THE IRREVOCABLE LIFE INSURANCE TRUST  
WITH CRUMMEY WITHDRAWAL RIGHTS

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IRREVOCABLE LIFE INSURANCE TRUST  
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# Introduction

## General Characteristics of an Irrevocable Life Insurance Trust (“ILIT”).

### Irrevocable. An ILIT is always irrevocable.

### Life Insurance is Principal Asset. Initially, life insurance policy (or policies) is primary asset. Policy generally insures the life of the grantor, grantor’s spouse or second to die of the grantor and spouse.

### Gifts Are Source of Premium Payments. An ILIT receives funds for life insurance premium payments through gifts from grantor-insured, non-insured spouse[[1]](#footnote-1), grantor- insured’s children and/or others.

### Usually a “Crummey” Trust. In the large majority of cases, an ILIT gives the beneficiaries Crummey-type withdrawal rights. The “Crummey” label comes from a famous gift tax case which held that a gift to a discretionary trust for a beneficiary qualifies for the gift tax annual exclusion only if that beneficiary (or his guardian) has an opportunity to withdraw the gift.

## Main Advantages of the Crummey Trust.

### Proceeds Received Estate Tax Free. If properly structured, insurance proceeds will be excluded from the estates of both the grantor-insured and his spouse for federal estate tax purposes.

### Proceeds Free From GSTT. Proceeds can also be insulated from the onerous and draconian generation-skipping transfer tax (“GSTT”).

### Proceeds Available to Provide Estate Liquidity. Although received free from estate and generation-skipping transfer taxes, insurance proceeds can nonetheless be made available to insured’s and/or spouse’s estate to provide estate liquidity through arms-length loans and asset purchases.

### Minimum Adverse Gift Tax Consequences. Adverse gift tax consequences to donor(s) can be minimized and often eliminated.

### Proceeds Insulated From Creditor Claims. Proceeds (and life insurance cash values) can often be insulated from the claims of the grantor-insured’s or beneficiaries’ creditors.

### Flexible Trust Provisions. The trust provisions can be much more flexible than life insurance policy settlement options.

## Disadvantages.

### Administrative Costs. There are costs and administrative burdens associated with drafting, implementing and maintaining the trust. These can include, but are not limited to, the cost of drafting and establishing the trust, ongoing notice requirements each time a gift is made to the trust, and annual tax return filing requirements.

### Current No-Ruling Policy Raises Uncertainty. The IRS[[2]](#footnote-2) no ruling policy casts a cloud of uncertainty over the tax consequences of Crummey insurance trusts. See Rev. Proc. 99-3, 1999-1 I.R.B. 103, §§ 5.22 and 5.27. The Service will not issue rulings or determination letters on the allowability of the annual gift tax exclusion for transfers of property to irrevocable trusts if those trusts have the following features: (1) the trust corpus consists substantially of insurance policies on the life of the grantor or the grantor’s spouse; (2) the trustee or any other person has the power to apply trust income or corpus to premium payments for insurance on the life of the grantor or the grantor’s spouse; (3) the trustee or any other person has the power to use the trust assets to make loans to the grantor’s estate or purchase assets from the grantor’s estate; (4) the trust beneficiaries have the power in any person to withdraw, on demand, any additional transfers made to the trust; and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under I.R.C. §§ 673-677.[[3]](#footnote-3)

### Trust Irrevocable. Trust is irrevocable, i.e., insurance belongs to the trust, not client. Some clients lose sight of this fact.

### Biggest Disadvantage—Waste of the Client’s Unified Credit. The most serious “disadvantage” of the irrevocable trust with “Crummey” withdrawal rights is the bad tax effect that results from a trust that is improperly implemented and carelessly administered. As will be noted later in this outline, that “disadvantage” can be avoided (or at least controlled). Practitioners should not minimize the consequences of unnecessary waste of a client’s unified credit that will occur if the formalities of implementation and administration of this type of trust are ignored.

## Focus of Outline. This outline addresses a wide variety of gift, estate, generation skipping, and income tax consequences of the establishment and implementation of the irrevocable life insurance trust with Crummey type withdrawal rights. However, the focus of today’s presentation will be on the proper implementation and administration of these trusts to take full advantage of the gift, estate and generation-skipping tax savings that can occur with this trust arrangement. In particular, we will examine those situations that often do give rise to a waste of the unified credit, i.e., those situations where the irrevocable life insurance trust with Crummey withdrawal rights serves more as a meat cleaver than a light sabre vis-a-vis utilization of the unified credit.

# tAX cONSEQUENCES TO THE gRANTOR

## Gift Tax Consequences to Grantor-Insured. There could be gift tax consequences to the grantor-insured upon his establishment and continued funding of the trust. If the grantor-insured transfers, by gift, an existing life insurance policy to the trust, the gift tax consequences depend on (1) the date-of-gift value of the policy and (2) the provisions of the trust. There will be similar gift tax consequences if the grantor-insured makes cash gifts to the trust to enable the trustee to pay life insurance premiums.

### Basic Statutory Provision.

#### In General. A donor may make gifts of cash and/or other property of up to $15,000 per donee each calendar year without having to pay a gift tax or even file a gift tax return. If a donor-spouse makes gifts of separate property and the non donor-spouse joins in the gifts (as authorized by I.R.C. § 2513), or if a married couple, domiciled in a community property state, makes gifts of community property, the couple can give away up $30,000 per donee per year. To qualify for this annual gift tax exclusion, the gifts must be gifts of a present interest. I.R.C. § 2503(b).

#### Present and Future Interest Defined.

##### Gift of a Present Interest. A gift of property to a beneficiary is a gift of a “present interest” if the beneficiary has the unrestricted right to the immediate use, possession, or enjoyment of the gifted property. Treas. Reg. § 25.2503-3(b). For example, a father’s outright gift of cash to his son is a gift of present interest, as is father’s payment of premiums on a life insurance policy that is owned by his son. Treas. Reg. § 25.2503-3(c), Example (6).

##### Gift of a Future Interest. A gift of property to a beneficiary shall be a gift of a “future interest” if the beneficiary’s enjoyment of the property is limited to commence in use, possession or enjoyment at some future date or time. Treas. Reg. § 25.2503-3(a): Fondren v. Commissioner, 324 U.S. 18 (1945). See also Rev. Rul. 83-108, 1983-1 C.B. 14, 15 (The IRS points out that if a trustee has discretion to accumulate the trust income even for a brief period, the gift of an income interest is a gift of a future interest.).

##### Transfer of Life Insurance Policy. An outright transfer of a life insurance policy is a gift of a present interest even if the policy has no cash value. Treas. Reg. § 25.2503-3(a); Rev. Rul. 55-408, 1955-1 C.B. 113.

#### Value of Gift of Policy. The value of a life insurance policy for gift tax purposes is generally based on the sale of comparable contracts. Treas. Reg. § 25.2512-6.

##### New Policy. If the grantor-insured makes a gift of the policy immediately after its purchase, the gift tax value is the gross premium for the policy. Treas. Reg. § 25.2512-6(a), Example (1).

##### Existing Policy. If the policy is an existing policy that is not paid-up, the gift tax value is the date-of-gift value of the sum of the policy’s interpolated terminal reserve and the unearned premium minus the date-of-gift value of the outstanding loan on the policy. Id., Example (6).

##### Single Premium Policy. If the policy is a single premium or paid-up policy, the gift tax value is the single premium charged currently for a comparable contract of equal face value on a person of the insured’s age at the time of assignment. Id., Example (3).

##### Term Policy. The value of a term policy is probably equal to the policy’s unearned premium at the time of the gift. But see Rev. Rul. 76-490, 1976-2 C.B. 300 (IRS held that insured-employee’s interest in group term life insurance policy has no ascertainable value.).

##### Policy Subject to Split Dollar Agreement. The gift tax value of a policy subject to a split dollar agreement is the interpolated terminal reserve plus the value of the unearned premium on the date of the gift, minus the date-of-gift value of the employer’s interest in the policy. Rev. Rul. 81-198, 1981-2 C.B. 188.

##### Do Traditional Value Principals Apply to Modern Policies? The valuation of modern types of policies (e.g., universal life, variable life, policies with no-lapse guarantees) may not be susceptible to traditional valuation methods. See Brody, Lawrence, What’s Hot in Sophisticated Life Insurance Planning in 2013–Policy Valuation Issues, Life Settlements, and Insurable Interests, 32nd Annual Kansas City Estate Planning Symposium, April 26, 2013, PP 1–10.

#### Gift Tax Consequences Re: Premium Payments - General. If a donor gives a life insurance policy to a donee but continues to pay the premiums on that policy, each premium payment is a gift by the donor to the donee. Treas. Reg. § 25.2503-3(c), Example (6); Rev. Rul. 76-490, 1976-2 C.B. 300 (Insured irrevocably assigned his group term insurance to a trust. The IRS held that each time the employer made a premium payment on the group term coverage, the employer premium payment resulted in an indirect gift to the trust by the employee.).

#### Group Term Insurance - Employer Premium Payments. With respect to the assignment of group term coverage, the value of the gift can be computed with reference to the premiums under Table I of Treas. Reg. § 1.79-3(d)(2) so long as the company’s plan of group term insurance meets the non-discrimination requirements of I.R.C. § 79(d) or so long as the employee-assignor is not a key employee within the meaning of I.R.C. § 79(d)(6). Rev. Rul. 84-147, 1984-2 C.B. 201.

#### Employer Split Dollar Arrangements. With respect to insurance subject to a split dollar arrangement, Rev. Rul. 78-420, 1978-2 C.B. 67, holds that employer premium payments on a policy on the employee’s life owned by the non-employee wife and subject to a split dollar insurance arrangement would result in a gift equal to the P.S. 58 cost (or the company’s one-year term rates, if lower) less the wife’s contribution toward premiums. If the policy is a “second-to-die” policy and both insureds are alive, the “very economical” P.S. 38 rates can be used in place of the P.S. 58 rates. See also, TAM 9604001.

#### Intergenerational Private Split Dollar Arrangements; Morrissette v. Comm., 146 T.C. 171 (2016). Discussed with Cahill v. Comm. at page 29.

### The Crummey Case and Subsequent Pronouncements.

#### The Statutory and Judicial Setting. Gifts to discretionary trusts can, without more, be gifts of a future interest unless the trust meets the requirements of I.R.C. § 2503(c), or unless the trust grants the beneficiaries Crummey withdrawal rights.

##### The Crummey Case--Crummey v. Comm., 397 F.2d 82 (9th Cir. 1968). FACTS: Taxpayer-donors established irrevocable trusts for the benefit of each of their four children. Each time a gift was made to a trust, the beneficiary was given the right to demand at any time, up to December 31st of the year in which the gift was made, the lesser of $4,000 or the amount of the gift. If the beneficiary was a minor at the time of the gift, his guardian could demand the money on his behalf. If no demand was made by the beneficiary or his guardian, the gift irrevocably became a part of trust corpus.

HELD: Although conceding that demands by the minors were not likely to be made, the Ninth Circuit held that the gifts, coupled with the demand rights, constituted gifts of a present interest. In Crummey, no guardians had officially been appointed for the years when the gifts under scrutiny were made and, in fact, there could be no demand made by the minors. The court also noted that it was unlikely that minor- beneficiaries knew (or would ever know) about the gifts.

##### Significance of Holding. Because of Crummey, it is possible to structure an irrevocable trust for a beneficiary that qualifies for the $15,000 exclusion even if the trustee has absolute discretion over distributions.

#### The Doctrine Since Crummey. Through a series of public and private rulings, the IRS has limited the scope of the Crummey decision.

##### General Rule--Minor Beneficiaries. If a gift is made to a discretionary trust for a beneficiary who is a minor and that beneficiary is given the right under the trust instrument to demand distribution of that gift to himself, the gift shall be a gift of a present interest as long as the trust instrument or local law does not prevent the appointment of a guardian who could exercise the withdrawal right in the minor’s behalf. Rev. Rul. 73-405, 1973-2 C.B. 321; Mary Hull Naumoff, 46 T.C.M. 852 (1983).

##### Adult Beneficiaries Must Have Notice of Withdrawal Right. Under Rev. Rul. 81-7, 1981-1 C.B. 474, the IRS held that after a gift is made to a Crummey-type trust, each adult beneficiary must have (a) actual notice of his withdrawal right and (b) an adequate or reasonable opportunity to exercise the withdrawal right prior to its lapse. Otherwise, no present interest exclusion will be available as to that adult beneficiary. See also PLRs 8019038; 8121069; 8813019; 9232013; 9532001 and 9625031.

##### Notice Need Not Be In Year of Gift. However, in Rev. Rul. 83-108, 1983-1 C.B. 14, the IRS held that a gift made at the end of 1981 to a Crummey trust which granted the beneficiary a withdrawal right that did not lapse until the following year constituted a gift of a present interest in 1981. This is because the beneficiary had a reasonable opportunity to exercise the withdrawal right. Note, in this ruling, the beneficiary did not receive notice of the gift and withdrawal right until 1982.

##### Should Notice Be Given to Minor Beneficiaries? It is currently unsettled whether a parent-donor, pursuant to the terms of the trust, can receive notice of a gift and exercise (or decide not to exercise) a withdrawal right in the minor child-beneficiary’s behalf. Under Ltr. Rul. 8008040 (11/28/79), the IRS held that such an arrangement did result in a gift of a present interest. See also PLRs 8022048 (3/4/80); 7944019 (7/31/79). But see PLR 8330005 (3/29/83) which held, in the context of I.R.C. § 2035, that a donor-parent’s power to exercise a withdrawal right in behalf of the donor’s minor children was illusory since it would be against the parent’s interest to exercise the withdrawal right in the children’s behalf.

A minor or incompetent beneficiary should have enough time to have a guardian appointed to make the election. See PLRs 8813019; 8134135; and 8103074.

##### The Naked or “Near Naked” Withdrawal Right. In PLR 8727003 (3/16/87), the Service held that a beneficiary must have more than a mere withdrawal right over the trust before the annual exclusion would be allowed as to gifts to that trust. The Service concluded that a “gift coupled with a withdrawal right” would qualify for the annual exclusion only if the withdrawal right was actually exercised or if the beneficiary had a continuing (i.e., more than a nominal) interest in the trust.

In TAM 9045002, the IRS again held that beneficiaries whose only interests in the trust were mere withdrawal rights or contingent remainder interests did not receive gifts of a present interest because in the IRS’ view, adding beneficiaries with such limited rights was nothing more than an attempt to avoid the federal gift tax through a proliferation of annual exclusions. But see Cristofani v. Comm., 97 T.C. 74 (1991), acq. in result only, where the Tax Court approved of Crummey-type powers even though (a) the withdrawal period was only 15 days, (b) none of the donees had any interest in the trust until after the insured’s death and (c) some of the grandchildren/donees were merely contingent remaindermen. See also, PLR 9030005.

##### Continued Attack on “Naked Withdrawal Rights” Despite Cristofani. Despite the taxpayer victory in Cristofani, the Internal Revenue Service continued its attack on what it viewed as abusive arrangements designed to improperly expand the availability of annual gift tax exclusions. In TAM 9141008 (June 14, 1991), the Internal Revenue Service addressed a situation which it felt epitomized “abusive Crummey trusts.” In that situation, the decedent, prior to her death, established three irrevocable trusts, one for the benefit of each of her three children. Each trust lasted for a child’s lifetime and provided that all income was to be distributed to that child on a quarterly basis. Upon the death of the child, that child was given a limited testamentary power of appointment to appoint the trust to his or her spouse. Any unappointed property was to be held in further trust for the child’s then living issue. Each trust further provided that when the donor made gifts to the trust, each of that child, his or her children and grandchildren and spouse had a Crummey type withdrawal right as to a pro rata portion of the gift.

At the time that the trust was established, the decedent had three children and 32 grandchildren and great-grandchildren. From 1984 through 1987, the decedent made gifts of partnership interests having a value of $350,000 per year ($10,000 multiplied by 35 beneficiaries). Gift tax returns were filed each year claiming 35 annual exclusions.

The National Office of the Internal Revenue Service rendered an opinion that only the gifts for the benefit of the three children would qualify for the annual gift tax exclusion. The following language from the ruling outlines the basis for the IRS’ position:

The pertinent factual question is whether the beneficiaries ever expected that any of them (other than the donor’s children) would enjoy any bona fide rights at all. Under the instrument, any of the beneficiaries had the right to make a demand upon the trust. Under the facts of this case, where the nominal beneficiaries (other than the donor’s children) enjoyed only remote contingent rights to the remainder, there is no reason why at least one of them would not have exercised his withdrawal rights, unless there was some kind of an understanding with the donor that no one would do so, or that they knew that doing so would result in undesirable consequences of some kind, or both.

. . . More conspicuously, in our case, it is understandable that the donor’s three children would not exercise their right of withdrawal. All of them had substantial future rights in the Trusts. But it is significant that none of the other 32 beneficiaries ever exercised any withdrawal rights, despite numerous opportunities to do so over a four year period, and despite the absence of any logical reason for their failure to do so. It must be inferred that the beneficiaries had reached a prior understanding with the donor that the withdrawal rights would not be exercised.

