Turning the Spotlight on *Crummey* Powers and ILITs

The Office of Chief Counsel has recently issued a negative ruling on Crummey powers (CCA Letter Ruling 201208026) that is worthy of greater scrutiny. To further explain this ruling and for his insights on the proper administration of irrevocable life insurance trusts (ILITs) and the current opportunities such trusts provide, we turned to Lee Slavutin, MD, CLU. Dr. Slavutin is a principal of Stern Slavutin-2 Inc., an insurance and estate planning firm in New York City, and a member of the CCH Financial and Estate Planning Advisory Board.

Crummey Powers

CCH: Before we begin any discussion of the recent Chief Counsel Advice, could you provide our readers with some background on the subject of *Crummey* powers in general?

Dr. Slavutin: The *Crummey* power is the primary mechanism used to qualify a gift to a trust for the annual exclusion from gift taxes under Code Sec. 2503(b). The term, of course, comes originally from the name of a case dating from the 1960s, *D. Crummey* (CA-9, 68-2 USTC ¶12,541, 397 F2d 82; rev'g 25 TCM 772, CCH Dec. 28,012(M), TC Memo. 1966-144). The power referred to is a limited power of withdrawal granted to the beneficiary of a trust. The object of granting such a power is to ensure that the trust beneficiary is deemed to have a present interest in at least a portion of the trust property so that a gift to the trust would qualify for the annual gift tax exclusion. Although the concept of *Crummey* powers could conceivably involve other types of trusts, the issue is most often encountered in the context of gifts to an irrevocable life insurance trust (ILIT).

Accordingly, using the current inflation-adjusted amount, one could make a $13,000 gift per beneficiary ($26,000 with gift splitting) to a trust each year. For ILITs this can be a powerful tool to provide premium funding.

CCH: Are there any particular issues or problems that present themselves with respect to the implementation of a gift to an ILIT using *Crummey* powers?

Dr. Slavutin: I would state that there are at least four main points to consider. The first centers on the structure of the initial gift. The second concerns the specifics of the *Crummey* notice itself. The third point involves the relationship of the beneficiaries to the donor. And, finally, the fourth point relates to the duration of the withdrawal right.

With respect to the first point, while normally we would want to have the donor make a gift to the trust, have a trust bank account set up, and allow the beneficiary a certain amount of time to withdraw the funds, it may be possible to structure the transaction differently. For example, it is possible to pay the premium directly to the insurance company and still qualify for the annual exclusion if the beneficiary has a withdrawal right to an equivalent amount being held in the trust, such as where the insurance policies held by the trust have sufficient cash value. Furthermore, it is possible to make a qualifying present interest gift to a trust holding term insurance, which does not have cash value. In order to do this successfully, the trust should have language granting the beneficiary the right to withdraw an interest in the policy equivalent to the amount of the gift. For an example of this I would direct your readers to IRS Letter Rulings 8006109 and 8021058.

Despite the Tax Court's rather lenient decision recently in *C. Turner Sr., Est.*, 102 TCM 214, CCH Dec. 58,743(M), TC Memo. 2011-209, I would

maintain that the *Crummey* notice should always be in writing. Not to do so would simply be inviting an IRS challenge. In addition, it is not acceptable to provide one notice that is intended to apply to all future years. Although it is possible to simplify procedures by creating a standard form with a "fill-in-the-blank" date, the point is that the notice should be sent every year when an annual exclusion gift is being made. In the case of a beneficiary who is a minor, the notice should be sent to the beneficiary's guardian. It may also be advisable to require some form of proof of service in order to avoid a later claim that proper notice was never sent. Having the beneficiary acknowledge that he or she is waiving the right to withdraw is another possible administrative alternative.

Specifically, the IRS attacked the legitimacy of the beneficiary's withdrawal right because, under the terms of the trust, the beneficiary could not enforce his withdrawal rights in a state court.

As to the relationship issue, there have been numerous instances in which the IRS contested attempts to claim annual exclusion gifts made to contingent beneficiaries. For example, in *L. Kohlsaat Est.*, 73 TCM 2732, CCH Dec. 52,031(M), TC Memo.1997-212, the unrestricted rights of each of 16 contingent beneficiaries to demand distributions of up to $10,000 annually from an irrevocable trust created by the decedent constituted gifts of present interests because there was no evidence of an agreement that the beneficiaries would not exercise their rights. As a result, the $10,000 annual exclusion was applicable to the gifts and they were not includible in the decedent's gross estate as adjusted taxable gifts. The subject of contingent beneficiaries remains an important consideration in structuring gifts via *Crummey* powers even now.

