ownership under IRC Section 2042(2) in the policy regardless of whether the removal power was exercised. TAM 8922003.

(1) The TAM reached its result by combining the rationale of Rev. Rul. 84-179 (an insured/grantor serving as trustee has incidents of ownership over policy owned by trust) with that of Rev. Rul. 79-353, 1979-2 C.B. 325 (if grantor retains power to remove the trustee, the grantor is deemed to possess the powers of the trustee).

(2) The TAM grandfathered life insurance trusts where the insured/grantor retained trustee removal powers when the policy was transferred irrevocably to the trust before October 29, 1979, citing Rev. Rul. 81-51, 1981-1 C.B. 458, which had similarly grandfathered trusts from the impact of Rev. Rul. 79-353.

(3) In the Estate of Headrick v. United States, 918 F.2d. 1263 (6th Cir. 1990), the insured grantor reserved the right to replace the corporate trustee and the court found that the three year rule of IRC Section 2035 did not apply since the decedent never had incidents of ownership in the policy. However, the IRS apparently never argued the rationale of Rev. Rul. 79-353 in the case although it unsuccessfully cited the removal power as one of several facts supporting its theory that the trustee was the insured's agent.

b. Does Rev. Rul. 95-58 Override Trustee Incidents of Ownership?. TAM 8922003 is an extension of Rev. Rul. 79-353 which stood for the proposition that the grantor's retention of an unqualified power to remove and replace the trustee is, in effect, a retention of the powers of the trustee.

(1) Rev. Rul. 79-353 Criticized

(a) Rev. Rul. 79-353 was subjected to much criticism since it presumed that a trustee (corporate as well as individual) will violate fiduciary responsibilities at the request of the person having the removal power.

(b) The IRS position was rejected by the 8th Circuit and by the Tax Court, with Rev. Rul. 79-353 expressly being rejected in the latter decision. Estate of Vak v. Commissioner, 973 F.2d. 1409, 1414 (8th Cir. 1992). Estate of Wall v. Commissioner, 101 T.C. 300, 311 (1993).

(2) Rev. Rul. 95-58 Revokes Rev. Rul. 79-353. Citing the Estate of Wall and the Estate of Vak, the IRS in Rev. Rul. 95-58, 1995-2 C.B. 191 revoked Rev. Rul. 79-353 and Rev. Rul. 81-51 and ruled that a decedent would not have retained a trustee's discretionary control over trust income just because the decedent-grantor reserved an unqualified power to remove a trustee and appoint an individual or corporate successor trustee "that was not related or subordinate to the decedent (within the meaning of Section 672(c))."

(a) The reference to the appointment of a related or subordinate successor trustee in the revenue ruling has created confusion. There is no reference to related or subordinate parties in IRC Sections 2036(a)(2) or 2038(a)(1) or the applicable regulations.

(b) Neither is there such a reference in the Estate of Wall. Although the Estate of Vak involved a grantor power to remove a trustee without appointing a successor trustee who is a

related or subordinate to the grantor within the meaning of IRC Section 672(c), that was a specific provision of the trust instrument involved in that case and did not constitute a restriction imposed by the decision itself.

(c) Representatives of the IRS have informally stated that the related or subordinate party requirement is a safe harbor and that the IRS intends to apply some sort of facts and circumstances test to determine the estate tax includability if the trust instrument does not contain such a limitation.

(3) Impact Upon Trustee Incident of Ownership. Although Rev. Rul. 79-353 only expressly applied to IRC Sections 2036 and 2038, presumably, its revocation by Rev. Rul. 95-58 implies that the extension of the rationale to IRC Section 2042 by TAM 8922003 is no longer valid.

(a) The IRS has extended the rationale of Rev. Rul. 95-58 to Section 2041. In PLR 9607008, citing Rev. Rul. 95-58, the IRS ruled that the power of a co-trustee who was a beneficiary to replace the corporate co-trustee with another corporate co-trustee did not give the beneficiary a general power of appointment (although the corporate co-trustee had broad discretionary power to make distributions to the beneficiary) if the trust were reformed to provide that any successor corporate trustee so appointed cannot be related or subordinate to the individual trustee, within the meaning of IRC Section 672(c). This ruling is opposite to PLR 8916032 which pre-dated Rev. Rul. 95-58.

(b) The IRS has privately ruled that the ability of the insured to remove a trustee for cause and to replace with someone other than the insured was not an incident of ownership. PLR 9832039.

(c) Reportedly, IRS representatives have informally agreed that the power of an insured to replace the trustee does not attribute the trustee's powers to the insured in IRC Section 2042(2), with the restriction the successor cannot be a related or subordinate party to the insured. See PLR 200314009 (although power to remove not present).

(4) Bottom Line. Although Rev. Rul. 79-353 has been revoked, the safest course of action would be not to give the insured either trustee removal or trustee replacement powers and give this authority to some other family member, preferably someone who is not a beneficiary of the trust unless the trustee powers are limited by an ascertainable standard.

5. Incidents of Ownership Held by Controlled Corporation

a. Controlled Corporation Incidents of Ownership Rule. If the insured owns the majority of the voting stock of a corporation, the incidents of

ownership possessed by the controlled corporation over any policy on the insured shareholder's life will be attributable to the shareholder except for proceeds of the policy payable to the corporation (or payable to a third party for a valid corporate business purpose). Reg. Section 20.2042-1(c)(6).

b. Grandfathered Split Dollar Arrangements. Entered into before September 18, 2003, and not materially modified after September 17, 2003.

(1) Applicable to Some Split Dollar Policies. The most common situation where the controlling shareholder regulation might apply is where an irrevocable life insurance trust has split dollared an insurance policy with a corporation controlled by the insured. The IRS has taken the position that the controlling shareholder regulation applies to split dollar policies. Rev. Rul. 76-274, 1976-2 C.B. 278. Rev. Rul. 82-145, 1982-2 C.B. 213.