Author’s Comment: The National Office’s logic in this case is interesting, and if ultimately proven to be correct, puts a taxpayer in a box. Basically, the IRS is saying that unless a beneficiary has more than a contingent interest in the trust, his or her failure to exercise the withdrawal right is, in fact, evidence of a pre- arrangement not to do so despite the fact that the beneficiary has a legal right to do so. With this ruling, the IRS begins its onslaught on Crummey withdrawal rights under the “prearranged plan” theory.

The IRS continued its battle through two subsequent announcements. In AOD 1992-09, 1992-2 C.B.1, 1992 TNT 74-31, the IRS indicated it intended to litigate cases “whose facts indicate a greater abuse of the Crummey power than those of Cristofani, preferably outside the Ninth Circuit.” While the IRS indicated it will attack transfers that show a greater abuse than in Cristofani, it also concluded that extending the invasion power beyond income and vested remainder interests is an abuse.

No pronouncements occurred for the next couple of years (apparently because the Internal Revenue Service was waiting for the “right” fact pattern). The Service then issued two pronouncements on the same day. In the first, AOD 1996-010, the IRS rejected the Cristofani opinion to the extent it extended invasion powers to persons other than holders of income interests or “vested” remainder interests. The new AOD said that absent the powerholders having “continuing economic interests” in the trust, the Crummey doctrine did not apply. The Service went further by stating that the IRS shall deny annual exclusions if it concludes that in substance there was a “prearranged understanding that the withdrawal right would not be exercised or that doing so would result in adverse consequences to its holder (e.g., losing other rights or gifts under the instrument or other beneficial arrangements).”

On the same day the IRS released TAM 9628004 for publication. This technical advice memorandum denied annual exclusions for interests in irrevocable trusts under the theory that the donor did not intend to make bona fide gifts. These trusts granted three children, their spouses and seven grandchildren Crummey type withdrawal rights but under the instrument, there was no requirement that the trustee provide notice of gifts to the beneficiaries. Despite this requirement, in most years, notice of the gifts and attendant withdrawal rights were made in late December and the withdrawal rights lapsed at the end of December. The IRS completely denied annual exclusions for all transfers to the trusts. The Service’s position was that many beneficiaries had no genuine interest in the trust other than invasion rights. The Service opined that there was no logical reason for them not to exercise their invasion rights and therefore the IRS argued that there must of been a prearranged understanding among all the beneficiaries that these rights were “naked withdrawal rights” because by exercising them bad consequences would flow to the holders of the power.

Author’s Comment: Two of the most troubling aspects of the AOD and TAM mentioned above are the requirements that a beneficiary have a “vested remainder” interest in a trust and the Service’s insistence that given a remote interest, the failure to exercise a withdrawal right must necessarily give rise to a pre-arrangement.

##### Estate of Lieselotte Kohlsaat v. Comm., T.C.M. 212 (1997). In Kohlsaat the IRS finally had an opportunity to argue its “prearranged plan” doctrine in a case which it believed represented the “quintessential abusive Crummey trust” situation. In Kohlsaat, the taxpayer, before her death, transferred a building worth $155,000 to two trusts. Each trust was for the primary benefit of one of her two children, who were also co-trustees of the trusts. Under each trust, each child was entitled to receive all income and could receive discretionary distributions of principal (however, a child who is also a trustee could not distribute to himself or herself). Each child was also given a special power of appointment (exercisable during life and at death) to appoint property among his or her issue. Unappointed property would pass to the child’s issue, per stirpes.

Under the trust, each of the two children plus sixteen adult and minor grandchildren (who were contingent remaindermen) were given Crummey type withdrawal rights. None of the beneficiaries exercised their withdrawal rights. Eighteen annual exclusions were claimed.

These gifts were disclosed on the decedent’s federal estate tax return and were denied. In the Government’s brief, the IRS reemphasized that the attack on the annual exclusions was not an attempt to overturn the Crummey or Cristofani cases. Instead, the service was attacking these annual exclusions on the basis of a prearranged plan holding that the Crummey rights granted to the beneficiaries (other than the two children) were illusory. A portion of the Government’s brief is significant to those practitioners who routinely recommend, draft, and implement irrevocable life insurance “Crummey” trust arrangements.

What constitutes an understanding or pre- arrangement? [The IRS] believes that an understanding or pre-arrangement includes, but is not limited to, an express or tacit understanding among the beneficiaries, trustees, and/or grantor, that the Crummey rights will not be exercised. For example, an arrangement or understanding sufficient to disallow the annual exclusion should be found where: (1) the beneficiaries fail to withdraw the specified amount because they understand that the gift was not meant to be given presently, but instead was intended to remain in the trust; (2) the beneficiaries are led to believe that they would be penalized--by being excluded from the remainder of the trust, future gifts, or a will--if they exercise their power of withdrawal; (3) the trustees fail to thoroughly explain all aspects of the withdrawal rights to the beneficiaries in a manner sufficient to allow them to make an intelligent and informed decision about whether those rights should be exercised; or (4) the beneficiaries are led to believe that their exercise of the right would create family disharmony and/or disrupt the donor’s estate plan.

Despite the Internal Revenue Service protestations, the Tax Court, in rather summary fashion, rejected the Service’s prearranged plan argument and refused to deny any of the annual exclusions. The opinion is not long and implicitly seems to say “Didn’t we review these facts in Cristofani so why are we reviewing them again?” Significant language in the opinion follows:

Pursuant to the provisions of the trust, for a 30-day period following a transfer of property to the trust, the contingent beneficiaries were given unrestricted rights to legally demand immediate distribution to them of trust property. The evidence does not establish that any understandings existed between decedent and the beneficiaries that the contingent beneficiaries would not exercise those rights following a transfer of property to the trust. At trial, several credible reasons were offered by the trust beneficiaries as to why they did not exercise their rights to demand a distribution of trust property. The fact that none of the beneficiaries exercised their rights or that none of the beneficiaries requested notification of future transfers of property to the trust does not imply to us that the beneficiaries had agreed with the decedent not to do so, and we refuse to infer any understanding.

The evidence does not support respondent’s contention that the contingent beneficiaries believed they would be penalized for exercising their rights to demand distributions of trust property or that the trustees purposefully withheld information from the beneficiaries.

Further, the contingent beneficiaries received actual notice from the trustees with regard to their rights. Decedent intended to benefit the contingent beneficiaries by giving them interests in the trust. The contingent beneficiaries were decedent’s relatives.

For the reasons stated above, the contingent beneficiaries’ unrestricted rights to demand immediate distributions of trust property are to be treated as present interests in property. Decedent’s transfer of the commercial building to the trust qualifies for sixteen annual gift tax exclusions under Section 2503 (b) with regard to the present interests of the 16 contingent beneficiaries therein.

Author’s comment: Although the Tax Court did not preclude the possibility of denial of the exclusions under the “prearranged plan doctrine”, it appears clear that the primary focus was whether the taxpayer, pursuant to the terms of the trust, conferred unrestricted rights of withdrawal on a beneficiary (regardless of his contingent or vested status) and whether the beneficiary had notice of those rights with respect to each gift.

##### Estate of Carolyn W. Holland, 73 T.C.M. 3236 (1997)--Another Taxpayer Victory. Holland, is a Tax Court case dealing with a multiplicity of issues. However, the decision of the Court arguably imposes important limits on the scope of the “prearranged plan” argument.

In the facts relevant to this discussion, donor established eight trusts, one for each of her eight great-grandchildren. Except for the name of the beneficiary, each trust was identical and gave each beneficiary a sixty day “Crummey” withdrawal right with respect to each gift to the trust. The co-trustees of each trust were two of the donor’s grandchildren, Jack and Lewis. Several of the trusts were for Jack’s minor children and another trust was for one of Lewis’ minor child.

The IRS denied the annual gift tax exclusions with respect to gifts to these trusts because (1) written notice of the gift was not provided to the beneficiaries (or their natural guardians) as required under the trust instrument and (2) the IRS concluded a prearranged plan existed not to exercise the withdrawal rights.

The Tax Court rejected the IRS arguments and held that the gifts were gifts of a present interest. With respect to the issue of failure to give notice to minor beneficiaries, the Court held that such written notice was not required since the parent of the minor beneficiary was the trustee and did not need to give notice to himself. 73 T.C.M. at 3237-10. With respect to the failure to give written notice to the adult beneficiaries, the Court stated that such written notice was not required when there was evidence of actual notice. 73 T.C.M. at 3237-10. In dealing with the prearranged agreement issue, the Court held that the most important factor in determining whether a gift to a “Crummey-type” trust was a gift of a present interest is whether or not the beneficiary possessed a legal right to make a demand for payment; not whether it is likely that the minor beneficiary is to receive any enjoyment of that property. In this connection, the Court stated “The sufficiency of the notice given the beneficiaries is a factor in the likelihood that the right of withdrawal will be exercised; it is not a factor in the legal right to demand payment from the trustee.” 73 T.C.M. at 3237-10. The Court also found no evidence to support a prearrangement. 73 T.C.M. at 3237-10.

##### Estate of Turner v. Comm., T.C.M. 209 (2011). Facts: On January 7, 1992, Clyde W. Turner, Sr. (“Clyde”) created an irrevocable life insurance trust with Son and Daughter as Co-Trustees. There were 12 beneficiaries of the trust (children and grandchildren). Clyde, Sr. arranged for the trust to purchase three life insurance policies on Clyde’s life. Clyde, Sr. never transferred money to the trust to pay the premiums. Instead, he remitted the premium directly to the insurance companies. Further, the trustees never notified any of the beneficiaries of the indirect gifts via direct premium payments. The trust contained all of the provisions normally found in a well drafted ILIT. The trust provided that after each direct or indirect gift to the ILIT, each beneficiary was given a right to withdraw the amount of the gift equal to the then available annual exclusion amount (after considering other annual exclusion gifts previously made during that calendar year). If a beneficiary wished to exercise his or her withdrawal right, he could do so by giving 30 days prior notice to the trustees of the beneficiary’s intention to exercise the right. Upon receipt of the notice, the trustees were required to distribute trust assets in an amount sufficient to satisfy the withdrawal right. The trust further provided that in satisfying the withdrawal right, the trustees could distribute cash, or any other trust property, including cash obtained from policy loans. The IRS held that the beneficiaries’ withdrawal rights were illusory because Clyde, Sr. did not deposit cash with the trustees but instead paid the premiums directly. The Tax Court rejected the IRS argument and found the gifts, via direct premium payments, to be gifts of a present interest. The Court held, “the test is not whether the beneficiary was likely to receive the present enjoyment of the property, but whether he or she had a legal right to demand it.”

##### Restricted or Illusory Withdrawal Rights. In CCA 201208026, the Office of Chief Counsel advised that no gift tax annual exclusion was allowable to the donor for any of the withdrawal rights because the rights were not legally enforceable and, thus, were not present interests. Under the terms of the trust, beneficiaries could not enforce their withdrawal rights in a state court, but could only seek redress in an "other forum," which did not recognize state or federal law. Additionally, if a beneficiary were to proceed to state court, his or her existing right to income and/or principal would immediately terminate and the beneficiary's future withdrawal rights would be extinguished. Because the threat of severe economic punishment loomed over any beneficiary contemplating a civil enforcement suit, the Office of Chief Counsel characterized the withdrawal rights as illusory and advised that no annual exclusion under Section 2505(b) was allowable. But see, Mikel v. Comm., T.C. Memo 2015-64. In a motion for summary judgment, the IRS argued that the beneficiaries' ability to withdraw from transfers to an irrevocable trust were not legally enforceable. The trust instrument restricted the right to appeal to a religious arbitration panel, and an in terrorem clause, applicable to pursuing an action in state court, removed all rights to trust benefits. Citing Cristofani, the Tax Court held that the beneficiaries did have legally enforceable rights via their appeal to the arbitration panel and to the courts, and that the in terrorem clause applied only to court action for a distribution dispute, not for the enforcement of a withdrawal right.

#### Drafting and Practice Pointers.

##### Trust Should Require Notice But Exonerate Trustee. QUESTION: Numerous letter rulings have found Crummey type gifts to be gifts of a present interest and in reaching this conclusion have commented on the fact that the trust requires notice. See, e.g., PLRs 7939061; 8007080; 8047131; 8251064; 8445004; 9030005; and 9232013. Should the instrument therefore require the trustee to give each beneficiary who has a withdrawal right notice of each gift? ANSWER: Yes, but consider exonerating the trustee for failing to give notice unless failure was due to willful misconduct or gross negligence. Banks may require exculpatory language and a friendly individual trustee (who has agreed to serve without a fee) may need protection from unfriendly beneficiaries if notice is mistakenly withheld.

##### Give Notice Promptly. QUESTION: When should notice be given? ANSWER: Notice should be given promptly after each gift is made even if the document does not require notice.

##### Avoid Arrangements Resulting in Many Gifts During a Year. Try to avoid premium payment arrangements that require [or result in] numerous gifts within a single calendar year. For example, if an employee transfers his interest in employer-funded group term life insurance to an irrevocable life insurance trust, each monthly premium payment by the employer under the master contract would result in an indirect gift by the employee to the trust. Rev. Rul. 76-490, 1976-2 C.B. 300.

This could also occur in a split dollar insurance arrangement where the insurance policy is owned by an irrevocable life insurance trust and the employer payments are made on a monthly bank draft basis. Rev. Rul. 78-420, 1978-2 C.B. 67.

##### However, Single Notice of Premium Payments may be O.K. If group term life insurance is transferred to an irrevocable trust with Crummey type withdrawal rights, consideration should be given to providing each beneficiary, once a year (rather than once a month), with a schedule of employer premium payments (aka “indirect gifts by the donor”) that clearly indicate when the premiums will be paid, the amount of the premium, and each beneficiary’s withdrawal right with respect to each such “indirect gift”. This technique has been approved in a number of private letter rulings. See, e.g., PLRs 8006109; 8111123; 8134135; 8138170; 8138171; and 8143045.

##### Use Annual Premium Modes. If an insured desires to transfer an existing individual policy to a Crummey-type trust and premiums are currently being made by him on a premium mode other than annual, consider changing the mode to an annual premium. If that insured is paying premiums through a monthly bank draft and does not want to change the premium mode, contribute a sufficient amount of cash to the trust to enable the drafts to be charged against the trust bank account.

##### Keep Sufficient “Hard” Assets in Trust to Satisfy Withdrawal Rights. There should also be sufficient assets in the trust at all times to satisfy all then outstanding withdrawal rights. This is particularly true with respect to trusts that own group term life insurance since the gifts to those trusts are indirect and no money actually comes from the donor to the trustee. See, e.g., PLR 8103074 (Donor transferred $1,000 in group term insurance to an irrevocable trust with Crummey type withdrawal rights. The IRS held that the indirect gifts via employer premium payments were gifts of a present interest but only to the extent that there was sufficient cash, or assets reducible to cash, in the trust to satisfy the withdrawal rights).

##### Endorsing Gift Checks to Life Insurance Company. QUESTION: If a donor makes a gift, by check, to an irrevocable life insurance trust with Crummey withdrawal provisions, after the withdrawal right lapses, can the trustee merely endorse the gift check in favor of the life insurance company in lieu of establishing a trust bank account? ANSWER: No.

Example: The donor writes a gift check to the trustee in an amount exactly equal to the required premium payment. The trustee immediately notifies the beneficiary(ies) that a gift has been made and that a withdrawal right is available. If the beneficiary (or the beneficiary’s natural guardian) exercises the withdrawal right, the trustee cashes the check and distributes the funds to the beneficiary. If the withdrawal right lapses (or is earlier waived by the beneficiary or the beneficiary’s natural guardian), the trustee endorses the gift check in favor of the life insurance company.

There are two problems with the above example. First, the withdrawal right could be viewed as illusory since there was never actually a fund of cash in the trust against which a withdrawal right could be exercised. Cf. Estate of Kurihara v. Comm., 82 T.C. 51 (1984). Second, since the check would not be cashed prior to the lapse of the withdrawal right, the donor has arguably retained dominion and control over the funds, and therefore the gift could be deemed incomplete, until the check is cashed. Dillingham Estate, 88 T.C. 1569 (1987); McCarthy v. United States, 806 F.2d 129, (7th Cir. 1986); PLR 8706011 (10/29/86) (checks given by decedent but uncashed at death were held to be incomplete gifts and therefore value of checks are includable in decedent’s estate). But see Metzger v. Comm., 38 F.3d 118, (4th Cir. 1994) (A donor makes several gifts by checks dated 12/14/85 which were deposited by the donees on 12/31/85 but did not clear the bank until 1/2/86. Held: Gifts were complete in 1985).

##### Try to Avoid “Late” Year-End Gifts. If practicable, the client should avoid making year-end gifts by check to the irrevocable trust, especially if it is unlikely that the trustee will be able to deposit the check prior to the end of the year. If the trustee is unable to deposit the check into the trust bank account prior to year end, the gift will not be deemed to be complete until the following year. However, if the trustee can deposit the check prior to year end, Metzger supra stands for the proposition that the gift will be complete in the year the check is deposited even if the check does not clear the bank until the following year.