Finally, comes the question of how long a period of time should be allowed to a beneficiary before his or her withdrawal right expires? In a case that predated *Kohlsaat*, the Tax Court concluded that the legal rights of a decedent's minor grandchildren to withdraw an amount, not to exceed the amount of the annual gift tax exclusion (per donee), from the corpus of the decedent-settlor's irrevocable inter vivos trust within 15 days following the settlor's contribution of property to the trust constituted a present interest (*M. Cristofani Est.*, 97 TC 74, CCH Dec. 47,491, Acq. in result 1992-1 CB 1 and 1996-2 CB 1). As in *Kohlsaat*, it was noted that because there was no agreement or understanding between the decedent-settlor, the trustees, and the beneficiaries that the grandchildren would not exercise their withdrawal rights and the trustees could not legally resist the grandchildren's rights of withdrawal, such rights constituted gifts of a present interest in property for purposes of the annual gift tax exclusion. Accordingly, the decedent's estate was entitled to claim the annual gift tax exclusion with respect to the withdrawal rights of each of the grandchildren in computing the decedent's adjusted taxable gifts for estate tax purposes. Although there is no specific time limit on the duration of a withdrawal right, the objective should be to make sure the time limit is not so short as to be deemed illusory by the IRS. Most trusts we see have a 30 day period for the possible withdrawal of assets by the *Crummey* beneficiary.

CCA 201208026

CCH: In CCA Letter Ruling 201208026 the IRS went after another aspect of *Crummey* powers. Would you please elaborate on that point?

Dr. Slavutin: First, let me stress that this ruling considered issues other than *Crummey* powers, but with respect to that subject only, the IRS addressed a question that I have not previously encountered. Specifically, the IRS attacked the legitimacy of the beneficiary's withdrawal right

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because, under the terms of the trust, the beneficiary could not enforce his withdrawal rights in a state court. Apparently, the trust language required that such an action be brought before some form of arbitration body (referred to in the ruling as "Other Forum"). In terms of the *Crummey* power, this was deemed a fatal flaw by the IRS. To quote directly from the ruling:

> Notwithstanding any provisions in the Trust to the contrary, the Other Forum will not recognize State or federal law. If the beneficiary proceeds to a State court, his existing right to income and/or principal for his health, education, maintenance and support will immediately terminate. He will not receive any income or principal for his marriage, to buy a home or business, to enter a trade, or for any other purpose. He will not have withdrawal rights in the future, and his contingent inheritance rights will be extinguished. Thus, a beneficiary faces dire consequences if he seeks legal redress. As a practical matter, a beneficiary is foreclosed from enforcing his withdrawal right in a State court of law or equity.
>
> Withdrawal rights such as these are not the legally enforceable rights necessary to constitute a present interest. Because the threat of severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory. Consequently, no annual exclusion' under §2503(b) is allowable for any of the withdrawal rights. See Rev. Rul. 85-24, 1985-1 C.B. 329; Rev. Rul. 81-7, 1981-1 C.B. 474.

Without getting into a protracted debate as to whether the IRS is right or wrong on this issue, I think the lesson to be learned from the CCA is that, if you want to preserve the present interest character of the gift, avoid the kind of restrictive language that was included in this particular trust.

Other *Crummey* Issues

CCH: In your experience, are there other issues concerning *Crummey* powers that should be highlighted?

Dr. Slavutin: I would suggest at least two major concerns that I have noted. The first involves the fact that trustees generally find it tedious to comply with the proper procedures when dealing with *Crummey* powers and ILITs. There are instances where the notices are not sent in a timely manner or not sent to the proper parties or addresses. These are not just theoretical concerns. It is important to remember that in the context of an estate tax audit, even if the insurance policies are technically outside of the taxable estate, past uses of *Crummey* powers may be questioned. A disallowance of *Crummey* powers can result in the related gifts being brought back into the estate as adjusted taxable gifts, meaning that unified credit would have to be used to protect them from tax or that tax would actually have to be paid on those gifts.

The second concern involves trusts in which the language governing *Crummey* powers is problematic. For example, the trust describes the withdrawal power in terms of $10,000, which was the amount of the annual exclusion before the law was changed to provide for an inflation adjustment. Or, there may be a situation where everyone assumed the trust included a *Crummey* provision, but for whatever reason that was not the case.

There are at least two possible solutions to the second problem. The first possibility is "decanting" in which you are effectively appointing the property from one trust to another without any adverse tax consequences (but note that IRS is examining the possible tax consequences of decanting; see Notice 2011-101, IRB 2011-52, 932) . The most common requirement to allow decanting is that the trustee has an unfettered right to invade principal. Decanting is now allowed in at least 13 states, with proposed statutes in several more (see "Decanting: Eliminating Trust Sediment," by Sanford J. Schlesinger and Martin R. Goodman, Esq., ESTATE PLANNING REVIEW—THE JOURNAL, February 16, 2012, page 23).