(a) Under these rulings, if the corporation possesses incidents of ownership, the portion of the split dollar proceeds payable to the third party (*e.g.*, the trustee) would be includable in the insured's estate but the proceeds payable to the corporation would not be (except to the extent that they affect the value of the closely held stock owned by the insured).

(b) The controlling shareholder regulation applied where the corporate employer possessed the right of assignment, to change the beneficiary of the cash value, to borrow against the policy and the right to modify the policy. Estate of Levy, 70 T.C. 873 (1978).

(c) The controlling shareholder regulation applied where the corporate employer possessed the right to veto a beneficiary change, to elect settlement options, to cancel or assign the policy and to borrow against the cash value. Estate of Dimen, 72 T.C. 198 (1979), *aff'd*, 633 F.2d 203 (2nd Cir. 1980) (unpublished opinion).

(2) Applicable to All Split Dollar Policies? In Rev. Rul. 76-274, the IRS initially took the position that the controlling shareholder regulation did not apply if the corporation's rights in the split dollar policy were sufficiently limited to those of a secured creditor, including the right to borrow against the policy.

(a) Right to Borrow is Incident of Ownership. However, the IRS reversed its field in Rev. Rul. 82-145 when it modified the 1976 ruling to exclude from the "secured creditor" exception to the controlling shareholder rule the corporate right to borrow. The latter ruling expressly grandfathered insurance policies "obtained" before August 2, 1982, except to the extent of a subsequent increase of insurance proceeds of such policies payable to someone other than the corporation.

(b) Is the Secured Lender Exception Still Applicable? Although only dealing with the right to borrow, many practitioners feared that Rev. Rul. 82-145 represented the beginning of the end of the secured lender exception so that any interest of the controlled corporation in the split dollar policy would result in imputation of incidents of ownership to the insured over the at risk element payable to the life insurance trust. However, these fears have been allayed by a series of private letter rulings concerning bare bones collateral assignment discussed below.

(i) Bare Bones Collateral Assignment. Many practitioners have combined the requirements of Rev. Rul. 76-274 and Rev. Rul. 82-145 together and prepared split dollar agreements as well as the accompanying collateral assignments to prohibit the controlled corporation from exercising any rights under the insurance policy, particularly prohibiting borrowing against the policy, taking any action which would endanger the interest of the third-party owner, surrendering the policy for cancellation and assigning its rights to anyone other than the third-party owner. In other words, the split dollar agreement and the "bare bones" collateral assignment (also known as restricted access collateral assignment) restrict the controlled corporation's rights to the receipt of its investment element from the cash value of the policy or the death proceeds. All other rights in the policy are given to the third-party owner (*e.g.*, irrevocable life insurance trust).

(ii) The IRS Position. The IRS has blessed the bare bones collateral assignment in a series of private letter rulings which concluded that the controlled corporation did not possess incidents of ownership to be imputed to the insured. PLR 9511046. PLR 9651030. *See also* PLR 9348009.

c. Loan Regime and Economic Benefit Regime Split Dollar Arrangements. These are arrangements entered into or materially modified on or after September 18, 2003.

(1) Loan Regime Split Dollar Arrangement.

(a) Under the final regulations, the loan regime is treated as a loan rather than an ownership interest by the controlled corporation in the policy. Reg. Section 1.7872-15(a). Consequently, the loan itself should not result in incidents of ownership under IRC Section 2042. In PLR 9809032, the IRS ruled that the lending of premium payments by the insured to a trust he created does not create incidents of ownership. Likewise,

the lending of premium payments by the controlled corporation to the trust should not create incidents of ownership.

(b) However, care should be taken if the controlled corporation receives a collateral assignment against the cash value and death proceeds of the policy to secure the loan. The typical collateral assignment would give broad powers to the controlled corporation which might constitute incidents of ownership. It could be argued that the incident of ownership is confined to the cash value of the policy and does not taint the death proceeds under Reg. Section 20.2042-1(c)(6). However, to play it safe, the collateral assignment should be drafted as a bare bones collateral assignment discussed above.

(2) Economic Benefit Regime Split Dollar Arrangement.

(a) Without special drafting, this type of split dollar arrangement, where the controlled corporation owns the policy and there is an endorsement of part of the death proceeds to the life insurance trust, could trigger the controlling shareholder regulation since the controlled corporation would have incidents of ownership in the policy and the death proceeds payable to the trust.

(b) Although the typical arrangement is to have the controlled corporation own the policy with an endorsement to the trust, the final split dollar regulations authorize economic benefit regime treatment where the trust owns the policy and the employer has a collateral assignment against the policy but the employer is entitled to all of the cash value (a non-equity arrangement). Reg. Section 1.61-22(c)(1)(ii)(A)(1).

(c) Although the regulation and its preamble are silent as to the reason for the special ownership exception, the probable reason for this exception would be to allow, in non-equity situations, a bare bones or restrictive collateral assignment in employer/employee and private split dollar arrangements in order to avoid imputation of the estate tax incidents of ownership under the controlling shareholder regulation.

6. Incidents of Ownership Held By a Partnership — Aggregate or Entity Theories.

a. Aggregate Theory — A partnership is an aggregate of its individual partners and any incident of ownership in a life insurance policy held by a partnership is effectively held by the partners as individuals.

(1) The IRS has adopted the aggregate theory but modified. In Rev. Rul. 83-147, 1983-2 C.B. 158, a partnership owned an insurance policy on the life of a one-third partner the proceeds of which were paid to the insured's child. The IRS adopted the aggregate theory and allocated the incidents of ownership to the deceased insured partner. However, the

ruling limited the aggregate theory by stating that incidents of ownership would not be attributed to a partner for insurance proceeds payable to or for the benefit of the partnership since this would result in unwarranted double-taxation because the proceeds payable to or for the benefit of the partnership would be includable in the value of the decedent's partnership interest.

(2) Accordingly, in PLR 9630024, the IRS found no incidents of ownership in a policy of a general partner owned by and payable to the partnership.