##### Beneficiaries Should Have More Than Mere Withdrawal Rights. To avoid the scope of Ltr. Ruls. 8727003, TAM 9045002, TAM 9141008, and TAM 9628004; and despite the result in Cristofani and Kohlsaat supra, make sure that each beneficiary who has a withdrawal right has more than a nominal interest in the trust. As to existing trusts that do not comply with this ruling, the client can consider several alternatives including the following:

###### The client could attempt to judicially reform the trust to remove the beneficiaries who have nominal interests (or retain those beneficiaries but grant each of them a sufficient interest in the trust to avoid the scope of the ruling). However, this could be costly and could have adverse generation-skipping transfer tax consequences if the removal of the beneficiaries is considered a constructive addition to the trust because of the increased interests of the remaining beneficiaries.

###### policy for fair market value and recontribute the policy to another trust that does not run afoul of the above letter ruling. However, this transfer will be subject to a new three-year transfer period under I.R.C. § 2035(a).

###### The insured could create another trust that does not run afoul of the above letter ruling. That trust could then become a partner with the insured, with an existing (or newly created) family limited partnership. The new trust, with gifts from the insured, could then purchase the insurance policy from the old trust for fair market value. Because the new trust is a partner of the insured, the purchase of the policy by the new trust from the old trust will not run afoul of the transfer-for-value rules.

##### Special Problems--and Practice Pointers with Group Term and Split Dollar Insurance in Crummey Trusts. This author has encountered numerous tax problems associated with irrevocable life insurance Crummey trusts funded with group term life insurance. These types of arrangements require special care to avoid a major “meat cleaver” effect on a donor’s unified credit.

Meat Cleaver Example: Under this example, which has been taken from a real life situation, a senior executive from a major oil company, prior to moving to Texas from New York, transferred all of his employer paid group term and related insurance (totalling approximately $2 million) to an irrevocable life insurance Crummey trust under which his spouse, son, mother, and sister were permissible beneficiaries. Upon retirement, approximately $500,000 of the insurance lapsed and was no longer available; however, the company agreed to maintain in force for the rest of the employee’s life approximately $1.5 million of coverage with the corporation paying the bulk of the premium (and with a small portion required to be paid by the employee). In the early years of the policies, the annual premium, due to the employee’s age, was easily covered by the annual gift tax exclusions. However, except for the first year when the trust was established and implemented, no notices of gifts and attendant withdrawal rights were given to the spouse and any of the other beneficiaries. Moreover, now that the employee has retired and has attained age 62, the annual premiums attributable to these policies are in excess of $20,000 per year and in ten years will be in excess of $50,000 per year. In fact, if the insured lives into his eighties (which is entirely possible given this insured’s family history), annual premiums on the $1.5 million dollars of coverage could exceed $100,000 per year. This insured has completely exhausted his unified credit exemption equivalent. Moreover, since the insured has moved to Texas, and since payments by the employer of insurance premiums are forms of compensation, wife is deemed to have made a partial transfer to the trust each time a premium is made and as a result, at her death, a portion of the trust could be includable in her estate for federal estate tax purposes.

The above example illustrates the serious problems that can occur even if a well drafted irrevocable trust is ignored or not properly implemented by the lawyer or the client. In this case, I am sure that the practitioner was well meaning when he established the trust (and in fact the trust itself appears to be well drafted). However, it is also clear from the facts that the practitioner lost track of the client and did not have in place any post-signing administrative due diligence to prevent potentially disastrous tax consequences.

##### How to Properly Implement an Irrevocable Life Insurance Trust that Owns Group Term Insurance where the Spouse is not a Beneficiary of the Trust. Follow these steps:

Step One: Determine when monthly premium payments are made by the employer for each of the twelve months following the proposed irrevocable transfer of the group term insurance to the trust and determine the amount of those premium payments.

Step Two: Have the donor irrevocably assign the group term insurance to the trust along with cash or other hard assets (e.g., common stock) equal to three times the average monthly premium payment for the twelve months following the creation of the trust.

Step Three: Have the trustee designate the trustee as beneficiary on the group term insurance, in behalf of the trust.

Step Four: Have the trustee transfer all cash received as a gift into a bank account in the name of the trust (note, an employer i.d. number may be required).

Step Five: Have the trustee send each withdrawal right beneficiary a letter promptly after the creation of the trust and the transfer of the group term insurance stating that a gift of group term insurance (and cash and/or other property) has been made to the trust, the value of the gift, and a schedule of premium payments for the next twelve months including the approximate date of each such payment and the amount of the payment. Most importantly, this letter should explain to each beneficiary that within a specified period of time after such premium payment is made, each beneficiary would have a right to withdraw a pro rata share of the gift (or perhaps some greater or lesser amount as determined in the notice of gift).

At the beginning of the second year of the trust, and at the beginning of each subsequent year, a letter described at step five should again be sent to the beneficiaries. This will require you or the trustee to contact the human resources department of the company providing the group term insurance to obtain the schedule of premium payments.

##### Procedure if Spouse is a Beneficiary. If the non-insured spouse is intended to be a beneficiary of the trust, care must be taken to ensure that all gifts (including deemed gifts in connection with employer premium payments) are made with the insured spouse’s sole and separate property. Because of the nature of group term insurance, this could prove tricky unless the implementation of the trust is preceded by a marital property partition agreement that ensures that the group term life insurance itself and all premium payments (and economic benefits attributable thereto) are the insured’s spouse’s sole and separate property.

This author uses one of two approaches to ensuring the above results:

Approach One: Under this approach, the spouses would agree in writing that the subject group term insurance, all premium payments attributable thereto (whether contributory or non-contributory) and all economic benefits attributable to those premium payments shall be the insured’s spouse’s sole and separate property. In return, a lump sum amount (equal to the present value of the foregoing described premium payments discounted over the actuarial life expectancy of the insured’s spouse) shall be set aside to the non-insured spouse.

Approach Two: Under this approach, the spouses would agree to set aside to the insured’s spouse the group term insurance itself, all premium payments attributable to that insurance (whether contributory or non-contributory) and the economic benefits attributable to those premium payments. The spouses would set aside to the non-insured spouse, a portion of the insured’s spouse’s salary and/or retirement payments (if the insured’s spouse is retired) equal in value to the foregoing described premium payments plus a one time amount equal to the value of the group term insurance (generally equal to one month’s unearned premium).

After this marital property partition agreement is duly executed, steps one through five above can be implemented.

##### Example of Crummey Withdrawal Form. See Exhibit A attached.

## Estate Tax Consequences to Grantor-Insured. The most relevant sections of the Code will be explored in order of importance.

### I.R.C. § 2035.

#### General Rule for Decedents Dying Before 1982. With respect to a decedent dying prior to 1982, the value of the decedent’s gross estate includes the value of all property to the extent of any interest therein of which that decedent has at any time made a transfer, by trust or otherwise, within three years before the decedent’s death. I.R.C. § 2035(a). This general inclusion rule shall not apply to any bona fide sale for adequate and full consideration in money or money’s worth or to any gift of a present interest by the decedent within the allowable annual exclusion amount; however, this latter exception to inclusion does not apply to a transfer “with respect to a life insurance policy.” I.R.C. § 2035(b).

#### Rule for Decedents Dying After 1981.

##### General Rule. The Economic Recovery Tax Act of 1981 (“ERTA”) added Code Section 2035(d), which applies to estates of decedents dying after 1981. Section 2035(d) nullifies the general inclusion rule of Section 2035(a) except for any transfer occurring within three years of the decedent’s death if such transfer was a transfer of an interest in property which is included in the value of the decedent’s gross estate under Code Sections 2036, 2037, 2038, or 2042 or would have been included under any of such sections if the interest had been retained by the decedent. I.R.C. § 2035(d).

##### Three Year Rule Still Applicable to Gift of Life Insurance by the Insured. Notwithstanding the addition of I.R.C. § 2035(d), it is clear that the “three year inclusion rule” does apply with respect to a gift of life insurance by the insured. Thus, if the insured-donor dies within three years of the gift of his life insurance, the proceeds will be includable in his gross estate even if the gift qualified for the annual gift tax exclusion. I.R.C. § 2035(d)(2).

Result if Policy Community Property: If the transferred policy was the community property of the grantor-insured and his spouse, only half of the proceeds should be includable in the grantor-insured’s gross estate for federal estate tax purposes.

##### But No Inclusion on New Policy if Insured Never Possessed Incidents of Ownership. After a series of taxpayer victories over the I.R.S., it is now clear with respect to post-1981 insurance purchases that if an insured never possesses any incidents of ownership in a policy, origination of the life insurance policy by someone other than the insured (e.g., trustee of an irrevocable life insurance trust) will and avoid inclusion of the policy in the insured’s estate under I.R.C. § 2035(d) so long as the insured never processed any incidents of ownership in the policy. Headrick v. Comm., 93 T.C. 171 (1989), aff’d, 918 F.2d 1263 (6th Cir. 1990) and Action on Decision 1991-012 (1991) recommending acquiescence. See also Estate of Perry v. Comm., 927 F.2d 209 (5th Cir. 1991); Estate of Leder v. Comm., 89 T.C. 235 (1987); and Estate of Mildred Eaton Chapman, 56 T.C.M. 1451 (1989). This favorable result will apparently obtain even if (i) the insured plays a role in the acquisition of the insurance (e.g., finds the carrier, checks premium quotes, etc.), (ii) submits to a physical exam, (iii) signs the application as insured, and (iv) pays the initial and all subsequent premiums. See, e.g., PLR 9323002.

#### Planning to Avoid I.R.C. § 2035. Consider the following approaches to avoid the broad scope of I.R.C. § 2035:

##### Take Advantage of Headrick et al--Insured Should Never Have Incidents of Ownership in the Policy. Given the planning opportunity afforded by Headrick, Perry, Leder, and Chapman, and AOD 1991-012 (1991), the practitioner should make sure that the insured never possesses incidents of ownership in the policy even if the irrevocable trust is established shortly before the acquisition of the policy by the trustee. For example, in Headrick, the corporate trustee applied for the life insurance as owner and beneficiary on the day after the trust was funded by the proposed insured.

##### Extra Precaution for Super Cautious Client and/or Practitioner: Avoid Transfers of Premiums by Insured. If you think Headrick et al is “too good to be true,” during the first three policy years [or at least for the first policy year], avoid having the insured transfer his property to the trust for the purpose of premium payments. Thus, even a finding that the policy and not the premium was transferred to the trust should avoid the application of I.R.C. § 2035 since the insured would not be the transferor. See I.R.C. § 2035(d)(2) (which applies only if the transferor [or deemed transferor] of the life insurance policy was the insured).

##### Let Non-Insured Spouse Make Transfer. If the insured’s spouse is the only other individual willing to participate in making gifts to the trust [and if she is not a beneficiary of the trust], consider having the non-insured spouse use her separate property to establish and maintain the irrevocable life insurance trust during the first three policy years. If the non-insured spouse has no separate property, separate cash can be obtained via interspousal gifts or, in community property states, a community property partition. This should avoid application of the “deemed transfer” theory of Bel, Kurihara, Etc.

##### Follow Usual Formalities. Purchase of the insurance should occur only after gift notices are sent to the beneficiaries who have withdrawal rights and those rights lapse.

##### Drafting and Practice Pointer in Connection with the Transfer of an Existing Policy--Safety Net for Deaths Within Three Years. If the insured is the grantor of the trust and has transferred an existing policy to the trust, consideration should be given as to whether the irrevocable trust should provide for a contingent qualified terminable interest trust if the insured dies within three years after the policy is transferred to the trust. If the grantor-insured’s estate plan calls for complete deferral of all federal estate tax liability until the death of the noninsured spouse, then such a provision should be included if inclusion within three years would result in a federal estate tax.

### I.R.C. § 2042.

#### The Code Provision. Proceeds of an insurance policy on a decedent’s life are includable in his gross estate for federal estate tax purposes (1) if receivable by or for the benefit of the decedent’s estate, or, (2) if the decedent, at his death, possessed any incidents of ownership in the policy, exercisable either alone or in conjunction with any other person. I.R.C. § 2042.

##### Payable to or for the Benefit of Insured’s Estate. Insurance proceeds are includable in a decedent-insured’s estate if payable directly to his estate. Treas. Reg. § 20.2042-1(b)(1). Same result if paid to a third person (e.g., an irrevocable trust) but subject to a legally binding obligation to pay estate taxes, debts, and expenses. Id. In the latter event, amount so includable under I.R.C. § 2042(1) shall be the amount required to discharge such taxes, debts and expenses.

Result Re: Community Property Policy. If decedent- insured only had a community property interest in the policy and therefore decedent’s spouse has, under local community property law, a right to one-half of the proceeds, only one-half includable under I.R.C. § 2042 even if payable to the insured’s estate. Treas. Reg. § 20.2042-1(b)(2).

##### Predeceased Non-Insured Spouse--Estate of Alto B. Cervin v. Comm. Recently the Fifth Circuit Court of Appeals reversed the Tax Court on a significant “right to proceeds” ruling. In Estate of Alto B. Cervin v. Comm., 79 AFTR2 ¶ 97-869 (5th Cir. 1997), the decedent, a Texas resident, purchased three life insurance policies on his life. The policies were purchased with community funds, and the premiums were paid, while the decedent and his wife were alive, with community funds.

Several years after the purchase of the policies, the non-insured spouse died and one- half of the cash surrender value of the insurance policies was includable in her estate. Since she died intestate, her one-half interest in the policies passed under Texas intestacy laws to the couple’s two children. However, these children did not withdraw half of the cash value from the policies. Instead, they elected to allow the insurance policies to remain in effect.

The insured died ten years after the death of his wife. His estate included only one- half of the policies of insurance. Upon audit, the IRS determined that all of the proceeds were includable in the insured’s estate and the Tax Court agreed. Reversing the Tax Court, the Fifth Circuit Court of Appeals held that since the children had not “settled” their share of the policy, they continued to retain a right to one-half of the proceeds. Apparently this result would have been different had the children elected to receive their share of the cash value. Had one-half of the cash value been delivered to the children, they no longer would have had any right to the proceeds and 100% of those proceeds would have been includable in the insured’s spouse’s estate at his death.

##### Proceeds Payable to Third Party But Insured, at His Death, Possessed Incident(s) of Ownership in Policy.

###### Incident of Ownership Defined. The term “incident of ownership” is not limited to pure ownership. It includes any right of the insured or his estate to control the economic benefits of the policy. Treas. Reg. § 20.2042-1(c)(2).

###### Examples: Examples of incidents of ownership:

Power to change beneficiary (even if right arises out of contract with someone other than the life insurance company). Estate of James O. Tomerlin, 51 T.C.M. 831 (1986) (decedent-insured’s rights over the policy arose via agreement with someone other than the life insurance company); Estate of Gordon E. Thompson, Jr., 41 T.C.M. 1333 (1981). Same result even if decedent- insured could not surrender, assign, or borrow against the policy. Estate of Sidney Riefberg, 43 T.C.M. 519 (1982)).

Power to surrender or cancel the policy. Treas. Reg. § 20.2042-1(c)(2).

Power to assign the policy. Treas. Reg. § 20.2042-1(c)(2).

Power to pledge the policy for a loan or obtain loan on policy from the insurer. Treas. Reg. § 20.2042- 1(c)(2).

Reversionary interest in the policy or proceeds if immediately before insured’s death, the value of the reversionary interest exceeded 5% of the value of the policy. Treas. Reg. § 20.2042-1(c)(2).

Power to elect a settlement option (even if option could not be exercised in favor of the insured). In Re Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973); Rev. Rul. 81-128, 1981-1 C.B. 469. See also Lober v. United States, 346 U.S. 335 (1953).

Veto power over assignee’s right to assign policy or designate policy beneficiaries. Rev. Rul. 75-70, 1975-1 C.B. 301; Karegheusian v. Comm., 205 F.2d 197 (2d Cir. 1956); Goldstein’s Estate v. United States, 122 F. Supp 677 (Ct. Cl. 1954), cert. denied, 348 U.S. 942 (1955). But see, Rockwell v. Comm., 779 F.2d 931, 86-1 USTC 13,651 (3rd Cir. 1985) (Veto power over policy assignments and beneficiary changes “retained” by insured was rendered a virtual nullity and therefore held not to be an incident of ownership. Because of the unusual circumstances, Rockwell has limited applicability.).

But not the right to convert group term insurance to an individual contract upon the voluntary or involuntary termination of employment. Estate of Smead, 78 T.C. 43 (1982); Rev. Rul. 84-130, 1984-2 C.B. 194.

Result if Policy is Community Property. If the insurance policy is the community property of the decedent and his spouse, only one-half of the proceeds would be includable in the insured’s estate. Rev. Rul. 232, 1953-2 C.B. 268; PLR 8928003 (3/14/89).

#### Incidents of Ownership Held by a Controlled Corporation--The Majority Shareholder Issue. Code section 20.2042-1(c)(6) of the regulations to I.R.C. § 2042 provides that in the case of incidents of ownership in a life insurance policy on the decedent’s life that are reserved to a corporation of which the decedent is the controlling shareholder, the corporation’s incidents of ownership will not be attributed to the decedent through his stock ownership if either of the following conditions are met: (1) the proceeds of the policy are payable to the corporation or (2) the proceeds are payable to a third party for a valid business purpose of the corporation such as the satisfaction of a business debt of the corporation so that the net worth of the corporation is increased by the amount of such proceeds. See PLR 8906002 (9/16/88) (Decedent-insured held no incidents of ownership in two policies owned by and payable to the decedent-insured’s former corporation.). If any part of the proceeds of the policy is not payable to or for the benefit of the corporation, any incidents of ownership held by the corporation attributable to that part will be attributed to the decedent-controlling shareholder. Estate of Levy v. Comm., 70 T.C. 873 (1978). Two important comments can be made about this regulation:

(1) Can this problem ever arise if the stock is community property since the decedent-insured’s undivided one-half interest in the stock can never be more than 50% of the outstanding stock of the corporation? A form of attribution would likely apply. However, the spousal attribution rules invariably arise by statute. See e.g., I.R.C. § 2036(c) and I.R.C. § 2032A.