The second solution is a sale from the existing trust to a new trust. And, so long as the new "buyer trust" is a defective grantor trust for income tax purposes, there will be no transfer-for-value problem (see Rev. Rul. 2007-13, IRB 2007-1 CB 684). In relation to this issue, note that in Rev. Rul. 2008-22, IRB 2008-16, 796, the IRS concluded that a decedent's retained power to acquire prop-

erty held in trust by substituting assets of equivalent value was not, by itself, sufficient to cause inclusion of the trust corpus in the grantors' gross estate. The IRS has recently extended the rationale of Rev. Rul. 2008-22 to a decedent's retained power to substitute assets of equivalent value for a life insurance policy held by a trust and concluded that retained power was not an incident of ownership under Code Sec. 2042(2) (Rev. Rul. 2011-28, IRB 2011-49, 830).

The Devil is in the Details

CCH: Moving on to the procedural aspects of administering ILITs, what recommendations would you make to our readers?

Dr. Slavutin: In addition to the *Crummey* powers that we have already discussed there are a number of procedural hurdles that can result in some very adverse consequences. One in particular that comes to mind is where do the premium notices go? Assuming for the moment that the notices go to a large institution, what is the back-up plan if they somehow "fall between the cracks"? The last thing in the world anyone wants to happen is for the insurance policy to lapse because the premiums were not paid. Using a naming convention that is too long may result in the address being truncated and key details being left off. I prefer to list the name of the trustee first and to abbreviate the proper name of the trust. This sounds very basic, but it is important for someone to monitor these kinds of details.

Monitoring Policies in ILITs

CCH: Following the collapse of Lehman Brothers and the greater financial tumult of 2008-2009, the financial strength of some insurance companies was in doubt. What is the situation today?

Dr. Slavutin: In monitoring policies in an ILIT, we have to look primarily at the Uniform Prudent Investor Act and see how its guidelines apply to life insurance policies. I would remind your readers of the decision in the *Cochran* case [*Stuart Cochran Irrevocable Trust, Chanell and Micaela Cochran*, Appellants-Petitioners v. KeyBank, N.A., Appellee-Respondent, 901 N.E. 2d 1128 (Indiana Court of Appeals, March 2, 2009)], in which the trustee—KeyBank—was sued over a transaction involving a change in insurance policies. KeyBank won primarily because it performed the due diligence of getting an independent second opinion from an insurance advisor concerning the proposal before the policy was changed.

The first thing an ILIT trustee should regularly check is the financial strength of the life insurer issuing the policy. One of the most useful indicators, at least as a screening device, that I have found is the Comdex score (www.ebixlife.com). The Comdex score is a composite of all the ratings an insurance company has received from the various rating agencies, such as A.M. Best, Fitch, Standard & Poor's, and Moody's, expressed as a percentile score among its peer group of companies. The highest score is 100. Generally speaking we tend to recommend companies with a Comdex score of 90 or above, and occasionally those with a score between 85 and 90.

To paraphrase Joe Belth (author of *The Insurance Forum*), the single most important factor that a consumer should consider when purchasing a life or health insurance policy is the financial strength of the insurance company. Another important point I want to emphasize is that it is not sufficient to just consider the financial strength of the insurance company when buying a policy, but it also must be checked after the purchase. This is the kind of check that should be done at least quarterly.

CCH: What other issues should a life insurance trustee be concerned with?

Dr. Slavutin: Suitability of the policy is a concern when the initial purchase is being made. Do you buy whole life, variable life, term insurance, etc.? In this regard I like to use a medical analogy. A doctor should never prescribe a medication for a patient without doing a thorough diagnostic work up. This same idea should be applied to life insurance. It is necessary to come up with a rational process for selecting the policy and this process should be documented in writing and included in the trustee's file. For example, a young client may want a policy where the death benefit increases over time to match inflation. Whole life insurance may be suitable for this client, whereas universal life with a secondary guarantee and a level death benefit may not.

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Another question that must be asked concerns premium adequacy. Are the premiums being paid sufficient to keep the policy going for life? This is very important for universal life and variable life policies that are generally not fully guaranteed. Is the original premium still sufficient? In the case of policies that were purchased back in the 1990's when interest rates were running at eight or nine percent, do you now have to increase the premium or can you leave it as is?

Is the product still well priced? A simple example is term insurance. Can the client get the same coverage for a lower premium or a longer duration?

Finally, an often overlooked concern is the health of the insured. For example, a significant improvement in a person's health—they stopped smoking, got their blood pressure or cholesterol under control—could result in a premium reduction. Health of the insured could also be relevant if you are contemplating other estate planning strategies, such as a long-term grantor retained annuity trust (GRAT) or qualified personal residence trust (QPRT). The chances of the insured surviving for the term of such a trust can be important to the success of the strategy. Obtaining the medical records and determining life expectancy will improve the chances of the GRAT or QPRT succeeding.