(3) Unlike the corporate situation where incidents of ownership are only attributed to a controlling insured shareholder, Rev. Rul. 83-147 attributed partnership incidents to an insured with less than a controlling interest (e.g., one-third). The difference is the IRS view that the assets of the partnership are controlled by the partners while the board of directors of a corporation control the corporate assets and not the individual shareholders. *See* GCM 39034 which reviewed Rev. Rul. 83-147.

(4) Another exception to the aggregate theory is where the partnership agreement expressly prohibits the partner from exercising incidents of ownership.

(a) Where the insured was a limited partner and a general partner, the IRS found no incidents of ownership in the insured where the partnership agreement prohibited an insured partner, whether limited or general, from participating in the exercise of any incident of ownership with respect to partnership held policies insuring his or her life. PLR 200017051.

(b) Where the insured was a limited partner, the IRS found no incidents of ownership in the insured for partnership owned insurance when the partnership instrument reserved all management control to the general partner and granted no management control to the limited partner. PLR 200111038.

(5) Will proceeds payable to the partnership but not included in valuing the insured's partnership interest still be excludable from the insured's gross estate?

(a) Partnership Exclusion for General Partner. GCM 39034 acknowledged that, had the insurance proceeds considered in Rev. Rul. 83-147 been payable to the partnership, two-thirds of the policy proceeds would neither be includable in valuing the decedent's one-third partnership interest under IRC Section 2031 nor be includable under IRC Section 2042(2).

(b) No proceeds included for General Partner. One commentary opines that incidents of ownership might be attributable to an insured general partner for proceeds payable to the partnership if there is a contract or agreement valuing the

deceased's interest in the partnership without regard to any key person insurance proceeds. Richard B. Stephens, Guy B. Maxfield, Stephen A. Lind & Dennis A. Calfee, Federal Estate and Gift Taxation (6 Ed. 1991), Paragraph 4.14[5][b]. In other words the exclusion might not apply if there would otherwise be no double taxation. *Also see* PLR 9623024 where the taxpayer represented that the value of the taxpayer's partnership interest will include taxpayer's proportionate share of the insurance proceeds.

(c) Limited Partner Exclusion. Since a limited partner has no rights to manage the partnership and therefore could not control the incidents of ownership of the insurance policy, there should be no inclusion under IRC Section 2042(2) without regard to whether the insurance proceeds are included in valuing the limited partnership interest or not.

b. Entity Theory — The partnership is a separate legal entity controlling its assets with a partner having no more than a share in the profits and surplus.

(1) The Tax Court has found, when a partnership owned and was the beneficiary of insurance policies on the life of one of its general partners, there would be no incidents of ownership in the insured partner since the insurance is the asset of the partnership and the insured has no rights in the policy other than those flowing from his partnership interests. Estate of Knipp v. Commissioner, 25 T.C. 153 (1955) acq. in result 1959-1 C.B. 4, affd. on another issue, 244 F.2d 436 (4th Cir. 1957), cert. denied, 355 U.S. 827 (1957). Watson v. Commissioner, 36 TCM 1084 (1977).

(2) Although Knipp involved payment of death proceeds to the partnership, the Tax Court apparently rejected the aggregate theory of partnership in favor of the entity theory. By emphasizing that the policy was an asset of the partnership with no rights flowing to the insured partner, the presumption is that the court would have found no incidents of ownership in the insured even if the proceeds had been payable to someone else other than the partnership.

(3) The IRS does not agree with any implication in Knipp that incidents of ownership possessed by a partnership should not be attributed to an insured partner when the policy proceeds are paid other than to or for the benefit of the partnership. Rev. Rul. 83-147, 1982-2 C.B. 158.

(4) If the insured partner had more than a 50% general partnership interest, would the entity theory result in attribution of partnership incidents of ownership to the controlling shareholder for insurance proceeds payable to someone other than the partnership?

(a) Under a strict application of the entity theory, no incidents of ownership would be attributable to the insured partner for proceeds payable to someone other than the partnership unless

the partnership were a sham or alter ego of the partner. Although there is such an attribution of incidents of ownership from a corporation to its controlling shareholder, this is pursuant to the provisions of Reg. Section 20.2042-1(c)(6). It can be argued that, without such an express regulation, such attribution of incidents of ownership is not applicable in a partnership situation.

(b) GCM 39034 expressed concern that Knipp could be so interpreted: "In fact, there is language in Knipp suggesting that a partnership's incidents of ownership should never be attributed to the insured partner, even if he controls the partnership."

(c) The Watson court observed that there would be no incidents of ownership attributable to the insured partner "merely by virtue of his control as a 50% partner." The quoted language might be an indication that the decision would have been different had the insured been a more than 50% partner. On the other hand, the quoted language may merely be a reference to the facts before the court.

c. The Partnership, the Irrevocable Life Insurance Trust and Split Dollar Insurance.

(1) Grandfathered Split Dollar Arrangements. Entered into before September 18, 2003, and not materially modified after September 17, 2003.

(a) With the exception of PLR 9204041 discussed below, there are no direct authorities concerning grandfathered split dollar arrangements between a partnership and a third party involving an insurance policy on the partner's life.

(b) If the partnership entity theory is strictly applied, there may not be any incidents of ownership attributable to the partner regardless of whether he is a controlling general partner. Extra protection if there is a controlling partner could be found in the use of a bare bones collateral assignment or a sole owner split dollar arrangement without a collateral assignment or lien on the policy.

(c) If the aggregate theory is applied, then incidents of ownership from the partnership might be attributable to the insured partner even though he is not the controlling general partner. However, incidents of ownership may be cut off by the partnership agreement expressly prohibiting the insured from controlling any insurance policies owned by the partnership, limiting the insured to a limited partnership interest or by using a bare bones collateral assignment or sole ownership method. In PLR 9204041, there was a split dollar arrangement between a life insurance trust and a partnership with a bare bones collateral assignment. The IRS

concluded that the rules applicable to split dollar and the controlled corporation also applied to split dollar in a partnership but there were no incidents of ownership attributable to the insured from the partnership because of the partnership's limited rights to the cash value of the policy.