(2) The “majority shareholder” problem often arises in the context of a split dollar life insurance agreement involving a life insurance policy which has been irrevocably transferred to a third party (e.g., trust). The agreement is between the employee/transferor and the corporation that he controls and incidents of ownership in the policy are attributed to the employee through his majority ownership. It is therefore essential that the split dollar life insurance agreement does not grant the corporation prohibited incidents of ownership over the policy through the agreement. Rev. Rul. 82-145, 1982-2 C.B. 213. For an interesting application of Treas. Reg. § 20.2042-1(c)(6). See PLR 8710004 (11/21/87).

#### Incidents of Ownership Held in Trust. It is not complicated to draft an irrevocable life insurance trust that avoids I.R.C. § 2042(1) or (2). But remember that the IRS has been successful in including insurance proceeds in the estate of an insured when the insured possessed incidents of ownership over a policy of life insurance on his life even though those ownership rights were held by the insured merely as a fiduciary (i.e., as trustee). Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), cert denied, 427 U.S. 977 (1976). But see Bloch v. Comm., 78 T.C. 850 (1982).

However, in Rev. Rul. 84-179, 1984-2 C.B. 195, the Internal Revenue Service has softened its position somewhat with respect to incidents of ownership held by an insured- trustee. The current position is that a decedent will not be deemed to possess incidents of ownership in a life insurance policy on his life which are held by that decedent as a fiduciary if all of the following requirements are satisfied:

(1) The decedent’s powers are held only in a fiduciary capacity; benefit;

(2) Those powers are not exercisable for the decedent’s personal

(3) The decedent did not transfer the policy to the trust and did not transfer to the trust from personal assets any of the consideration for purchasing or maintaining the policy by the trust; and

(4) The decedent did not obtain his trustee powers through some prearranged plan in which the decedent participated.

Although it appears theoretically possible for an insured to serve as a trustee of an irrevocable life insurance trust that is the owner and beneficiary of a policy on the life of an insured without running afoul of I.R.C. § 2042(2), it would appear quite difficult to avoid the “pre-arranged plan” prohibition. See also General Counsel Memorandum 39333 (10/15/84). Such arrangements are not recommended.

#### Intentionally Defective Grantor Trusts; Insured’s Power to Substitute Property. Many trusts will contain a power in the grantor, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. Where such a power is held by the grantor of an irrevocable life insurance trust, the issue arises as to whether such power will cause the trust assets, including any life insurance policy on the grantor's life, to be includible in the grantor/insured's estate. In Jordahl Est. v. Comm., 65 T.C. 92 (1975), acq, 1977-2 C.B.1., the Tax Court determined that a decedent's reserve power to substitute securities or other property of equivalent value for assets held in a trust was not a power to alter, amend, or revoke the trust within the meaning of Section 2038 and would not cause the trust to be includible in the decedent's estate. The Tax Court stated that, because the decedent was bound by fiduciary standards and was, therefore, accountable in equity to the succeeding income beneficiary and remainder beneficiaries, the decedent could not exercise the substitution power to deplete the trust or to shift trust benefits among beneficiaries. In PLR 9843024, the IRS ruled, though, that the right of the grantor of a trust to substitute assets of equal value was not by itself considered an incident of ownership under Section 2042(2) where the right could be exercised to acquire the insurance policy on the grantor's life directly. See also Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (grantor’s retention of power to substitute other assets of equivalent value for insurance policy held in trust does not cause value of policy to be includable in grantor's gross estate if trustee has fiduciary obligation to ensure grantor's compliance); PLR 201235006 (taxpayer's power to substitute assets did not result in possession of incidents of ownership because (1) taxpayer could not exercise power in manner that would reduce value of trust corpus or increase his own net worth, and (2) under state law, trustee had ability to reinvest assets and had duty of impartiality to trust beneficiaries, preventing any potential shift of benefits that could have resulted from substitution of property by grantor).

#### Rev. Rul. 79-353 is Revoked! Long Live Rev. Rul. 95-58!!

##### General. In 1979, IRS issued Revenue Ruling 79-353, 1979-2 C.B. 327, which held, in effect, that if a settlor of an irrevocable trust retained the unlimited right to remove a corporate trustee and appoint only another corporate trustee, the settlor was deemed to be in possession of the powers of the trustee. After considerable taxpayer and practitioner complaints, the IRS decided that this ruling would be applied to trusts that were irrevocable after October 28, 1979. Rev. Rul. 81-51, 1981-1 C.B. 458. Nonetheless, if left unchecked, the scope of the ruling could have been substantial.

For example, if an individual was given an unlimited power to remove a trustee and appoint another trustee other than himself, and the trust owned a life insurance policy on that individual’s life, that individual could arguably have been deemed to have an incident of ownership (held in a fiduciary capacity) over the life insurance policy. See, e.g., PLR 8922003 (extends the rationale of Rev. Rul. 79-353 to situations involving irrevocable life insurance trusts and I.R.C. § 2042(2)). By similar application, the I.R.C. §§ 2036 and 2038 prohibited powers held by the corporate trustee could have been applied to the settlor of the trust. One planning technique was to vest the power of removal in a truly independent party or parties.

##### Major Taxpayers Victories Convince IRS to in Large Part Capitulate. After a long struggle and two major defeats in Estate of Wall v. Comm., 101 T.C. 300 (1993), and Estate of Vak v. Comm., 973 F.2d 1409 (8th Cir. 1992), the IRS has finally had enough and has, in large part, capitulated. In Rev. Rul. 95-58, I.R.B. 1995-36 (September 5, 1995), the IRS has specifically revoked Rev. Ruls. 79-353 and 81-51. Under this new ruling, an individual can create an irrevocable trust and retain the power to replace the trustee without adverse estate or gift tax consequences so long as the individual is prohibited from appointing himself as trustee or any other individual who is related or subordinate to that individual (within the meaning of I.R.C. § 672(c).

##### Trustee Removal and Appointment Provisions. See Exhibit B attached.

### I.R.C. §§ 2036 and 2038--Transfers with Retained Income or Reserved Power to Control Beneficial Enjoyment.

#### The Basic Code Sections. In relevant part, I.R.C. § 2036(a) provides that the gross estate includes “the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . under which he has retained for his life . . . the . . . enjoyment of . . . the property . . .” In relevant part, I.R.C. § 2038 provides that the value of the gross estate shall include “the value of all property . . . that the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment [of the transferred property] was subject [to his] power . . . [exercisable] alone or . . . in conjunction with any other person . . . to alter, amend, revoke, or terminate. . . .”

Despite some different wording, in practice, I.R.C. §§ 2036 and 2038 are virtually identical in application. Accordingly, a violation of one Code section is often held to be a violation of the other. See e.g. Rev. Rul. 79-353, 1979-2 C.B. 327.

#### Application of Basic Code Sections to Irrevocable Life Insurance Trust. Aside from obvious examples (e.g., retained income interests or transfers to a revocable trust), consider the following examples of how the above Code sections can be applied to require inclusion of irrevocable life insurance trust assets (including insurance proceeds) in the estate of the grantor-insured:

##### If Trustee Is Required to Use Trust Assets to Discharge Support Obligations. Insured, prior to his death, transfers (or is deemed to transfer) policy of insurance on his life to an irrevocable life insurance trust and, pursuant to the terms of the trust, the trustee is required to use trust income and/or principal to discharge the insured-donor’s legal obligation to support his minor children. Insurance proceeds will be includable. Treas. Reg. § 20.2036-1(b)(2). Estate of Gokey v. Comm., 72 T.C. 72 (1979); Est. of Frederick J. McTighe, 36 T.C.M. 1655 (1977).

##### Can Insured Retain a Trustee Removal Power without Adverse Tax Consequences? Assume grantor-insured establishes irrevocable life insurance trust with Bank as trustee. Bank is given unlimited discretion (i.e., not subject to an ascertainable standard) to distribute trust income and/or principal to and among grantor-insured’s children. Grantor-insured divests himself of all rights and interests over the trust except he retains the right to fire any trustee with or without cause and appoint a bank as a successor. Even though the trust has no other assets other than a life insurance policy and therefore the right to distribute income and/or principal appears illusory, in light of Rev. Rul. 95-58, is it likely the IRS will hold that the transferor-insured is, in effect, the trustee and therefore insurance proceeds are includable in grantor-insured’s estate for federal estate tax purposes? The answer to this question is hopefully “no.” However, the ruling, while specifically revoking Rev. Ruls. 79-353 and 81-51, seems to be limited to retained powers under I.R.C. §§ 2036 and 2038. This author would feel better about the ruling if the IRS had simply held that the grantor will not be deemed to possess any powers of the trustee so long as the removal power precludes the appointment of the grantor or a related or subordinate party (within the meaning of I.R.C § 672(c). In at least one private letter ruling, the IRS tried to extend 79-353 to I.R.C. § 2042(2) powers.

#### Possible Problem - Reciprocal Trust Doctrine. Consider the following example:

Example: Brother transfers $100,000 cash to an irrevocable trust with Sister as the lifetime income beneficiary and with Bank as sole trustee. On or about the same time, Sister transfers a like amount to an irrevocable trust with Brother as lifetime income beneficiary and Bank as sole trustee. The effect of the Reciprocal Trust Doctrine is to deem that Brother transferred the $100,000 to the trust for his benefit and retained an income interest within the meaning of I.R.C. § 2036 (and same for Sister).

Doctrine formulated to prevent transfers of property that allowed grantor to retain same lifetime enjoyment of property as if he had owned property or was trustee of property. Court will “uncross” trusts and treat as if transaction never occurred. Estate of Moreno v. Comm., 260 F.2d 384 (8th Cir. 1958); Bischoff v. Comm., 69 T.C. 32 (1977).

##### No Quid Pro Quo Required. Application of the doctrine is not dependent upon a finding that each trust was created as consideration for the other; not necessary that there be proof of a tax avoidance motive. Application of the doctrine requires only that the trusts be interrelated and that arrangement leaves the settlors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries. United States v. Estate of Grace, 395 U.S. 316 (1969).

##### Extension of Doctrine. Doctrine has been extended to result in estate taxation under the following circumstances:

###### Custodianships. Husband (in a non-community property state) establishes Uniform Gifts to Minors Act custodianship account for children, naming Wife as custodian, and Wife does the same, naming Husband as custodian. Exchange National Bank and Trust Co. v. Thomas, 82-1 U.S.T.C. 84 (1981).

###### Applied to Trustee Powers. Brother Number One (“B-1”) establishes irrevocable trust for B-1’s children, naming Brother Number Two (“B-2”) as trustee; and at the same time, B-2 establishes irrevocable trust for B-2’s children, naming B-1 as trustee. Each trust provided for broad powers in the trustee to distribute income and principal to and among the children. IRS held that upon either Brother’s death, deceased Brother would be deemed to be the trustee of the trust for his own children. From there it was an easy step to find inclusion. PLR 8019041 (2/12/80).

##### Doctrine May Be Limited if Trusts Not Identical. Tax Court has apparently limited application of the doctrine and has refused to find reciprocal trusts when Husband and Wife each created trusts, with each other as trustee, having substantially identical terms except that the trust created by the Husband granted Wife a special power to appoint trust assets. That power of appointment was held to prevent application of the doctrine. Levy v. Commissioner, 46 T.C.M. 910 (1983).

##### Applied to Destroy Crummey Powers. The IRS has even invoked the reciprocal trust doctrine to disallow Crummey withdrawal right powers. In Rev. Rul. 85-24, 1985-1 C.B. 329, each of three partners in a partnership created separate trusts for the benefit of their respective children. Each trust gave the grantor’s child a so-called Crummey withdrawal power. Each trust also gave the grantor’s two partners similar withdrawal rights. The idea was to expand the number of annual exclusions per trust. The IRS relied on Grace and ruled that the withdrawal powers granted to the partners in each trust were reciprocal and therefore based on adequate consideration. The IRS held that no gift tax exclusions would be allowed for the reciprocal Crummey powers. The IRS therefore allowed only the annual exclusion resulting from the child’s withdrawal power. See also PLR 8727003 (3/16/87).

##### Possible Application to Irrevocable Life Insurance Trusts. Will the reciprocal trust doctrine apply to any of the following situations involving irrevocable life insurance trusts?

###### Cross Trusts. Husband transfers his separate property policy to irrevocable trust with Wife as life beneficiary. At same time, Wife transfers her separate property policy to irrevocable trust with Husband as life beneficiary. Doctrine would seem to apply.

###### Transfers to Avoid I.R.C. § 2035. To avoid application of I.R.C. § 2035 (requiring that the insured be a transferor), Husband transfers his separate property policy on Wife’s life to irrevocable life insurance trust for children. On or about the same time, Wife transfers her separate property policy on Husband’s life to irrevocable life insurance trust for same children. If Husband dies within three years of Wife’s transfer, will doctrine deem Husband to be the transferor of his policy? Doctrine seems inapplicable since spouses are not in the same economic condition after the transfers.

###### Trusts Funded with Separate Property and Cross Trustees. Husband, with his separate property, establishes irrevocable life insurance trust for his children (owning a policy of insurance on his life) naming Wife as trustee. Wife, on or about the same time, establishes a substantially identical trust with her separate property (owning a policy on her life) with Husband as trustee. Doctrine seems to apply. See PLR 8019041 (2/12/80).

### Intergenerational Private Split Dollar Arrangements; Morrissette v. Comm., 146 T.C. 171 (2016). Discussed with Cahill v. Comm. at page 29.

##### Facts. In Morrissette, a revocable trust, which became irrevocable when the grantor died, made payments toward premiums on life insurance owned by irrevocable trusts created by the same grantor but insuring lives of family members in the 2nd generation (The revocable trust was the “premium-paying trust” and the irrevocable trust was the “policy-owning trust.”). Upon the death of a 2nd generation insured, a portion of the death benefit equal to the greater of the total premiums paid or the cash surrender value of the policy immediately before a 2nd generation insured’s death would be payable to the premium-paying trust. Thus, the benefit of this intergenerational split-dollar arrangement was that because the insureds are members of the next generation, their deaths are actuarially likely to occur long after the grantor’s death, and this reimbursement right of the premium-paying (now irrevocable) trust was valued for estate tax purposes at a significant discount reflecting the time-value of money. The split-dollar agreement also provided that it could be terminated during the insured’s life by the mutual agreement of the trustees of the premium-paying trust and the policy-owning trust. If the split-dollar agreement was terminated during the insured’s life, the premium paying trust had an unqualified right to receive the greater of the total amount of premiums paid or the cash surrender value of the policy, and the policy owning trust would receive nothing.

##### Tax Court. The gift tax return reported the cost of the life insurance protection as gifts to the policy-owning trusts, in accordance with the favorable “economic benefit regime” for the taxation of split-dollar arrangements under Treas. Reg. §1.61-22. The Tax Court agreed that the economic benefit regime was appropriate because the policy-owning trusts received no additional economic benefit beyond the current life insurance protection. The Tax Court did not, however, determine the amount includable in the grantor’s gross estate with respect to the arrangements, which in turn requires consideration of the basis for inclusion. See Cahill v. Comm.

### Estate Tax Consequences of Intergenerational Split Dollar Life Insurance; Estate of Cahill v. Comm., T. C. Memo 2018-84 (June 18, 2018) I.R.C. §§2026 and 2038 and §2703.

#### Cahill Facts. The decedent’s revocable trust (the 1st generation) had advanced $10 million to an irrevocable trust under a split dollar agreement for the irrevocable trust to purchase life insurance policies on the lives of the decedent’s son and his wife (the 2nd generation). Upon the death of the decedent, the estate valued the estate’s right eventually to be reimbursed for its advances at an actuarial value of only $183,700, due to the long period of time before the policies would mature at the 2nd generation insureds’ deaths. The IRS argued that the reimbursement right should have a value equal to the full cash surrender value of the policies ($9,600,000) in part because of I.R.C. §§2036, 2038, and 2703.

#### Tax Court. The Tax Court was of the opinion that I.R.C. §§2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split dollar plan entitling the decedent to the cash surrender value of the policies (without waiting until the 2nd generation insureds’ deaths), and because the advance of the premiums was not a bona fide sale for full and adequate consideration. See Powell v. Comm., 148 T.C. No. 18 (May 18, 2017).

The Tax Court did opine that I.R.C. §2703(a) applied to disregard the irrevocable trust’s ability to prevent an early termination of the agreement in valuing the reimbursement right because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (I.R.C. §2703(a)(1)), and, in addition, the agreement significantly restricted the decedent’s right to use his “termination rights” under the agreement (I.R.C. §2703(a)(2)).