(2) Loan Regime and Economic Benefit Regimes Split Dollar Arrangements. These are arrangements entered into or materially modified on or after September 18, 2003.

(a) The new final regulations are strangely silent as to whether they apply to split dollar arrangements between a partner (or life insurance trust) and a partnership. The regulation has a section which is reserved for life insurance contracts owned by partnerships. Reg. Section 1.61-22(c)(1)(iv). Perhaps the concern is determining whether there is a real partnership. The IRS has a policy against rulings involving transfer for value where partnership assets consist of 50% or more of insurance policies. *See* Rev. Proc. 2007-3, Section 3.01(7), 2007-I.R.B., January 2, 2007 (adopting a no-ruling position when the unincorporated organization's assets are "substantially all" insurance policies). Apparently, the Service's position is that 50% or more of the partnership assets constituting life insurance is "substantially all. *See* PLR 200017051. Hopefully, the IRS will give guidance in the near future.

(b) Assuming that the new split dollar regulations do apply to partnership split dollar arrangements, the loan regime should be treated as a loan rather than an ownership interest by the partnership in the policy. Reg. Section 1.7872-15(a). Consequently, the loan itself should not result in incidents of ownership under IRC Section 2042. However, as mentioned above in connection with controlled corporations, if there is a collateral assignment in favor of the partnership, it should be drafted as a bare bones collateral assignment in order to avoid any incidents of ownership from that document.

(c) Again, assuming that the economic benefit regime split dollar rules would apply where the partnership owns the policy and there is an endorsement of part of the death proceeds to the life insurance trust, the partnership incidents of ownership (since it is the owner) could be attributed to the insured partner if the aggregate theory discussed above is adopted. Again, in order to avoid this problem, the partnership agreement should prevent the insured partner from having any say with regard to the policies and their incidents of ownership either as a general partner or a limited partner.

C. CRUMMEY WITHDRAWAL POWERS — BENEFICIARY/DONEE. As in the case of gift taxation, a trust beneficiary who possesses a withdrawal power at the date of death or has allowed withdrawal powers to lapse before the date of death can experience estate tax complications.

1. Unlapsed Powers. If a beneficiary should die while possessing a Crummey withdrawal right which has not lapsed, the property subject to the withdrawal right will be includable in his gross estate as a general power of appointment. IRC Section 2041(a)(2). The risk of possessing a general power of appointment at the date of death is reduced by limiting the Crummey withdrawal power to a specific period of time, *e.g.*, 30 days, since the direct inclusion would only occur if the beneficiary died within that period of time.

2. Lapsed Powers. The Code also states that any property which was subject to a general power of appointment which was released or allowed to lapse by the possessor of the power will be includable in the possessor's estate if the transfer of such property will be includable in the possessor's estate under IRC Sections 2035 to 2038 if the property had been owned by the possessor before transfer to the trust. IRC Section 2041(a)(2) and (b)(2). Thus, the annual lapse of Crummey withdrawals will subject the property covered by the powers to inclusion in the beneficiary's estate.

3. The 5 and 5 Exception. However, if the Crummey power for each beneficiary is limited to the greater of $5,000 or 5% of the value of the trust property, the lapse of the power will result in no inclusion in the beneficiary's estate. IRC Section 2041(b)(2).

a. To the extent that the lapse of a withdrawal power exceeds the 5 and 5 exception, only the excess would be includable in the beneficiary's estate. Note that the exception applies only to the lapse and not the waiver or release of a power.

b. The value of each lapsed gift in excess of the 5-and-5 exception would not be the exact value of the powers subject to the lapse but would be determined by a fraction of the trust assets specified in Reg. Sec. 20.2041(d)(4). Thus, as the annual lapse of the excess withdrawal powers expressed as a fraction of the trust assets accumulates, a growing portion of the trust assets would be subject to estate tax inclusion for the beneficiary. See Whitty, "Crummey Trust Computations," 9 Probate & Property 35 (Jan/Feb 1995). *Also see* PLR 200022035.

4. Only One 5 and 5 Exception Each Year. There is only one 5 and 5 exception each year for every beneficiary who lets his withdrawal powers lapse, even though he has several withdraw powers for trusts created by different grantors. Rev. Rul. 85-88, 1985-2 C.B. 201.

5. $12,000 v. $5,000 Dilemma. As in the case of gift tax consequences to the beneficiary who allows his Crummey power to lapse, there is a dilemma for the grantor of the irrevocable life insurance trust as to whether to shelter the full $12,000 ($24,000 if split gift elected) of annual gifts to the trust from becoming taxable gifts to the grantor or

limit the shelter to the 5 and 5 exception in order to protect the beneficiary from untoward estate tax consequences.

a. Two of the solutions to prevent gift tax exposure to the beneficiary are not available to prevent estate tax exposure — giving the beneficiary a special or general power of appointment or by distributing the assets to the estate of the beneficiary. This would continue to result in estate tax exposure to the beneficiary.

b. The hanging power would have applicability to both the gift and estate tax problems for the beneficiary. Of course, to the extent that the hanging power is still in existence at the date of the beneficiary's death, the property subject to the hanging power would be includable in the beneficiary's estate as a general power of appointment. However, if the hanging power works, this would limit the estate tax exposure to the amount of the unlapsed gifts and not to a fractional share of the trust assets. See the earlier discussion concerning the practical problems of hanging powers.

c. If the beneficiary has a lifetime interest in the trust (*e.g.*, a dynasty trust) such beneficiary could have significant estate tax problems if the 5 and 5 exception is not followed and the hanging power is not valid. If a dynasty trust is involved, the failure to follow the 5 and 5 exception would result in diminished GST possibilities.

VI. GENERATION-SKIPPING TRANSFER (GST) TAX CONSEQUENCES

A. POTENTIAL LEVERAGE OF IRREVOCABLE LIFE INSURANCE TRUST BY USE OF GST EXEMPTION

1. Just as the proper use of the gift tax annual exclusion and the estate/gift unified credit for the lower insurance premium gifts to a life insurance trust can shelter from estate taxation to the insured grantor the much higher insurance proceeds received by the trust at his death, the proper use of the GST exemption for premium contributions to the trust can result in the elimination of GST and other transfer taxes for trust property ultimately distributed to grandchildren or even younger generations as long as the inclusion ratio of the trust remains zero. Thus, the leverage of using gift tax exclusions, unified credit exemption and GST exemption against premium gifts to a life insurance trust to avoid transfer taxation of the insurance proceeds are useful whether the desire is to avoid taxation at the death of the grantors and their children or at the death of subsequent generations up to the rule against perpetuity in the case of a dynasty trust. Yet, the insurance proceeds after the death of the insured are available to pay other estate taxes and debts at the death of any family member (through loans or purchases) and to support younger generations of the family.

2. Additional leverage can be achieved by having the trust purchase a second to die policy on the joint lives of the mother and the father (if the insurance proceeds are only needed to provide liquidity to pay estate taxes at the death of the survivor). The much smaller premium required on joint lives policies allows a more effective use for leverage of the gift tax annual exclusion, the unified credit and GST exemption.

3. Additional leverage can be achieved if a family corporation is involved through a split-dollar arrangement with the corporation whereby the value of the gift to the life insurance trust is the much reduced government or insurance carrier's term premium rate because of the corporation's partial ownership of the policy (economic benefit regime) or the applicable federal interest rate (loan regime). If a second to die policy is involved, the term rate is even lower creating more leverage. Of course, one must be careful of the controlling shareholder estate tax rule and the ever increasing income and gift tax consequences of the term rates during the existence of the economic benefit regime split-dollar arrangement.

B. LIFE INSURANCE TRUST PLANNING AND THE GST TAX. Life insurance is the ideal asset for a grandfathered or exempt trust because of its inherent appreciation — all of which will be exempt from the GST tax.

1. Grandfathered Irrevocable Life Insurance Trusts. Life insurance trusts which are irrevocable on or before September 25, 1985 (Reg. Section 26.2601-1(b)), are totally exempt from the GST tax as long as any subsequent gifts to the trust receive an allocation of a portion of the GST $2,000,000 exemption.

2. Grandfathered Irrevocable Non-Insurance Trusts. Pre-September 26, 1985, irrevocable trusts not established for life insurance purposes are excellent candidates to purchase life insurance and still be totally exempt from GST tax if the trust instrument or state law permits investment in life insurance.

a. If the assets in the grandfathered trust are sufficient, large amounts of insurance could be purchased without the insured having to use GST exemption (or gift tax annual exclusions) to meet future premium payments. However, if the insured has to supplement trust property by future gifts to pay premiums, future gifts should receive an allocation of GST exemption.

b. If the insurance is on the life of either the grantor or the grantor's spouse, income of the trust up to the premium payments will be taxable to the grantor under the grantor trust rules if trust income may be used to pay the premiums. IRC Section 677(a).

3. Non-Grandfathered Irrevocable Life Insurance Trusts. If post-September 25, 1985, life insurance trust is for the benefit of grandchildren or other skip persons, the GST tax will not apply to the trust as long as all transfers to the trust receive an allocation of GST exemption.

C. RELATION OF THE GST EXEMPTION TO IRREVOCABLE LIFE INSURANCE GIFTS

1. Automatic Allocation and Allocation of Exemption on Timely Filed Return. If an exemption is automatically allocated or in the case there is no automatic allocation, if a gift tax return is timely filed, the value of the premium gift to the trust for GST purposes is the value on the date of transfer. IRC Section 2632(c). Reg. Section 26-2642-2(a)(1).

2. Allocation of Exemption on Untimely Filed Return. If the GST exemption is not automatic and if a gift tax return is not timely filed, the value of the premium gift for GST exemption allocation purposes is the value of the premium gift at the date the

allocation is filed with the Secretary (on a subsequent gift tax return). Reg. Section 26.2642-2(a)(2).

a. GST Appreciates. Thus, the failure to allocate a GST exemption on a timely filed gift tax return will result in any future appreciation of the transferred property affecting the amount of a future allocation of GST exemption. If the insured should die within that period of time, then the allocation of GST exemption would be based on all or part of the insurance proceeds rather than the original premium gift.

b. GST Depreciates. Presumably, if the value of the premium gift declines, then the lower value at the date the untimely gift tax return is filed would be used in determining the amount of GST exemption allocation. Does this give the taxpayer a chance to play games with gifts to life insurance trusts and will the IRS let the taxpayer get away with the games? Gingiss, "A Road Map to Generation-Skipping Elections," Probate & Property, March/April 1990, p. 19 at 21-23.

(1) In the early years of many whole-life insurance policies, the cash value (actually, interpolated terminal reserve plus unused premium) is less than the aggregate premium payments on the policy. Can the insured take advantage of this situation by blocking an automatic GST exemption allocation and by filing an untimely GST exemption allocation shortly after the due date for the gift tax return for the year of the gift? If so, he might be able to reduce the use of allocation to all or part of the cash value of the policy rather than the higher premium gift.

(2) In the case of a term insurance policy (or term premium reimbursement split-dollar policy) the value of the gift to the life insurance trust would be the term premium.

(a) If the insured blocks an automatic GST exemption allocation and lives beyond the term premium payment period, can the donor claim that no GST exemption allocation is necessary even on a late return because the premium gift value is now zero since it was "used up" during the premium payment period?

(b) If the insured died before the expiration of the term premium payment and before the due date of the gift tax return, the insured's executor should either allow the automatic allocation to take place or, if not automatic, should file a timely gift tax return allocating GST exemption for the value of the premium gift retroactive to the date paid. Failure to do so would require allocation of GST exemption for the entire insurance proceeds.