The Tax Court also stated that Treas. Reg. §1.61-22 generally treats the amount transferred each year under a split dollar plan governed by the economic benefit regime as the cost of current life insurance protection in that year. That regulation, however, applies only for income and gift tax purposes, not for estate tax purposes. Therefore, the regulation does not apply directly in valuing the transfer at the decedent’s death benefit rights for estate tax purposes, and is not inconsistent with the application of I.R.C. §§2036, 2038, and 2703.

## Income Tax Consequences to Grantor-Insured (and Possibly Insured’s Spouse).

### General: Income tax consequences to grantor-insured in maintaining an irrevocable life insurance trust are generally minimal because the trust is often funded only with a life insurance policy (or policies). There are, however, potentially adverse income tax consequences that can arise after grantor-insured’s death. This occurs when the grantor-insured’s spouse is a co-grantor of the trust (as may be the case when community property is transferred to the trust). A brief discussion of each of the main tax consequences to the grantor-insured and his spouse follows.

### Inclusion of Trust Income in Grantor-Insured’s Income under I.R.C. § 677(a)(3). I.R.C. § 677(a)(3), in pertinent part, provides:

a. GENERAL RULE - The grantor shall be treated as the owner of any portion of a trust [and therefore taxed on trust income attributable to that portion] . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be –

. . .

b. applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse . . .”

Literal reading of I.R.C. § 677(a)(3) would require grantor-insured to include all of the trust income which is or may be applied to the payment of premiums for insurance on his life even if the insurance premiums on policies actually owned by the trust are less than trust income. Reliable case law would limit the bad tax result. Authority suggests grantor should only be taxed in an amount equal to the lesser of (i) the income of the trust or (ii) the annual premiums on life insurance actually owned by the trust. See Corning v. Comm., 104 F.2d 329, 333 (6th Cir. 1939); John H. Beasley, 42 B.T.A. 275 (1940); Lorenz Iversen, 3 T.C. 756, 774 (1944); Philip Meyers, 3 T.C.M. 468, 473 (1944); Genevieve F. Moore, 39 B.T.A. 808, 812 (1939); Joseph Weil, 3 T.C. 579 (1944). One possible planning technique may be to prohibit the trustee from using trust income to make such premium payments.

### Potential Income Tax Consequences to Grantor-Insured’s Spouse--Even if Spouse Not a Beneficiary. If the grantor-insured’s spouse is grantor of the trust (e.g., because, under community property laws, she contributed half of the gifts), after the grantor-insured dies, care must be taken to avoid application of the grantor trust rules so that the grantor-insured’s spouse is not taxed on a part of the income of the trust. For example, if non-insured spouse’s brother is a trustee and he is given unlimited discretion to distribute income and principal among spouse’s children, I.R.C. §§ 674(b)(5) and 674 (d) could cause part of trust income to be taxed to spouse. This can largely be eliminated through a proper selection of trustee or through careful drafting of the trust so as to avoid the sweep of I.R.C. § 674.

### If Grantor-Insured’s Spouse is a Beneficiary of the Trust. If grantor-insured’s spouse is a beneficiary of the trust after the grantor-insured’s death, care must be taken to avoid spouse as being treated as a grantor of the trust. I.R.C. § 677(a)(1). This can be accomplished by making sure that all transfers to the trust are from the grantor-insured’s separate property.

## Generation-Skipping Transfer Tax Consequences to Grantor-Insured.

### Brief Overview of GSTT. A complete discussion of the generation-skipping transfer tax rules is way beyond the scope of this outline. However, a brief overview may be helpful in discussing their potential application to the irrevocable life insurance trust. This tax is neither tax simplification nor tax relief. It is a punitive tax which is levied in addition to the applicable estate or gift tax. Under certain circumstances the combined estate (or gift) and generation-skipping transfer tax can be as high as 80% of the property subject to tax. As under prior law, the GSTT taxes as “taxable terminations” and “taxable distributions” those terminations or distributions where the beneficiary of the property upon termination or upon distribution from a generation-skipping trust is in a generation at least two levels below the transferor. The GST tax also applies to so-called “direct skips” such as outright gifts from grandparents to grandchildren or gifts in trust for the benefit of grandchildren.

### Exclusions and Exemptions from Tax.

#### $11,400,000 Generation-Skipping Transfer Tax Exemption. Each individual is currently allowed a $11,400,000 generation-skipping transfer tax exemption, and such amount is indexed for inflation. That individual or his personal representative, if deceased, may allocate this exemption among all property for which that individual is treated as a transferor. I.R.C. § 2631(a). However, if the voluntary election is made, it becomes an irrevocable election. I.R.C. § 2631(b). If as a result of the allocation(s), a trust to which gifts have been made has an inclusion ratio of zero, that trust and all of its appreciation will be exempted from application of the generation-skipping transfer tax.

An individual’s $11,400,000 GSTT exemption can be allocated at any time on or prior to the due date for filing that individual’s federal estate tax return (including any extended date). I.R.C. § 2632(a)(1). Before death, the transferor makes the allocation. After death, the personal representative of the transferor’s estate makes the allocation. With respect to a lifetime transfer that is a direct skip, the $11,400,000 exemption will automatically be allocated to that direct skip unless the individual formally elects not to have the allocation made. I.R.C. § 2632(b)(3). This “election out” is to be made on or before the due date (including extensions) for filing the gift tax return for the year in which the direct skip occurred. Prop. Treas. Reg. § 26.2632-1(b). Any such election out is irrevocable. Id.

#### Annual Gift Tax Exclusion. For a pre-April 1, 1988 direct skip (either outright, or to a trust to which transfers constitute direct skips), that direct skip will be excluded from application of the generation-skipping transfer tax if within the then available annual gift tax exclusion amount. This means that such pre-April 1, 1988 annual exclusion gifts, and all appreciation thereon, completely avoid application of the gift tax, estate tax and generation-skipping transfer tax. This is particularly significant for an irrevocable life insurance trust if pre-April 1, 1988 gifts to that trust were completely encompassed by annual exclusions. If so, at the insured’s death, the insurance proceeds and all appreciation thereafter occurring as a result of investment of those proceeds can be exempted from the generation-skipping transfer tax.

#### Technical Corrections Changes Annual Exclusion Result. However, under TAMRA[[4]](#footnote-4), a post-March 31, 1988 direct skip will only be excluded from application of the generation-skipping transfer tax if the direct skip is either (a) outright to a natural person (including custodial gifts) or (b) to a trust which has a single beneficiary and is includable in the beneficiary’s gross estate if he or she dies before termination. I.R.C. § 2642(c). Accordingly, if a post-March 31, 1988 annual exclusion gift to a trust is not a direct skip of the type described above (i.e., for a trust which has a single beneficiary and the assets of which are includable in the beneficiary’s estate), the only way to protect such a transfer from the potential generation-skipping transfer tax is to allocate part of the $11,400,000 million exemption to this gift.

#### That Pesky ETIP--Avoid Giving Wife a Withdrawal Right. As a general rule, the inclusion ratio of a trust will depend on the fair market value of property transferred to the trust and the amount of generation-skipping transfer tax exemption allocated to those transfers. This allows for considerable “gift leveraging” when a donor makes cash gifts to an irrevocable trust to enable the trustee of that trust to acquire and maintain insurance on the donor’s-insured’s life.

Example: George Generous establishes a long-term generation-skipping trust for the collective benefit of his children, grandchildren and more remote descendants. The trustee of that trust acquires a $5,000,000 life insurance policy on George’s life, having an annual premium of $50,000 per year. It is estimated that the policy will carry itself in 12 years. George makes 12 annual gifts to the trust, each in the amount of $50,000, all of which are fully covered by the annual gift tax exclusion. On George’s timely filed gift tax returns, he allocates $600,000 of his $11,400,000 generation-skipping transfer tax exemption to the trust, thereby causing the trust to have a zero inclusion ratio. Twenty years later, George dies and $5,000,000 of insurance proceeds are paid to the trust. Even though George only utilized $600,000 of his $11,400,000 generation-skipping transfer tax exemption, the entire $5,000,000 of proceeds is exempt from the generation-skipping tax because the trust had a zero inclusion ratio.

Despite the dramatic results illustrated by the above example, the regulations to the generation-skipping transfer tax rules raise uncertainty whether the above favorable “leveraging effect” would obtain if the donor’s spouse is a beneficiary of the trust and a Crummey withdrawal right donee. This is because I.R.C. 2642(f), added by TAMRA, provides that the allocation of the generation-skipping transfer tax exemption to transferred property that would be includable in the gross estate of the transferor (under any Code Section other than I.R.C. 2035) if he or she were to die immediately after the transfer will not be effective until termination of the “estate tax inclusion period.” I.R.C. § 2642(f)(1); Prop. Reg. § 26.2632-1(c)(1).

The estate tax inclusion period (“ETIP”) is the period during which if the transferor died, the transferred property would be includable in the transferor’s estate. I.R.C. § 2642(f)(3); Prop. Reg. § 26.2632-1(c)(2)(I). Furthermore, that Code Section states that “except as provided in regulations, any reference in this subsection to an individual or transferor shall be treated as including a reference to the spouse of such individual or transferor.” I.R.C. § 2642(f)(4); Prop. Reg. § 26.2632-1(c)(2)(iii).

While Treasury officials indicate that the regulations to that Code Section were not intended to impact irrevocable life insurance trusts under which a spouse is a beneficiary and permitted Crummey withdrawal right donee, it is also possible the regulations could, through a stretch of the imagination, give rise to that interpretation. Accordingly, out of an abundance of caution, it is recommended that practitioners who seek to make the donor-insured’s spouse a beneficiary of the trust, draft the trust so that the spouse is not a beneficiary during the insured’s lifetime and is not a donee of a Crummey power. This should avoid the potentially adverse tax consequences under the following rationale:

##### Example. Assume Husband establishes an irrevocable life insurance trust for the collective benefit of his children. Each child is given a “Crummey” withdrawal right, and is a beneficiary during Husband’s lifetime. Wife becomes a beneficiary of the trust after Husband’s death. All distributions are subject to an ascertainable standard. There are no provisions in the trust that would cause inclusion of the trust property in the estate of Husband should he die during the term of the trust. There are no provisions in the trust that would cause inclusion of the trust property in Wife’s estate if she dies during the term of this trust. Husband files a timely gift tax return in connection with the annual exclusion transfers to the trust and timely allocates his GST exemption to the trust to, in his mind, achieve a zero inclusion ratio.

(2) The regulations define the estate tax inclusion period as “the period during which, should death occur, the value of the transferred property would be includible (other than by reason of I.R.C. §2035) in the gross estate of (i) The transferor; (ii) The transferor had the transferor retained in interest held by the transferor’s spouse (but only to the extent the spouse acquired the interest from the transferor in an inter vivos transfer that was not included in the transferor’s taxable gifts or for which a deduction was allowed under § 2523 of the Code); or (iii) The spouse of the transferor.” Prop. Reg. § 26.2632-1(c)(2).

Comm: Under the assumed facts, if Husband dies during the term of the trust, the transferred property would not be includable in Husband’s estate or Wife’s estate. Therefore, paragraphs (2)(I) and (iii) are inapplicable. Moreover, paragraph (2)(ii) is an impossibility for Husband, since Wife’s interest only arises after Husband’s death.

(3) Furthermore, the regulations also provide that an ETIP shall terminate on “the first to occur of (i) The death of the transferor; (ii) The time at which no portion of the property (is or would be) includible in the transferor’s gross estate (other than by reason of § 2035) or, in the case of an individual who is a transferor solely by reason of an election under § 2513, the time at which no portion would be includible in the gross estate of the individual’s spouse (other than by reason of § 2035); (iii) The time of a [generation- skipping transfer], but only with respect to the property involved in the [generation-skipping transfer]; or (iv) In the case of an ETIP arising by reason of an interest held by the transferor’s spouse, at the first to occur of (A) The death of the spouse; or (B) The time at which no portion of the property would be includable in the spouse’s gross estate (other than by reason of I.R.C. § 2035).” Prop. Reg. § 26.2632-1(c)(3).

Comment: Literally applying Prop. Reg. § 26.2632-1(c)(3), it appears that the ETIP terminates immediately upon a gift by Husband to the above hypothetical trust because at that time no portion of the property (is or would be) includable in Husband’s gross estate under any section of the Internal Revenue Code. Moreover, if the ETIP arises because of the interest held by Wife, pursuant to Paragraph (3)(iv), that ETIP would also terminate immediately upon gift by Husband because at that time no portion of the property would be includable in spouse’s gross estate under any Code section.

Of course, if the trust owns a survivorship life insurance policy on the insured and the insured’s spouse, there is no reason to permit the spouse to be a beneficiary at all, and therefore the highly confusing “ETIP” rules should not apply.

### Application of TAMRA Changes to Preexisting Irrevocable Life Insurance Trusts. The TAMRA direct skip rules have had a significant impact on preexisting irrevocable life insurance trusts with Crummey withdrawal rights. In short, should the donor(s) allocate any exemption to the trust to preserve a zero inclusion ratio? Here are some ideas on how we cope with the change:

#### Preexisting Common Trust for Nonskip Persons (e.g., Children) and Skip Persons (e.g., Grandchildren). If the irrevocable life insurance trust is a preexisting common trust for the collective benefit of nonskip persons (e.g., children), the following approaches are suggested:

If the trust is expected to eventually terminate in favor of nonskip persons (e.g., children), and if distributions to the skip persons are discretionary, do not allocate the exemption to the trust [in connection with withdrawal right gifts] and limit skip persons’ distributions to the medical or educational exclusions. I.R.C. § 2611(b)(1) (the term “generation-skipping transfer” does not include any transfer that, if made by an individual, would not be considered a taxable gift because of I.R.C. § 2503(e)). The grantor has the rest of his life and even up to 15 months after his death to allocate the exemption to accommodate changing circumstances.

If the trust is expected to terminate in favor of skip persons or if substantial taxable distributions to skip persons are required, allocate the exemption with respect to all Crummey-type gifts to result in a zero inclusion ratio.

If the trust is a common trust that will, in part, terminate in favor of skip persons and, in part, terminate in favor of nonskip persons, then consider judicially reforming the trust into separate trusts, one for nonskip persons and the other for skip persons. Then allocate sufficient exemption to the skip persons’ trust to have a zero inclusion ratio.

#### Preexisting Separate Trusts for Nonskip Persons (e.g., Children) Which Will Terminate in Each Nonskip Person’s Favor. If the insurance is currently owned by several Crummey trusts, each for the primary benefit of a child of the grantor (or other nonskip person), and if each trust will eventually terminate in favor of the child/primary beneficiary, do not allocate the exemptions unless changed circumstances so warrant.

#### Preexisting Generation-Skipping Trusts. If the insurance is owned by a preexisting trust which is intended to be a generation-skipping trust (e.g., child is life beneficiary with remainder to grandchildren), allocate the exemption to produce an inclusion ratio of zero for each such trust.

#### Preexisting Generation-Skipping Trusts with Potential ETIP Problems Because of I.R.C. § 2642(f) and Regulations. If the insurance is owned by a preexisting trust which is intended to be a generation-skipping trust and the donor’s-insured’s spouse is a current beneficiary and is a Crummey withdrawal right donee, consider reforming the trust to eliminate her withdrawal right and to defer her beneficial interest until after the insured’s death. However, care should be taken to obtain an advance IRS determination letter that such reformation will not result in a constructive addition to the trust for GSTT purposes.

### In a Crummey-Type Irrevocable Life Insurance Trust, Whose Exemption Should Be Allocated--Donor’s or Donee’s?

#### The Problem. One of the perplexing problems with funding irrevocable life insurance “generation-skipping” trusts with gifts subject to Crummey withdrawal rights deals with whose exemption should be allocated--the donor’s or donee’s?

For example, assume Grandfather establishes an irrevocable trust that lasts for Son’s life with remainder to Grandson. Grandfather then makes a $10,000 gift to that trust. Further assume that Son is granted a Crummey withdrawal right over the entire $10,000 which is allowed by Son to lapse upon expiration of the 30-day withdrawal period. If the trust had a zero inclusion ratio immediately before the gift, how much of Grandfather’s GSTT exemption must be allocated to this gift to maintain this zero inclusion ratio?

The answer appears to depend upon whether the power has lapsed at the time Grandfather filed the gift tax return. If at that time the power had not lapsed, it appears clear that Grandfather should allocate $10,000 of his GST exemption to the trust to insure the trust will have a zero inclusion ratio. However, if at the time of the allocation of the GST exemption by Grandfather, Son’s Crummey withdrawal power had lapsed, then the regulations suggest that the amount of GST exemption that should be allocated by Grandfather would equal the amount of his transfer less that amount of the Son’s lapsed withdrawal right that is considered to be a taxable gift by Son (in the above example, $5,000). However, this author suggests that until the regulations become final and this issue is clarified, Grandfather should continue to allocate GST exemption in an amount equal to the entire amount of his transfer. Cf. Prop. Treas. Reg. § 26.2652-1(a)(5), at example 5.