(c) In order to prevent the coverage period extending beyond the filing date of the gift tax return, anniversary dates for term policies should be before April 15th.

(3) Will the IRS agree? At this time, the answer is not clear. A cautious approach would be to claim a full premium gift value of GST

exemption on a timely filed gift tax return even though a term or split-dollar policy or a policy with a cash value increase of less than the premium payment is involved.

3. Exemption Allocation Needed for Almost all Life Insurance Trusts. For transfers to an irrevocable life insurance trust after March 31, 1988, the only practical way to achieve an inclusion ratio of zero is to use some of the grantor's GST exemption. The only type of trust which qualifies for the gift tax annual exclusion and which is also excluded as a GST is a trust which is for the sole benefit of a single skip person with the trust assets includable in the skip person's gross estate at death (*e.g.*, a trust for the sole benefit of a grandchild who has a Crummey withdrawal power and who also possesses a general power of appointment over trust assets). IRC Section 2642(c). Thus, this type of trust would not apply to the typical irrevocable life insurance trust for the benefit of a spouse, children and multiple grandchildren even though contributions might be sheltered from gift taxation by the gift tax annual exclusion.

D. IMPACT OF CRUMMEY WITHDRAWAL POWERS. The impact of the lapse of Crummey withdrawal powers on the GST exemption and tax depends upon whether the lapse was within the 5 and 5 exception or in excess of the 5 and 5 exception but the powerholder's gift taxation is delayed because of a special power of appointment or a hanging power or whether a gift tax return is timely filed.

1. Who is the Transferor? Grantor or Powerholder

a. Definition. For GST purposes, the transferor is the individual with respect to whom property was most recently subject to federal estate or gift tax. Reg. Sec. 26.2652-1(a)(1).

b. Transfer Subject to Federal Estate or Gift Tax. For GST purposes, a transfer is subject to federal gift tax if a gift tax is imposed (without regard to exemptions, exclusions, deductions and credits). A transfer is subject to federal estate taxes if the value of the property is includable in the decedent's gross estate. Reg. Sec. 26.2652-1(a)(2).

c. Split Gift Transfers. If the donor's spouse makes an election under IRC Section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as transferor of one-half of the entire value of the property transferred by the donor and the donor is treated as the transferor of one-half of the value of the entire property. Reg. Section 26.2652-1(a)(5), Ex. 9.

2. Impact of Crummey Withdrawal Powers Upon Who is Transferor

a. Lapse Within the 5 and 5 Exception. If the withdrawal power is limited to the 5 and 5 exception, the grantor will be the transferor for GST purposes of the entire gift to the trust since the lapse of a power within the 5 and 5 exception has no estate or gift tax consequence to the powerholder. Reg. Sec. 26.2652-1(a)(6), Ex. 5. Thus, in the context of a grandchild or dynasty trust, the best estate and gift tax result for the powerholder and the best GST exemption allocation results for the grantor would be to limit the Crummey withdrawal power to the 5 and 5 exception, although this would not maximize the use of the gift tax annual exclusion by the grantor.

b. Lapse of Crummey Power in Excess of 5 and 5 Exception. Even when the withdrawal power exceeds the 5 and 5 exception, the grantor will remain the transferor of the amount of the gift up to the 5 and 5 exception since the lapse of that amount does not subject the powerholder to any gift or estate tax consequences. However, the lapse of the power in excess of the 5 and 5 exception could make the powerholder the transferor of the excess lapse depending upon the gift tax consequences of the lapse.

(1) Incomplete Gift Because of Powerholder's Power of Appointment. As noted earlier, the lapse of a Crummey withdrawal power in excess of the 5 and 5 exception is treated as a taxable gift by the powerholder to the trust and, if he or she has some retained power under IRC Sections 2035 through 2038, the trust property attributable to such lapse will be includable in his or her gross estate. However, it is quite common for the trust instrument to delay the gift tax consequences by giving the powerholder a special or general power of appointment or by having the trust payable to the powerholder's estate.

(a) Since the gift of the lapsed Crummey power in excess of the 5 and 5 exception is not completed, the grantor of the trust will remain the sole transferor for GST tax purposes requiring the grantor to allocate GST exemption equal to the entire gift to the trust (including the amount in excess of the 5 and 5 exception) in order to retain an inclusion ratio of zero.

(b) Since a fraction of the trust assets will be included in the powerholder's estate based upon the amount of the lapsed powers in excess of the 5 and 5 exception divided by the entire property transfers to the trust, the grantor's allocation of GST exemption to the gift to the trust is wasted to the extent of such estate tax inclusion. Thus, unless a hanging power is used, for a single generation skipping trust or a dynasty trust, the withdrawal power is normally limited to the 5 and 5 exception in order to reduce the estate and gift tax consequences to the powerholder and to increase the effective use of the grantor's GST exemption allocation although the full gift tax annual exclusion of the grantor would not be used.

(c) If a dynasty trust which skips multiple generations is involved, the executor of the powerholder's estate might allocate some of the powerholder's GST exemption to the portion of the trust includable in the powerholder's gross estate since the powerholder would be the transferor of that portion of the trust property for GST purposes.

(2) Impact of Hanging Crummey Withdrawal Powers. In a hanging power situation, since the withdrawal powers will not lapse in excess of the 5 and 5 exception, there would be no gift tax consequences

to the powerholder and the grantor would remain the sole transferor for GST tax purposes.

(a) However, to the extent that the hanging power has not totally lapsed by the death of the powerholder who is only one generation younger than the grantor, the amount subject to the hanging power at the date of the powerholder's death will be includable in his or her estate for estate tax purposes thus frustrating the ability to skip generations and, to that extent, wasting the grantor's GST exemption allocation. If the hanging power works, only the amount of the hanging power at the powerholder's death is subject to estate taxation and not a pro rata share of the insurance proceeds which would be protected from the GST tax by allocation of the grantor's exemption.

(b) One should be aware of potential gift tax and GST transferor problems in case the trust terminates during the powerholder's lifetime and the hanging power is canceled. At the time the hanging power lapses, there is a completed gift by the powerholder to the other trust beneficiaries and the powerholder will become the transferor for GST purposes of the lapsed hanging power. To avoid this complication, it may be desirable to draft the trust so that it does not terminate until the hanging power has lapsed within the 5 and 5 exception.

c. Lapse of Crummey Power in Excess of 5 and 5 Exception Resulting in a Completed Gift

(1) If the lapse of the Crummey power in excess of the 5 and 5 exception is deemed to be a taxable gift from the powerholder to the trust because of the lack of a special power of appointment or a hanging power, then the powerholder will be deemed to be a transferor to the trust of the amount of the taxable gift upon the lapse of the Crummey power which can be applied against his or her unified credit. Reg. Sec. 26.2652-1(a)(6), Ex. 5.

(2) This would result in two transferors to the trust for GST trust purposes--the original grantor up to the 5 and 5 exception and the powerholder for the excess. IRC Section 2654(b)(1). Reg. Sec. 26.2654-1(a)(2)(i)(ii).

3. Allocation of GST Exemption by Transferor

a. Lapse Does Not Exceed 5 and 5 Exception. Since the grantor is the sole transferor to the trust (there are no gift tax consequences to the powerholder of a lapse), only the grantor's GST exemption would be allocated to the gifts to the trust.

b. Lapse Exceeds 5 and 5 Exception but Incomplete Gift. Once again, the grantor would be the sole transferor since the existence of a special power of appointment in the trust property by the powerholder prevents the lapse

of the withdrawal power from being a completed gift by the powerholder. Consequently, the grantor's GST exemption would be allocated to the entire gift to the trust. However, upon the death of the powerholder, the powerholder will become the transferor for GST purposes of any portion of the trust property includable in the powerholder's gross estate that represented lapses in excess of 5 and 5. In that situation, if the trust would continue for additional generations below the powerholder, the executor of the powerholder's estate would need to allocate some of the powerholder's lifetime GST exemption.

c. Hanging Crummey Withdrawal Powers. The grantor would be the transferor for GST purposes of the entire gift to the trust since there would be no lapse of withdrawal powers in excess of 5 and 5. The grantor would allocate GST exemption to the entire gift. However, any unlapsed hanging power remaining at the death of the powerholder would be included in the powerholder's gross estate. If the trust would continue for multiple generations with respect to the powerholder, the powerholder's executor would allocate some of the powerholder's GST exemption to the portion of the hanging power includable in the powerholder's gross estate.

d. Lapse of a Power In Excess of 5 and 5 Exception Which Constitutes a Completed Gift. If a withdrawal power in excess of the 5 and 5 exemption should lapse and gift consequences with respect to the powerholder are not delayed because of a special or general power of appointment or hanging power, then the powerholder will become a transferor at the date the Crummey withdrawal power lapses and the grantor will be a transferor at the date of the original gift (e.g. 30 or 60 days prior to the lapse of the withdrawal power). In the case of a dynasty trust, it would be necessary for both the grantor and the powerholder to allocate GST exemption to their respective transfers.

(1) With regard to the powerholder, the amount of GST exemption application will be the portion of the lapsed power which exceeds the 5 and 5 exemption.

(2) With regard to the grantor, the amount of GST exemption allocation will depend upon whether the allocation of exemption is automatic, claimed on a timely filed Form 709 or claimed on an untimely filed Form 709.

(a) If the allocation is automatic or if the grantor timely files a gift tax return claiming the GST exemption, the allocation of GST exemption would be to the entire gift to the trust (including the portion in excess of the 5 and 5 exception) in order to achieve an inclusion ratio of zero. This is true since an automatic exemption allocation or an exemption allocated on a timely filed gift tax return is effective on and after the date of such transfer. IRC Section 2642(b)(1)(B). Since the date of the transfer by the grantor precedes the date of the lapse of the Crummey power by the powerholder, the entire gift would be considered a generation skipping transfer by the grantor. The result is a double GST

exemption allocation for the portion in excess of the 5 and 5 exception — grantor and powerholder.

(b) On the other hand where a "separate trust" is created under the Code and regulations (IRC Section 2654(b)(1) and Reg. Sec. 26.26.2654-1(a)(2)(i)) by a taxable gift of the lapsed power in excess of the 5 and 5 exception by the powerholder, the blocking of any automatic allocation on a timely filed gift tax return followed by an allocation of the GST exemption on a return that it not timely filed should allow the original grantor to achieve an inclusion ratio of zero for the original grantor's "separate trust" (the portion representing only the 5 and 5 exception) by just allocating the amount equal to the value of the "separate trust" at the date of allocation. The reason is that allocation of GST exemption other than on a timely filed gift tax return is effective on and after the date on which the allocation is filed with the Secretary of the Treasury. IRC Section 2642(b)(3)(B). The regulation permits the transferor who makes a late allocation of GST exemption to a trust to elect to treat the allocation as having been made on the first day of the month during which the late allocation is made, except with respect to a life insurance policy or a trust holding a life insurance policy if the insured individual has died. Reg. Sec. 26.2642-2(a)(2). However, the value of an untimely allocation is the present value of the gift and not the gift at the date of the original transfer, which could be severely inflated if the insured died in the meantime.

E. LAPSE OF CRUMMEY POWER POSSESSED BY A GRANDCHILD OR YOUNGER GENERATION

1. Non-Taxable Gifts. A non-taxable gift is not subject to the GST tax and is deemed to have an inclusion ratio of zero. These are direct skips (transfers to a skip person) which are not taxable gifts because of the gift tax annual exclusion or the direct payment of medical and tuition expense exclusion. IRC Section 2642(c).

a. For transfers on or before March 31, 1988, the non-taxable gift exclusion included all transfers to trusts for skip persons which qualified for the gift tax annual exclusion because of the Crummey withdrawal powers, IRC Section 2503(c) trust, etc.

b. Effective for transfers after March 31, 1988, TAMRA amended IRC Section 2642(c) to remove from the definition of non-taxable gift transfers to a trust for the benefit of a skip person, unless the trust provides that it is for the benefit of only one skip person, no portion of the trust property may be distributed to or for the benefit of any other individual and the trust assets will be includable in the skip person's estate should he or she die before the trust terminates.