#### A More Reliable Solution--Make Sure Son Is Not Deemed to Have Made a Gift Over. A more reliable solution, that is, a solution which insures that the correct individual is allocating his GSTT exemption, is to draft the trust in a manner that prevents the Crummey powerholder from making a completed gift upon lapse of the withdrawal right. Although discussed in more detail in the next section, common ways to accomplish this include (i) limiting the powerholder’s withdrawal right to the “$5,000 or 5%” limit or (ii) using the so-called “hanging power” approach.

# tax consequences to the beneficiary

## Gift, Estate, Income and Generation-Skipping Transfer Tax Consequences to Beneficiary-Donee Because of Crummey Demand Right.

### General.

#### Annual Exclusion. The annual gift tax exclusion is now $15,000 per year. This means that a married couple, acting together, can give up to $30,000 per year per donee without depleting the couple’s combined unified gift tax credit. The change also permits larger life insurance policies (with correspondingly larger annual premium payments) to be owned by an irrevocable life insurance trust with Crummey withdrawal rights. For example, if the trust has four beneficiaries with Crummey withdrawal rights, a married couple can contribute up to $80,000 to that trust without adverse gift tax consequences. The full annual exclusion can be obtained by allowing each beneficiary to withdraw the full $20,000.

#### Increased Exclusion to Donor Gives Rise to Potential Tax Problems for Donee. While the increased annual exclusion is certainly a significant benefit to donors, full utilization of this annual exclusion in connection with gifts to an irrevocable trust [insurance or otherwise] with Crummey withdrawal rights can result in adverse tax problems for each beneficiary-donee. This is because the withdrawal right is a general power of appointment and the lapse of that power can have adverse gift and estate tax consequences because of I.R.C. §§ 2514(e) and 2041(b)(2), neither of which were changed by ERTA.

##### I.R.C. § 2514(b) and (e). The exercise or release of a general power of appointment created after October 21, 1942 is treated, for gift tax purposes, as a transfer of property by the individual possessing the power of appointment. I.R.C. § 2514(b). Furthermore, the lapse of post-October 21, 1942 powers of appointment during a calendar year by the individual possessing those powers shall be considered a release of [and therefore a transfer of property subject to] those powers, but only to the extent that the property which could have been appointed by the exercise of such lapsed powers exceeds in value the greater of (a) $5,000 or (b) 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied. I.R.C. § 2514(e). This means that if the foregoing “$5,000 or 5%” limit is exceeded, the individual who allows such powers to lapse is deemed to have transferred that excess amount (hereinafter sometimes called the “Transferred Excess”) and that transfer is subject to scrutiny, under the gift tax statutes, in the same way as any other transfer. Thus, if the donee has parted with dominion and control of the Transferred Excess, he may be deemed to have made a gift.

##### I.R.C. § 2041(b)(2). I.R.C. §2041(b)(2) is the estate tax counterpart of I.R.C. § 2514(e). The language of I.R.C. § 2041(b)(2) is nearly identical to that used in I.R.C. § 2514(e). Thus, the lapse of post-October 21, 1942 general powers of appointment during a calendar year by the individual possessing those powers shall also be considered a release of [and therefore a transfer of property subject to] those powers but only to the extent that the property, which could have been appointed by the exercise of the lapsed powers, exceeded in value, at the time of the lapse, the greater of (a) $5,000 or (b) 5% of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied. Accordingly, if the donee is deemed to have made a transfer of such excess amount under the foregoing provisions and thereafter dies, the personal representative of the donee’s estate must determine if the property attributable to the Transferred Excess is includable in the donee’s estate under I.R.C. §§ 2035, 2036, 2037 and/or 2038. Treas. Reg. § 20.2041-3(d).

#### Warning Regarding Multiple Withdrawal Rights. Beware of Rev. Rul. 85-88, 1985-2 C.B. 201. That ruling makes it clear that a donee is allowed only a single “$5,000 or 5%” limitation for lapsed withdrawal rights during a calendar year regardless of the number of gifts in a calendar year. Thus, where a donor made two successive $5,000 gifts to a newly formed Crummey trust in the same calendar year, both of which lapsed within that year, the donee was deemed to have made a $5,000 transfer to the trust. Similarly, when a donor made a $5,000 gift to each of two Crummey trusts, the donee was required to aggregate the two gifts (as if made to the same trust) in applying the “$5,000 or 5%” limitation.

### Closer Examination of Gift, Estate, Income and Generation-Skipping Transfer Tax Consequences to Beneficiary-Donee of a Lapsed Withdrawal Right. In order to more carefully examine the potential gift, estate, income and generation-skipping transfer tax consequences to the beneficiary-donee when he or she allows a Crummey withdrawal right to lapse, a simple example is in order:

Example: Husband (age 45 and a nonsmoker) and Wife establish an irrevocable life insurance trust for Son, (age 22). The purpose of the trust is to provide estate liquidity to preserve the family business. Independent Trustee is considering the purchase of $1 million of whole life insurance on the life of Husband having an annual premium of $18,830. Thereafter, Husband and Wife make a gift of $20,000[[5]](#footnote-5) to the trust and Trustee thereafter notifies Son of his noncumulative right to withdraw $20,000 for a period of 30 days after receipt of the notice. Son, voluntarily and without coercion, allows his withdrawal right to lapse. After the withdrawal period has expired, Trustee purchases a $1 million whole life insurance policy on Husband’s life and, accordingly, the Trustee pays the annual $18,830 premium.

Under the terms of the trust, the Trustee may, in its sole and absolute discretion, make distributions of income or principal to or for the benefit of Son. If Son dies during the term of the trust, Son’s wife and two children will be beneficiaries. The Trust is to last until the later of (a) the last to die of Husband and Wife or (b) when the youngest of Son’s children is age 25.

Each year the “$20,000 gift-premium payment” process continues and Husband unexpectedly dies 20 years later. No other gifts are made to Son in any year; therefore, the $20,000 contribution each year does not exceed the available annual exclusions of Husband and Wife.

### Gift Tax Consequences to Donee. Each time Son allows his $20,000 withdrawal right to lapse, he is deemed to have transferred for gift tax purposes an amount equal to $20,000 minus the greater of (a) $5,000 or (b) 5% of the value of the trust at the time of the lapse. This could result in a gift of a future interest by Son that would require the filing of a gift tax return and use up Son’s federal gift tax unified credit. What can be done to prevent [or at least minimize] these adverse gift tax consequences?

#### The $5,000 Withdrawal Right Solution. From the beginning, the trust could have named Son, Son’s wife and two children as permissible distributees and could have granted Son, Son’s wife and two children separate Crummey withdrawal rights which were limited to $5,000 per beneficiary per year. Husband and Wife could then limit their trust gifts to $5,000 per donee-beneficiary per year ($20,000 total).

##### Advantages. The principal advantage to this approach is that when a donee-beneficiary allows his or her withdrawal right to lapse, there are no adverse gift or estate tax consequences since the $5,000 limitation is never exceeded. Second, other than the withdrawal right, a donee-beneficiary does not need to be given any control over the ultimate distribution of the trust. Third, this approach is easy to explain and requires very little special drafting. Finally, the trust funds will be there when the family needs the liquidity.

##### Disadvantages. There are two main disadvantages to this approach. First, this solution may not accommodate very large annual gifts (i.e., gifts which are greater than $5,000 per donee-beneficiary). Second, expanding the number of donees may increase the probability that a withdrawal right is exercised.

Question: Is the “$5,000 or 5%” Rule Applicable to a Withdrawal Right that is Waived? A literal reading of I.R.C. § 2514(e) and § 2041(b)(2) suggests that the “$5,000 or 5%” safe harbor only applies to a withdrawal right that lapses and does not apply to a withdrawal right that is affirmatively waived by the beneficiary. Although this author suspects this to be a distinction without a difference, prudence suggests that the irrevocable trust (and the written notice sent to the beneficiaries informing them of their Crummey withdrawal rights) should not allow the beneficiary to affirmatively waive or release the withdrawal right. If the beneficiary intends to allow the withdrawal right to lapse, and is anxious for the trustee to use the gifts for the purpose of paying premiums, the beneficiary should, in writing, inform the trustee of the beneficiary’s intent to allow the withdrawal right to lapse. The beneficiary should also affirm that the trustee may rely on this representation.

#### Estate Trust Solution.

##### Explanation of Approach. The trust could have been drafted so that Son is the sole beneficiary during his lifetime and upon Son’s death, the trust would terminate in favor of Son’s estate. This would prevent the Transferred Excess from being a gift by Son at the time of the lapse.

##### Advantages. The “Estate Trust Solution” is easily understood and avoids the beneficiary-donee’s gift tax problems upon the lapse.

##### Disadvantages. One of the reasons a client may have established such a trust is to create a source of liquidity (through loans and asset purchases) to the estate of the client and possibly the client’s spouse. Under the Estate Trust Solution of our example, if Son were to die before Husband or before Husband’s and/or Wife’s estate tax liability is paid, the $1 million of insurance would pass to Son’s estate, thereby creating further impediments to using those proceeds to provide liquidity to the estate of Husband and/or Wife. This is particularly true if Son has died intestate or has left his entire estate to his wife.

Under the Estate Trust Solution, Husband and Wife have no guarantee that the insurance proceeds will remain within their lineal line after Son’s death.

If Son dies after Husband’s death, the insurance proceeds will be included in his estate for federal estate tax purposes. This result could have been avoided all or in part by use of one of the other solutions described herein.

Since the trust will be included in Son’s estate, this is not a cost- effective generation-skipping device. In fact, Husband and Wife would have wasted any GSTT exemption allocated to the trust.

#### Special Power Solution.

##### Explanation of Approach. The above-described trust could have been drafted to grant Son a testamentary special power of appointment over the trust so that the Transferred Excess is deemed to be a transfer that is incomplete for gift tax purposes (hereinafter called the “Special Power Solution”). This approach has been sanctioned in several private letter rulings. See PLR 8825111 (3/30/88) (the lapse of a beneficiary’s withdrawal right in excess of the “5% or $5,000” limit was not a completed gift because the trust granted the beneficiary a testamentary general power of appointment); PLRs 8517052 (1/29/85) and 8229097 (4/22/82). The theory is that because of the special power, the beneficiary has retained dominion and control over the Transferred Excess. See Treas. Reg. § 25.2511-2(b). This is a very useful approach but does result in some potential estate tax and generation-skipping tax consequences as noted below.

##### Advantages. This solution is easy to draft and understand. Second, the special power of appointment can be drafted to assure that the proceeds will remain in trust until the estate liquidity needs of the donor(s) have disappeared. Third, the special power of appointment can be drafted to include only lineal descendants of the donor(s).

##### Disadvantage. The main disadvantage is the potential adverse estate tax consequences to the beneficiary-donee if he dies after the death of the insured donor and if any part of the trust is attributable to deemed transfers by the beneficiary-donee in excess of the “$5,000 or 5%” limitation. If so, that part of the trust would be includable in the beneficiary-donee’s estate for federal estate tax purposes under I.R.C. § 2036 [as a transfer with retained control through the testamentary special power of appointment].[[6]](#footnote-6) In addition, if the powerholder is a nonskip person (e.g., Son in above example), this solution should not be used for generation-skipping trusts because of the potentially adverse estate tax consequences to the beneficiary-donee. For example, inclusion in Son’s estate will waste some of Husband’s and Wife’s allocation of the GSTT exemption (i.e., to the extent attributable to any Transferred Excess).

Drafting Point. Under the Special Power Solution [and Hanging Power Solution], the draftsman should include a provision in the trust that permits [but does not require] the trustee to pay the estate tax liability attributable to inclusion of the trust in the beneficiary-donee’s estate.

##### Example of Special Power of Appointment. See Exhibit C attached.

#### Hanging Power Solution. The adverse gift and estate tax consequences could have been totally eliminated through use of a so-called “hanging” or “suspended” power approach (hereinafter sometimes called the “Hanging Power Solution”). See, Covey, “Power of Withdrawal,” U.S. Trust--Practical Drafting 77 (October, 1982). See also PLR 8701007 (9/30/86) (allowing annual exclusion where beneficiary had so-called “hanging” withdrawal power). But See Ltr. Rul. 8901004 (9/16/88) (In technical advice, the National Office held that the “hanging power” was, in effect, a condition subsequent and therefore ineffective to prevent the gift over.).

##### Explanation of Approach. The attractiveness of this approach is that if everything falls into place, the beneficiary-donee avoids all adverse gift and estate tax consequences in connection with the lapse of Crummey withdrawal rights. Under this approach, when a beneficiary-donee’s withdrawal right is about to lapse (but has not yet actually lapsed), the trust would provide that the lapse will occur only to the extent that the lapse will not be treated as a release of a general power of appointment under either I.R.C. § 2514 or I.R.C. § 2041. The amount which would have been considered a transfer (i.e., the amount in excess of the “$5,000 or 5%” limitation) remains open and subject to a continuing [or hanging] withdrawal right by the beneficiary-donee until such time as it can lapse without adverse gift or estate tax consequences. In essence, the “hanging” amount will carry forward into the subsequent calendar year and be subject to a new “$5,000 or 5%” limitation. If another gift is made in that subsequent calendar year, the prior year’s hanging amount and the new gift will be aggregated and be subject to an “aggregate withdrawal right” against which the “$5,000 or 5%” limitation will be applied. The objective of the Hanging Power Solution is to have a trust large enough in value so that eventually the 5% threshold will apply to the lapsed withdrawal rights and begin depleting the aggregate withdrawal right.

##### Example. To understand clearly how the Hanging Power Solution works, consider the following example:

Assume that on July 1 of a particular year, Parent established an irrevocable trust for the benefit of his only child, Donee. On that date Parent’s initial gift was $10,000. Further assume that Donee is given the right to withdraw any gift to the trust for a period of 30 days. At the end of the 30-day period, Donee’s withdrawal right shall lapse but only to the extent that the lapse shall not be treated as a release of a general power of appointment. That excess amount will not lapse and shall be subject to a continuing withdrawal right by Donee until the lapse of the withdrawal right is not treated as a release of a general power. Donee fails to exercise his withdrawal right within the 30-day period. As a result, only $5,000 [of the $10,000 withdrawal right] lapses and the remaining $5,000 is subject to a continuing [or “hanging”] withdrawal right. This is because the 5% threshold limitation does not apply.

On January 1 of the following year, Parent makes a very large gift to the trust equal to $290,000. At that time, the trust has assets equal to $10,000 (i.e., the original cash gift) making the total value of the trust equal to $300,000. Of the $290,000 gift, Donee is given the right to withdraw $10,000 and also has a right to withdraw the $5,000 hanging amount from the prior year, making a total withdrawal right of $15,000. Donee fails to exercise the withdrawal right within 30 days. Since 5% of the then value of the trust ($300,000) is equal to $15,000, the entire $15,000 withdrawal right can lapse without that lapse being treated as a release of the general power of appointment.

##### Advantages. As can be seen by the above example, the main advantage of the Hanging Power Solution is that under certain circumstances all adverse gift and estate tax consequences to the beneficiary-donee associated with the lapse of a Crummey withdrawal right can be eliminated. Second, if all withdrawal rights finally lapse, any allocation of the donor’s GSTT exemption would have been preserved. This approach is extremely useful in connection with irrevocable life insurance trusts that own a life insurance policy where the premiums “vanish” after a limited number of years (e.g., 10 years). When the policy premiums vanish, cumulative withdrawal rights will begin to systematically lapse each year to the extent of the “$5,000 or 5%” limitation until they disappear altogether.

##### Disadvantages. However, there are three main disadvantages to this approach which must be considered by the lawyer and the client. First, this solution is very difficult for a client to understand and almost as difficult for a lawyer to explain. Second, unless the trustee completely understands how the approach works and has a talent for accounting, he is likely to misstate available withdrawal rights. This is especially true if gifts are made for many years. Third, if the donee- beneficiary is a nonskip person and dies while “hanging” withdrawal rights are outstanding, then any allocation of GSTT exemption attributable to that hanging amount would have been wasted.

##### DRAFTING ALERT--BEWARE of PLR 8901004 (9/16/88). In drafting hanging powers, the draftsman should be aware of Technical Advice Memorandum 8901004 (9/16/88). Under the facts of that ruling, the donor created an irrevocable trust for the benefit of his descendants. The trust granted each descendant a noncumulative right, within 30 days after receiving notice that property has been added to the trust, to withdraw a pro rata share of each addition. The trust further provided that if upon termination of any power of withdrawal, the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes, then such power of withdrawal will not lapse, but will continue to exist with respect to the amount that would have been a taxable gift and will terminate as soon as such termination will not result in a taxable gift.

The obvious intent of the above provision was to put a cap on the amount of the withdrawal right that would lapse so that the only portion that lapsed would be that amount within the “5% or $5,000” limitation. The Service held, however, that the hanging power was not activated until after the withdrawal right lapsed and that the hanging power merely attempted to reverse federal gift tax consequences that already occurred. Relying on Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944), cert denied, 323 U.S. 756 (1944), the Service stated that the above provision was a “condition subsequent” and, therefore, invalid as “tending to discourage enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective.”

The soundness of the above ruling is questionable. Moreover, in this author’s opinion, a valid hanging power can be drafted by wording the power in a manner so as to define, by formula, the amount that is to lapse.