2. Grandchild's (or Other Skip Person's) Trust. If the trust is solely for the benefit of a grandchild (or other skip person) and the trust property is eventually includable in the grandchild's estate (e.g., after termination of the trust or through a

general power of appointment should the grandchild die prior to trust termination), then gifts to such trust up to the gift tax annual exclusion would be non-taxable gifts with an inclusion ratio of zero without any allocation of GST exemption by the grantor. The only types of trust for the sole benefit of a grandchild which would qualify under the statute as direct skips are Section 2503(c) trusts and trusts subject to a grandchild's Crummey withdrawal power.

a. This special trust exemption is not useful if the grantor wishes to make other persons beneficiaries of the trust (e.g. spouse, children, and multiple numbers of grandchildren).

b. Neither is this trust exemption useful for a dynasty trust when the grantor wishes to avoid transfer taxation at the death of the grandchild and delay it until the death of a great grandchild.

3. Grandchild Trust Gift Which is Partially Non-Taxable Gift. If the gift to a trust that is solely for the benefit of a grandchild and which is includable in the grandchild's gross estate exceeds the gift tax annual exclusion (e.g., gift is $12,000.00 and the grandchild's withdrawal power is $10,000.00), solely for the purpose of computing the tax on the direct skip of the gift to the trust, the transfer is divided into two portions. One portion is equal to the amount of the non-taxable transfer ($10,000.00) and has a zero inclusion ratio and the other portion is a GST ($2,000.00). Reg. Section 26.2642-1(d), Ex. 3. Since the gift to the trust is a direct skip, there will an automatic allocation of any remaining GST exemption of the grantor to the $2,000 gift unless the grantor elects against the automatic allocation in a timely filed form 709. IRC Section 2632(b)(1). Reg. Section 26.2642-1(d), Ex. 4.

4. Existence of a Grandchild's Withdrawal Powers Does Not Create a Direct Skip. As mentioned earlier, a direct gift to a grandchild which qualifies for the gift tax annual exclusion is a non-taxable gift with an inclusion ratio of zero. However, a gift to a generation-skipping trust that does not qualify as a "grandchild's trust" (because there are other beneficiaries or the assets are not includable in the gross estate of the grandchild) are not non-taxable gifts and GST exemptions must be used by the grantor to achieve zero inclusion ratio. Before the final regulations were issued, there was some question as to whether a gift to such a trust subject to a Crummey withdrawal power by a grandchild was a non-taxable gift directly to the grandchild or was a gift to the trust which did not qualify as a non-taxable gift. The final regulations make it clear that a gift to a trust subject to a withdrawal power by the grandchild is a gift to the trust and not to the grandchild in determining whether there is a non-taxable gift. Reg. Section 26.2652-1(a)(5) Ex. 5.

F. ETIP RULES AND WITHDRAWAL POWERS

1. Estate Tax Inclusion Period (ETIP). A GST exemption cannot be allocated to property until the close of the ETIP. IRC Section 2642(f). The ETIP is the period during which, should death occur, the value of the transferred property would be includable in the gross estate of the transferor or the spouse of the transferor (other than by reason of IRC Section 2035). Reg. Section 26.2632-1(c)(2).

2. Spousal Crummey Powers. Under a literal reading of the statute, any withdrawal power by the spouse over the trust, including Crummey withdrawal powers, would constitute an ETIP, which would prevent GST allocation by the transferor until the lapse of the power.

a. The final regulations create a limited exception for Crummey withdrawal powers possessed by a spouse of the transferor if the withdrawal power is no more than the greater of $5,000.00 or 5% of the trust corpus and such withdrawal power terminates no later than 60 days after the transfer to the trust. Reg. Sec. 26.2632-1(c)(2)(ii)(B).

b. Thus, under the ETIP rules, a spouse can have a 5 and 5 withdrawal power that does not exceed 60 days. Note that a hanging power would be unavailable to the spouse without constituting an ETIP.

VII. SOME THOUGHTS ON SELECTING CRUMMEY WITHDRAWAL CLAUSES

A. ONE GENERATION TRUST. In many cases, a donor faced with gifts in excess of $5,000 per donee will prefer to ignore the 5 and 5 exception rather than use up his or her unified credit or pay a gift tax currently just to save estate taxes for the beneficiary at some future date. This is particularly true if the trust is likely to terminate after the death of the grantor with the trust assets being distributed to the beneficiary for ultimate inclusion in his or her taxable estate. The only risk is if the beneficiary should predecease the grantor. In such a case, if the trust would otherwise quality for automatic allocation of GST exemption, an election out of allocation must be made on a timely filed gift tax return.

B. LIFETIME BENEFICIARIES. If the beneficiary has a lifetime interest in the trust (e.g., a dynasty or a GST trust), the safest approach is to follow the 5 and 5 exception to avoid any possible gift and estate tax consequences to the beneficiary.

C. FRONTEND LOAD. The $5,000.00 versus $12,000.00 dilemma could be eliminated if the grantor of the trust is willing to frontend load the trust with $240,000.00 or $480,000.00 of assets so that the five percent (5%) portion of the 5 and 5 exception would equal the full $12,000.00 (if one Grantor) or $24,000.00 (if there are community property gifts by husband and wife grantors).

D. HANGING POWER SOLUTION. As indicated earlier, if the 5 and 5 exception is not large enough to cover the full gift tax annual exclusion, the hanging power can preserve the gift tax annual exclusion in excess of the 5 and 5 lapse for the current year.

Disclosures: The views expressed in this outline are those of the author and do not necessarily reflect the position of the University of Texas System.

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