##### Example of Hanging Power of Withdrawal. See Exhibit D attached.

### Estate Tax Consequences to Beneficiary-Donee. In the above example, there could be adverse estate tax consequences to Son if he survives Husband and thereafter dies during the term of the trust. That portion of the trust attributable to Son’s lapsed withdrawal rights exceeding the “$5,000 or 5%” limitation would arguably be includable in his estate for federal estate tax purposes under I.R.C. § 2036. Query, whether any of the above solutions would eliminate or minimize adverse estate tax consequences to Son. Clearly the Estate Trust Solution would not. The proceeds would be includable in Son’s estate for federal estate tax purposes. Similarly, the Special Power Solution would not avoid the bad estate tax consequences because Son’s testamentary special power of appointment over the trust would cause that portion of the trust attributable to each Transferred Excess to be includable in Son’s gross estate under I.R.C. § 2036.

It appears that only the $5,000 Withdrawal Right Solution and the Hanging Power Solution can potentially eliminate adverse estate tax consequences for Son. This assumes, of course, that “hanging” withdrawal rights have been depleted prior to Son’s death.

### Income Tax Consequences to Beneficiary-Donee. The income tax consequences to a beneficiary-donee when that beneficiary allows his or her withdrawal rights to lapse are particularly perplexing (although perhaps no longer as onerous as a result of the Tax Reform Act of 1986 and Revenue Reconciliation Act of 1992).

#### Generally. As a general rule, the current IRS position is that the beneficiary-donee shall be taxed on trust income attributable to his or her Crummey withdrawal rights in two different ways. First, during the period that the withdrawal right is outstanding, the current IRS position is to tax the beneficiary-donee on that portion of the trust income attributable to the outstanding withdrawal right. I.R.C. § 678(a)(1) (which provides that a person, other than the grantor, shall be treated as the owner of any portion of a trust with respect to which that person has a power exercisable solely by himself to vest the corpus or the income in himself). See also PLRs 8701007 (9/30/86), 8521060 (2/26/85), and 8517052 (1/29/85).

Second, when the beneficiary-donee allows the withdrawal right to lapse, the IRS relies on I.R.C. § 678(a)(2) to hold that the beneficiary-donee is taxable on the income of the trust attributable to the entire lapsed withdrawal right. I.R.C. § 678(a)(2) provides that a person other than a grantor shall be treated as the owner of any portion of a trust with respect to which such person has previously partially released or otherwise modified such a power and after the release or modification retains such controls as would, within the principles of Section 671 to 677 of the Code, inclusive, subject a grantor of a trust to treatment as the owner of that trust. See PLRs 8701007 (9/30/86), 8521060 (2/26/85), and 8517052 (1/29/85). Apparently, therefore, the IRS will not extend the “$5,000 or 5%” exception to the grantor trust rules.

#### Exception to Inclusion. Although the IRS would appear to apply the foregoing general rule to an irrevocable “gift trust” (i.e., irrevocable trust with Crummey-type powers which does not own life insurance on the life of the grantor or his spouse), it is currently unclear whether I.R.C. § 678 will ever be applicable to standard irrevocable life insurance trusts. In relevant part, Section 678(b) states that the general rule of I.R.C. § 678(a) will not apply if the grantor of the trust is otherwise treated as the owner under any other provision of the grantor trust rules. Accordingly, since the grantor-insured of an irrevocable life insurance trust would clearly be taxed on trust income to the extent the income is less than or equal to the life insurance premiums payable, I.R.C. § 678(a) would appear not to be applicable to cause a donee-beneficiary to be taxed on trust income.

Query, whether the foregoing provision permanently avoids adverse income tax consequences to a beneficiary-donee who allows his withdrawal right to lapse (during a period when the grantor is taxable on trust income) or whether this is a temporary exclusion. A literal reading of I.R.C. § 678(b) indicates that so long as the grantor-insured is taxable on trust income, the beneficiary-donee will not be treated as a grantor of the trust (under I.R.C. § 678(b) and I.R.C. § 677) with respect to those withdrawal rights which lapse during those periods when the grantor-insured was taxable.

However, if the IRS concludes that the beneficiary-donee’s exemption from adverse income tax consequences under I.R.C. § 678(a)(2) is only temporary in that once the grantor is no longer taxed on trust income (e.g., because of his death), the beneficiary-donee is to be taxed on income attributable to all of the beneficiary-donee’s lapsed withdrawal rights, the adverse income tax consequences described earlier under the general rule could be applicable.

#### How to Avoid Adverse Income Tax Consequences to Donee. There are a number of ways to avoid adverse income tax consequences to the donee-beneficiary attributable to a lapsed withdrawal right. First, after the insured dies, the trustee could invest primarily in tax exempt securities and growth stocks. Although this approach would be subject to market risks, a properly managed portfolio could be a useful hedge against inflation and also provide the necessary liquidity when needed.

Second, the trust could provide for multiple beneficiaries and provide that a distribution shall be made to a donee-beneficiary only with the consent of one or more adverse parties (e.g., other beneficiaries). Thus, even if the donee-beneficiary is considered to be a grantor of the trust, income should not be taxable to that beneficiary because the consent of an adverse party is required. I.R.C. § 672(a); I.R.C. § 677(a).

#### So What? But does it really matter? Since under the Tax Reform Act of 1986 and Revenue Reconciliation Act of 1992 the highest tax brackets are accorded to trusts, is it likely that the IRS will complain since the tax at the trust level is very likely to be higher than it would have been had the income then been taxable to the donee-beneficiary (even if the parent of the donee-beneficiary is taxable on trust income)?

### Generation-Skipping Transfer Tax Consequences to Donee-Beneficiary.

#### Threshold Question--Which Solution is Appropriate For a Generation-Skipping Trust? Which of the foregoing solutions (to solve the donee’s/beneficiary’s gift tax consequences) would be appropriate in a generation-skipping trust. Clearly, the Estate Trust Solution and Special Power Solution would not be appropriate since under our earlier example those solutions would all or in part cause the property to be taxable in the estate of Son thereby defeating any generation-skipping benefits of the trust. Any allocation of Husband’s and Wife’s GSTT exemption to produce a zero inclusion ratio for the trust would have all or in part been wasted through the use of any of these solutions. The $5,000 Withdrawal Right Solution is an appropriate approach since the lapse of that withdrawal right would not result in adverse gift or estate tax consequences to Son. This is likewise the case for the Hanging Power Solution unless Son dies when unlapsed (or hanging) withdrawal rights are outstanding.

Comment: Arguably the best solution is to avoid granting any beneficiary a Crummey withdrawal right. While this would result in depletion of the donor’s unified credit each time a gift is made to the trust, the donor will have more certainty regarding maintenance of a zero inclusion ratio.

#### GSTT Exposure For Donee/Beneficiary. The generation-skipping transfer tax exposure to a donee/beneficiary will depend on two factors, the extent to which the donee/beneficiary, upon the lapse of the withdrawal right, is deemed to be the transferor for GSTT purposes and the terms of the trust. As noted earlier, if upon the lapse of a withdrawal right the Crummey powerholder is deemed to make a gift to the trust (e.g., because the lapsed withdrawal right exceeds the “$5,000 or 5%” threshold), then the powerholder is deemed to be the transferor of that portion of the trust attributable to the gift over. Accordingly, if at the powerholder’s death the trust terminates in favor of a grandson (or other skip person) of the powerholder or if a distribution is made to a skip person (relative to that powerholder) and does not qualify for the medical or educational exclusion, then a portion of that distribution (i.e., the portion attributable to the gift over by the powerholder) will be deemed to be a generation-skipping transfer and therefore subject to the tax unless a sufficient amount of the powerholder’s GSTT exemption has been allocated by the powerholder to the trust to result in a zero inclusion ratio. This bad GSTT result can be avoided through use of the $5,000 Withdrawal Right Solution and the Hanging Power Solution.

# STRUCTURING DECISIONS

## Who Should Be the Grantor? As a general proposition, anyone who is not a trust beneficiary can transfer cash to the trust to enable the trustee to pay life insurance premiums. However, let’s look at some likely candidates:

### Insured’s Spouse? If the noninsured spouse is to be a beneficiary after the grantor-insured’s death, someone other than the spouse should contribute property to the trust. However, if the noninsured spouse shall not be a beneficiary, he or she can transfer cash or other property to the trust without adverse tax consequences.

### The Insured? As a practical matter, the most likely transferor (i.e., grantor) would be the insured. This should not be a problem especially if the trustee is going to be the initial applicant, owner and beneficiary of the insurance. Even if the insured is transferring an existing policy, adverse estate tax consequences will generally disappear after three years.

### Other Beneficiaries. In some instances, it may be appropriate to have non- beneficiaries (other than the insured and the non-insured spouse) as grantors of the trust. For example, it could be tax advantageous for a child to fund an irrevocable life insurance trust, own a life insurance policy on the life of child’s father, the trust benefits the insured’s grandchildren.

Warning to Lawyers Whose Client is Moving to a Community Property Jurisdiction--Check Out those Insurance Trusts. Many attorneys who practice in common law jurisdictions will have clients who move to community property jurisdictions. If the attorney practicing in the common law jurisdiction learns of the client’s move, it is incumbent upon that attorney to review the terms of any irrevocable life insurance trusts established by that client. If the beneficiary of that trust includes the client’s spouse, it is important for the attorney to assess how the movement to a community property jurisdiction will impact the tax consequences sought to be achieved by that irrevocable life insurance trust. Consider the following:

(1) Once the client and his or her spouse move to the community property jurisdiction, any community property gifts to the trust (to enable the trustee to continue the premium payments on the insurance) will be treated for gift tax purposes as a gift by both the husband and the wife. If the spouse is a beneficiary of the trust, a portion of the trust would likely be includable in the spouse’s estate for federal estate tax purposes, under I.R.C. § 2036.

(2) The above problem is even more aggravated if the insurance trust owns a group term life insurance policy. In all community property jurisdictions, premiums paid by the employer for group term life insurance are considered compensation for personal services, and absent an agreement to the contrary, are considered community property. Thus, if an irrevocable trust owns the group insurance, each time the employer pays the premium, both the Husband and Wife will be deemed to have made a gift to the trust in an amount equal to the cost of the group term insurance. Again, this could taint the trust.

(3) All of the above problems can be avoided with proper, relatively uncomplicated documentation.

## Who Should Be The Trustee? The selection of a trustee for the irrevocable life insurance trust is a crucial decision that must not be made on a cavalier basis. Let’s look at some options.

### Insured? The insured should never be a trustee.

### Insured’s Spouse? Theoretically possible but may give rise to allegation that she is mere agent of the insured. If sustained, the insured could be deemed to be trustee. Furthermore, if noninsured spouse/trustee becomes a deemed grantor of the trust because of the community property rules, a portion of the trust could, in part, be includable in her estate under I.R.C. § 2036 or § 2038.

### Closely Related Party? A closely related individual, (i.e., related or subordinate party to the insured and/or spouse within the meaning of I.R.C. § 672(c)), is O.K. if no one else available but again may give rise to “agency” theory.

### Children and Other Beneficiaries. There is theoretically no problem in allowing children and other beneficiaries to be trustees of irrevocable life insurance trusts. However, the draftsman must carefully scrutinize any power that the trustee has to distribute property to himself or herself as a beneficiary. Any such power should be subject to an ascertainable standard and the trustee/beneficiary should be prohibited from distributing property in a manner that would discharge that trustee’s legal obligations to support or educate a beneficiary.

### Independent Party? Independent party, including, but not limited to, a bank or trust company? One of my choices.

### Combination? Combination of closely related party (including spouse) and independent party. One of my choices.

## Who Should Be the Insured, i.e., On Whose Life Should We Purchase the Insurance?

### Husband?

#### Advantages of Insurance on Husband.

##### Premiums Stop at Husband’s Death. Premium commitment ceases upon death of husband, which often makes sense since husband is often principal wage earner.

##### Husband More Likely to Die First. Actuarially, he is most likely individual to die and therefore his death provides a more immediate benefit.

##### Easier Conceptually. Often easiest concept to sell client since client often does not think in terms of insurance on wife.

#### Disadvantages.

##### Premiums More Expensive. Since husbands generally are older than wives, premiums tend to be more expensive.

##### Husband Needs Insurance. Husband may eventually need insurance for business purposes and therefore owning insurance as part of trust may be inflexible, especially if husband is uninsurable.

### Wife?

#### Advantages.

##### Premiums Less Expensive. Premiums often less expensive than on life of husband.

##### Insurance on Second to Die. Insurance most likely to be on life of second to die which, in light of unlimited marital deduction, may be most appropriate place to have insurance.

#### Disadvantages.

##### Premiums May Continue After Husband’s Death. If husband predeceases wife, wife may find continued gifts to trust (i.e., to enable trustee to pay premiums) impractical and a burden.

##### Children Wait for Benefits. Often results, because of actuarial factors, in children having to wait until both spouses deceased.

### Both Husband and Wife? See joint life comment below.

### Does it matter? May not matter.

## What Kind of Coverage and Type of Premium Mode?

### Whole Life? Level premium and fact that policy often can carry itself after several years (e.g., under vanishing premium) makes policy ideal for the irrevocable life insurance trust.

### Survivorship Whole Life? A survivorship whole life policy is an ideal vehicle for an irrevocable life insurance trust. It can provide significant death benefits when needed if the spouses elect to defer all estate tax liability until the second death. These types of policies are also quite useful if one of the individuals is uninsurable or highly rated since the addition of a healthy insured can often result in a very favorable premium.

### Universal Life? May be good life insurance product for an irrevocable life insurance trust given permanent coverage and potentially low premiums.

### Term? Often deceptively inexpensive at any given issuance year when compared to permanent contracts; however, may be all client can afford (or cares to consider) initially. In this event, large amounts of insurance can be purchased in early policy years with substantially less money when compared to similar face amounts using whole life.

Biggest concern is that insurance will become prohibitively expensive and ultimately lapse, in which event cost to draft and maintain the trust may have been wasted.

### Group Term? On the one hand, low value of group term life insurance may make gift of coverage ideal (remember, one revenue ruling said the policy has no ascertainable value). On the other hand, IRS position is that employer premium payments constitute gifts to the trust by employee insured. One private letter ruling says that gift qualifies for the annual gift tax exclusion; however, what is withdrawable? Also, since premiums are often paid on a monthly basis by employer, monthly notice requirements become impractical and burdensome, requiring client to resort to other means. Also risk of lapse upon termination of employment.

### Single Premium Whole Life? Until TAMRA, single premium whole life (“SPWL”) may have been an acceptable choice for two reasons: First, the “inside buildup” was considered the inside buildup of a life insurance policy and therefore not taxable. Second, the trustee would have tax-free access to the cash value through policy loans. TAMRA has eliminated the second advantage. If the policy fails to meet the “7 Pay Test” under I.R.C. § 7702A, the policy will be considered a modified endowment contract. Accordingly, amounts received under the policy will be treated as income first and as recovery of basis second. In addition, loans under the policy or for which the policy is used as security will be treated as amounts received under the policy. Finally, a 10 percent tax will be assessed on amounts received under the policy that are treated as income (with exceptions for amounts received (a) after age 59-1/2, (b) as a result of disability, or (c) as a part of a series of periodic payments for the life of the taxpayer or joint lives of a taxpayer and beneficiary).

### Other?

## Premium Mode. The Less Frequent the Premium Mode the Better.

## How Much Insurance? 100% of combined estate tax liability at each spouse’s death? Total tax liability at first death but no less than 50% of total tax liability? Liquidity needs beyond tax liability should not be overlooked.

## How Long Should the Trust Last?

### Until Insured’s Estate is Administered?

### Until Both Spouses’ Estates are Administered?

## Who Should be Beneficiaries?

### Spouse and Descendants?

### Descendants?

### Others?

Remember, the larger the number of bona fide beneficiaries (other than spouse), the more annual exclusions available and the larger the gifts that can be made to the trust without adverse gift tax consequences. Sham beneficiaries for the purposes only of obtaining annual exclusion are not an option. See PLR 8727003 (3/16/87).

## Common Trust or Separate Share Trusts? Should the insurance trust be a single (aka common) trust for the collective benefit of several donee-beneficiaries? Alternatively, should the insurance policy(ies) be owned by separate share trusts for each donee-beneficiary? The ultimate decision will be made by the client; however, there are advantages and disadvantages to each. The “common trust approach” can reduce paperwork and bookkeeping, especially after the insured dies. The common trust approach is also a useful approach under the $5,000 Withdrawal Right Solution and the Hanging Power Solution. Without complex drafting, however, it does not lend itself to the Special Power Solution. Furthermore, the common trust approach may be better suited for modest amounts of life insurance where division of the proceeds into separate shares could be uneconomical.

The separate share trust approach, on the other hand, does lend itself to the Special Power Solution and may be more appropriate where the children do not have the same parents (e.g., children from prior marriages).

# Uses of ILITs

## Standard Use to Provide Estate Liquidity and Provide for Beneficiaries. Most irrevocable life insurance trusts are designed to provide a source of tax free estate liquidity as well as to provide funds, immediately upon the death of the insured, for his children.

## When Complete Tax Deferral Not An Option - e.g., May Be Better Than QTIP Trust Arrangement. Some clients are not enamored with the QTIP Trust arrangement. Some clients are simply not comfortable with providing that the bulk of the estate should pass to surviving spouse. Irrevocable life insurance trust often more flexible than QTIP Trust.

### Characteristics of QTIP. A QTIP Trust must have the following characteristics:

#### All Income to Spouse. Spouse must receive all income (whether or not needed).

#### Spouse Only Beneficiary. Spouse can be the only beneficiary of the trust during her lifetime.

#### Spouse Has Indirect Power Over Unproductive Trust. Spouse must be given the power to compel the trustee to make the trust productive of income. Alternatively, trustee must be subject to prudent man investment rule. In either instance, QTIP Trust may not be an appropriate vehicle for certain types of assets. Consider what would happen if QTIP Trust funded with closely held business interest and spouse compels that the interest be made productive of income or that the trustee be subject to prudent man investment power (which may require diversification).

#### Trust Included in Spouse’s Estate. Value of trust includable in surviving spouse’s estate based on value at her death (or six months later).

### Characteristics of Irrevocable Life Insurance Trust as Compared to QTIP Trust:

#### Discretionary Distributions of Income O.K. Trust need not distribute all income to spouse. Trust can be a discretionary “spray” trust among spouse and descendants.

#### Broad Investment Powers. Trustee can be given broad investment powers, including the power to hold a closely held business interest.

#### Estate Tax Exclusion. Very likely that insurance proceeds will not be includable in spouse’s estate for federal estate tax purposes.

## To Freeze the Value of the Decedent’s Estate. The tax free insurance proceeds can be used to prevent post-mortem appreciation in a decedent’s estate. Accordingly, if the decedent’s estate consists of assets likely to appreciate in value, the irrevocable life insurance trust can prevent those assets from passing to or for the benefit of the surviving spouse (and therefore be subject to taxation upon her death) by purchasing the assets.

## To Provide Creditor-Proof Liquidity for Insured’s Family. Under certain circumstances, the irrevocable life insurance trust can protect assets from the reach of the donor’s creditors even if the donor subsequently experiences financial difficulties. Use of a whole life plan as the principal asset of the trust could be very helpful in this regard. So long as gifts to the trust do not render [or are made at a time when the donor-insured is] insolvent and so long as the gift is not made with an actual intent to hinder, defraud, or delay creditors, gifts to the trust should be insulated from the donor’s current and future creditors. Because of the changes to the tax treatment of single premium whole life products under TAMRA, a longer pay period is called for in the funding of the policy and trust. However, this plan can still be useful for protecting assets in hard times.

## To Provide for Non-Spouse Beneficiaries Without Adverse Estate Tax Consequences. One of the most important uses of an irrevocable life insurance trust is to provide for non-spouse beneficiaries upon the death of the insured without adverse estate tax consequences. Consider the following actual situations where this objective was important:

### Children From Prior Marriage - But Unlimited Marital Deduction Desired. Husband had children from a prior marriage and a child by his current wife. Husband had a sizeable estate and wanted to use the unlimited marital deduction (through a QTIP trust arrangement) for his wife primarily to avoid all federal estate tax liability at his death. However, since his wife was considerably younger than him, Husband did not want his children [from a prior marriage] to wait until his wife’s death to enjoy the benefits of his estate. Solution: Establishment of an irrevocable life insurance trust for the primary benefit of Husband’s children from his prior marriage.

### Family Business. Husband owned a huge ranch with substantial oil and gas production, farming and ranching. The ranch had been in Husband’s family for generations. If Husband used the unlimited marital deduction through a QTIP trust arrangement, nearly all of the ranch would pass into that trust and be subject to the prudent-man investment rule (which could require diversification of the QTIP trust assets) or Wife’s power to compel that the QTIP trust be made productive of income. Husband also wanted his children to enjoy approximately half of his estate immediately upon his death (through further trust arrangements). Solution: An irrevocable life insurance trust was established which owned approximately $15 million of life insurance on Husband’s life and another irrevocable life insurance trust was established which owned approximately $5,000,000 of insurance on Wife’s life. The executor of Husband’s estate and trustee of the testamentary trust under Husband’s will were then required, under the will, to sell the family ranch to either of the trusts if the ranch passed to an individual who was not a permitted transferee (or to a trust under which a permitted transferee was the primary beneficiary).

### Provide for Parents, Siblings, Etc. Husband and Wife wanted to provide for their parents and siblings without exhausting their collective unified credit exemption equivalents. Solution: An irrevocable life insurance trust was established for the benefit of those beneficiaries.

## To Perpetuate the Family Dynasty. The irrevocable life insurance trust can be an extremely useful tool to perpetuate the family dynasty. This is particularly true if the trust is set up as a generation-skipping transfer tax device. Consider the situation where Husband, a successful entrepreneur, with an estate of $50 million wishes to pass his estate to his children and grandchildren after he and his wife are deceased. Even if the marital deduction and bypass trust is used with an $11,400,000 exemption, the estate, through payment of estate taxes on the death of the surviving spouse will be significantly reduced and eventually by an additional tax if it is taxed at the children’s level or subject to generation-skipping transfer tax.

As part of this client’s planning, he decides to establish an irrevocable life insurance trust to own a survivorship whole life policy. This trust would provide for the lifetime benefit of the children and then for the grandchildren. The assets of this trust could be used to perpetuate the family businesses after the death of the surviving spouse so as to provide estate liquidity and to acquire assets from the estates of the insured and the insured’s spouse.

## Used in Conjunction with a Charitable Remainder Trust to Replace Wealth. Charitable remainder trusts continue to be popular estate planning arrangements for charitably- minded clients. Very often, such trusts are created during the donor’s lifetime and funded with low- basis liquid assets (e.g., publicly-traded common stock) which can then be sold by the trustee of the trust without recognition of gain. The income can then be paid to the donor for his lifetime (or for a term of years) with the remainder payable to charity. Often the donor is entitled to a federal income tax charitable deduction for the actuarial value of the remainder interest ultimately payable to charity.

An irrevocable life insurance trust can be an excellent complement to a charitable remainder trust. To replace the assets that are distributable to charity, the donor can use some of the income received from the charitable remainder trust to fund an irrevocable life insurance trust that owns sufficient insurance to replace the assets originally contributed to the charitable remainder trust.

## An Alternative to QDOT Planning. An irrevocable life insurance trust may be a marital deduction alternative to a donor-insured married to a noncitizen spouse. Under current law, lifetime or testamentary gifts from that donor-insured to the noncitizen spouse will not qualify for the federal estate or gift tax marital deduction unless the transfers are to the incredibly complicated qualified domestic trust. However, to alleviate some of the burden of having to create these trusts with respect to inter vivos transfers, the annual gift tax exclusion with respect to gifts from a donor- insured to his spouse has been increased from $10,000 to $100,000 per year. This additional amount would permit a substantial funding of an irrevocable trust to be the owner and beneficiary of a life insurance policy on the donor’s-insured’s life. This trust could be established to be excluded from the insured’s estate and could provide very flexible planning (far more flexible than the qualified domestic trust) for the benefit of the noncitizen spouse.

## The Irrevocable Insurance Trust as a Limited Partner in a Family Limited Partnership. Under certain circumstances it may be appropriate (and very advantageous) to allow an irrevocable life insurance trust to be a limited partner in a family limited partnership. If the family limited partnership generates substantial cash flow, the insurance trust can use that cash to pay life insurance premiums, thereby reducing the need for ongoing gifts to the trust. In using this approach, the practitioner must carefully evaluate the grantor trust applications of this arrangement. Unless the consent of an adverse party is required, any income received by the Trustee from the partnership that is used to pay premiums on policies actually owned by the trust would be taxable to the grantor in an amount equal to the lesser of the income from the trust or the premiums payable by the trust. At first blush this may seem to be a problem, however, payment of the income tax liability by the grantor is often viewed as a way to add value to the trust without adverse gift tax consequences. Actually, it is a way to prevent reduction of value.

**EXHIBIT A[[7]](#footnote-7)**

**Example of Standard Withdrawal Right**

      Primary and Secondary Beneficiary’s Right to Withdraw.

(a) Grant of Withdrawal Power. The Settlor, or any other person who transfers property to the trust or is deemed to have transferred property to the trust, shall have the power, with respect to a contribution to the trust to designate, by a writing delivered to the trustee, which members, if any, of the class consisting of the then beneficiaries of this trust, shall have the power to make a withdrawal from the trust as provided herein, and to designate the amount each beneficiary may withdraw. If no express designation was made by the transferor or transferors, then a beneficiary shall not have the power to withdraw from the trust as set forth below.

(b) Withdrawal Terms. If a Primary or Secondary Beneficiary is granted a withdrawal right as provided above, then upon initial funding and upon receiving additional assets or properties by lifetime gifts (as opposed to bequests or from transfers as a result of the death of the Settlor), the trustee will give notice to each Primary or Secondary Beneficiary with a withdrawal right (or if a Primary or Secondary Beneficiary is under any legal disability of any kind, to the Primary or Secondary Beneficiary’s legal guardian or if no legal guardian has been appointed, to such Primary or Secondary Beneficiary’s natural guardian, or if none, his attorney-in-fact) of said addition. On or before the thirtieth (30th) day following the date of the initial funding or the addition of additional assets or properties by lifetime gifts (as opposed to bequests or from transfers as a result of the death of the Settlor), or the last day of the calendar year in which the addition is made, whichever is earlier, each Primary or Secondary Beneficiary with a withdrawal right during the lifetime of the Primary or Secondary Beneficiary, may by written and signed request delivered to the trustee, withdraw from trust principal (unless a different amount is designated pursuant to Section \_\_\_\_\_ (a) above) the lesser of: (i) an amount equal to his pro rata share of the market value of such initial funding or such addition or additions to the trust; or (ii) the smaller of the amounts set forth in Section 2503(b) and Section 2514(e) of the Internal Revenue Code of 1986, as amended. If the Primary or Secondary Beneficiary is then under any legal disability of any kind, exercise of this right to withdraw principal may be by the legal guardian of the Primary or Secondary Beneficiary, (or if no legal guardian has been appointed, by the Primary or Secondary Beneficiary’s natural guardian), acting solely on behalf of the Primary or Secondary Beneficiary in making such demand and receiving such distribution for the Primary or Secondary Beneficiary’s sole benefit. This right shall not be cumulative and amounts not withdrawn in any taxable year may not be withdrawn in any subsequent year. The Primary or Secondary Beneficiary’s right to withdraw principal, if exercised, shall be applied by the trustee to exhaust assets added during the taxable year before resorting to the balance of the trust principal held by the trustee. Any asset held as trust principal by the trust, including, but not limited to, any term, group term, or whole life, life insurance policy on the life of the Settlor may be used to satisfy the withdrawal demand. The right to withdraw assets and properties pursuant to this Section \_\_\_\_\_ shall, during each year, be superior to and prior to any distributions under Section \_\_\_\_\_, and the trustee shall, at all times following an addition to the principal of the trust and while any such withdrawal rights are outstanding, retain sufficient liquid funds or transferable assets in the trust to satisfy all such withdrawal rights which are then outstanding.

**EXHIBIT B**

**Example of Removal and Appointment of Trustee**

      Removal of Trustee. The Settlor (succeeded by the Primary Beneficiary) of this trust agreement shall have the discretionary power to remove any trustee (except \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_) of a trust created by this trust agreement, with or without cause, and to appoint a successor trustee having the qualifications set forth in Section \_\_\_\_\_ below, upon giving written notice to the trustee. The trustee, upon receiving written acceptance of the trust from the successor trustee, shall transfer all of the trust assets to such successor trustee; provided, however, that if any of the trust assets are invested in a common trust fund managed by a bank serving as trustee, transfer of the trust assets shall be subject to the conditions set forth in Article \_\_\_\_\_ of this trust agreement.

      Qualifications of Successor Trustee. Any successor trustee appointed shall be: (a) if the Settlor is the appointor, then the appointee may be an individual, other than the Settlor, any other donor, or any individual who is related to or a subordinate of the Settlor under Section 672 (c) of the Internal Revenue Code of 1986, as amended; (b) if the Settlor is not the appointor then the appointee may be any individual, other than the Settlor or any other donor; or (c) a trust corporation or a state or national bank or trust company in the United States of America, having trust powers, with not less than Fifty Million Dollars unimpaired capital and surplus.

**EXHIBIT C**

**Example of Special Power of Appointment**

      Special Power of Appointment. Upon the death of the Beneficiary, the Beneficiary shall have the power, exercisable by the Beneficiary alone and in all events, to appoint the assets and property in the trust at the time of the death of the Beneficiary, or any part thereof, in fee simple and free of trust, or upon such trusts, terms and conditions as he may determine, to a Secondary Beneficiary, the Settlor, the Settlor’s issue then living or to any charitable organization meeting the qualification for income tax deductions under Section 170(c) of the Internal Revenue Code of 1986, as amended, but in no event shall such special testamentary power of appointment be exercised in favor of or for the benefit of the Beneficiary, Beneficiary’s estate, creditors of his estate, or his creditors. Such special testamentary power of appointment may be exercised in such shares, proportions, and amounts and for such estates, trusts and interest as he may determine, but such special testamentary power of appointment shall be exercised by the Beneficiary by an instrument in writing signed by the Beneficiary, acknowledged and filed with the trustee or by a will or codicil, executed after the date of the establishment of this trust, which refers specifically to this special testamentary power of appointment. If the Beneficiary does not exercise this special testamentary power of appointment, the assets and property of this trust shall pass in accordance with the following subsection \_\_\_\_\_.

**EXHIBIT D**

**Example of Hanging Power of Withdrawal**

      Primary and Secondary Beneficiary’s Right to Withdraw.

(a) Grant of Withdrawal Power. The Settlor, or any other person who transfers property to the trust or is deemed to have transferred property to the trust, shall have the power, with respect to a contribution to the trust to designate, by a writing delivered to the trustee, which members, if any, of the class consisting of the then beneficiaries of this trust, shall have the power to make a withdrawal from the trust as provided herein, and to designate the amount each beneficiary may withdraw. If no express designation was made by the transferor or transferors, then a beneficiary shall have the power to withdraw from the trust as set forth below.

(b) Withdrawal Terms. If a Primary or Secondary Beneficiary is granted a withdrawal right as provided above, then upon initial funding and upon receiving additional assets or properties by direct or indirect lifetime gifts (as opposed to bequests or from transfers as a result of the death of the Settlor), notice will be given to each Primary or Secondary Beneficiary with a withdrawal right (or if a Primary or Secondary Beneficiary is under any legal disability of any kind, to the Primary or Secondary Beneficiary’s legal guardian or if no legal guardian has been appointed, to such Primary or Secondary Beneficiary’s natural guardian, or if none, his attorney-in-fact) of said gift and withdrawal right. Each such beneficiary who has been granted a withdrawal right shall have the continuing cumulative right to exercise his or her power of withdrawal. Provided, however, that each beneficiary’s right of withdrawal shall lapse on December 31 of each calendar year with respect to a portion of the amount subject to withdrawal equal to the greater of $5,000 or 5 percent of the total value of the trust property on such date (or a larger amount as a future amendment may specify in Internal Revenue Code Sections 2514 and 2041). Provided, however, in no case shall a beneficiary’s right to withdraw transferred property lapse until thirty (30) days after the beneficiary learns of the transfer or receives notice as provided above. If the Primary or Secondary Beneficiary is then under any legal disability of any kind, exercise of this right to withdraw principal may be by the legal guardian of the Primary or Secondary Beneficiary, (or if no legal guardian has been appointed, by the Primary or Secondary Beneficiary’s natural guardian), acting solely on behalf of the Primary or Secondary Beneficiary in making such demand and receiving such distribution for the Primary or Secondary Beneficiary’s sole benefit. The Primary or Secondary Beneficiary’s right to withdraw principal, if exercised, shall be applied by the trustee to exhaust assets added during the taxable year before resorting to the balance of the trust principal held by the trustee. Any asset held as trust principal by the trust, including, but not limited to, any term, group term, or whole life, life insurance policy on the life of the Settlor may be used to satisfy the withdrawal demand. The right to withdraw assets and properties pursuant to this Section \_\_\_\_\_ shall, during each year, be superior to and prior to any distributions under Section \_\_\_\_\_, and the trustee shall, at all times following an addition to the principal of the trust and while any such withdrawal rights are outstanding, retain sufficient liquid funds or transferable assets in the trust to satisfy all such withdrawal rights which are then outstanding.

1. For convenience, the grantor-insured spouse will always be referred to in the masculine gender and the non-insured spouse will always be referred to in the feminine gender. [↑](#footnote-ref-1)
2. All references to the “Service” or “IRS” mean the Internal Revenue Service. [↑](#footnote-ref-2)
3. All references to “I.R.C.” or “Code” are to the Internal Revenue Code of 1986, as amended. [↑](#footnote-ref-3)
4. All references to “TAMRA” are to the Technical and Miscellaneous Revenue Act of 1988. [↑](#footnote-ref-4)
5. The extra amount covers the Trustee’s fees and projected expenses. [↑](#footnote-ref-5)
6. The adverse tax consequences, however, could be minimized by allowing the beneficiary-donee to appoint to his spouse or to a QTIP trust. Moreover, given the increased estate tax applicable exclusion ($11,400,000), this may not be much of a problem. [↑](#footnote-ref-6)
7. Example provisions attached as Exhibits are for discussion and educational purposes only. [↑](#footnote-ref-7)