Current Opportunities for Large Gifts to ILITs

CCH: The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) made a huge change with respect to the lifetime exclusion from gift taxes, increasing the amount from $1 million to $ 5 million and providing for that amount to be adjusted for inflation beginning in 2012 ($5,120,000 currently). With the pending expiration of the 2001 and 2010 tax changes looming at the end of 2012, what kinds of opportunities should planners and their clients be looking at before this benefit possibly goes away?

Fixing Old Problems: Split Dollar, Premium Financing and Policies Trapped in Retirement Plans

Dr. Slavutin: In light of the fact that we really do not know what is going to happen with estate and gift taxes after this year, there are a number of exciting possibilities that present themselves while we still have this relatively large exclusion amount available. For example, if we have an "old" split-dollar insurance arrangement that has become troublesome due to the increasing economic benefit cost of such plans each year, we can now make a large gift to the insurance trust and the trust could then potentially pay back the premium advances made under the split-dollar arrangement. Whether those payments are made to the family business or some outside lender that is funding the split-dollar arrangement, we can pay back the premium advances, terminate the split-dollar arrangement, and effectively end the problem. Of course, one caveat to be aware of when terminating a split-dollar arrangement is the amount of equity build up, assuming we are talking about an equity split-dollar arrangement. And, by "equity" I mean the cash value accumulated over the premiums paid. In such a split-dollar plan, the donor is only entitled to receive its premium advances, while the equity remains in the trust. If the plan is terminated, the equity becomes taxable at that time potentially for income and gift tax purposes. Consequently, terminating a split-dollar arrangement after making a large gift to the insurance trust should be best considered as a strategy in situations that do not involve an equity split-dollar arrangement or where the equity is relatively small.

A second possibility for using the current large lifetime gift tax exclusion involves premium financing. Prior to the increase in the exclusion amount under the 2010 Tax Relief Act, we were constrained for many years by the prior law $1 million gift tax exclusion amount. Premium financing, through a bank or other lender, was a way to fund the purchase of large amounts of life insurance during this time. However, premium financing has its own drawbacks, particularly the interest cost involved. Making a large gift to the trust to pay back the loan is one way to end this problem.

CCH: In the not-too-distant past the Tax Court dealt with various issues concerning insurance policies held in retirement plans. Take for example, *K. Matthies*, 134 TC 141, CCH Dec. 58,133, and *G. Cadwell Jr.*, 136 TC 38, CCH Dec. 58,502 (see ESTATE PLANNING REVIEW—THE JOURNAL, March 24, 2011, page 55). What potential opportunities are there at present with respect to insurance policies held in retirement plans?

Dr. Slavutin: Because a life insurance policy held in a retirement plan at death would result in that policy being part of a decedent's gross estate, it would be advantageous to remove the policy from the retirement plan. Under an exemption to the prohibited transaction rules it is possible to sell an insurance policy from the retirement plan to the participant or to an insurance trust for the benefit of the participant's family (PTE 92-6 and 67 Fed. Reg. 31835). Consequently, if we can make a large gift to the ILIT, the ILIT will be in a position to purchase the policy from the retirement plan. The transfer-for-value issue can be avoided by making the ILIT a grantor trust.

I would, however, suggest two warnings. First, if you are contemplating such a transaction it would be prudent to consult with an attorney who is an expert in the rules under the Employee Retirement Income Security Act of 1974 (ERISA) (P. L. 93-406). Second, one should follow the guidance provided by the IRS in Rev. Proc. 2005-25, 2005-1 CB 962, on exactly how to value the policy being sold by the retirement plan. Do not attempt to be overly aggressive by low-balling this valuation.

Large Gifts to ILITS in 2012

CCH: What about the case of the very wealthy client? Are there any special suggestions you may have for those individuals?

Dr. Slavutin: Assuming we are talking about a client who has the resources to make a $5.12 million gift (or double that amount for a married couple) without negatively affecting their lifestyle and that client, for whatever reason, has a need for life insurance as part of his or her estate plan, there are some intriguing options to consider. The first question to ask is, do you put this entire amount into the life insurance policy or do you split it up with part going toward the life insurance and part going toward an investment side fund, with the latter still held within the trust?

If you put the entire amount of the gift into purchasing the life insurance all in one year, the result will probably be a modified endowment contract (MEC). Accordingly, in the future, if the trust ever wanted to withdraw money from the cash value of the insurance policy that withdrawal is going to be taxable if there is a gain in the policy. You might say, why do I care about this since the reason for buying the insurance in the first place was to provide liquidity at death and not a source of cash during life? The answer is that you simply don't know what is going to happen in 15 or 20 years. Many things can change over time. Maybe the client's child wants to buy a house and the client would like to provide him or her with the cash to be able to do that. If the policy is a MEC that would result in a potentially big tax hit in order to use the cash value that has built up over time. That said, it is not that difficult to avoid the MEC problem. Instead of putting the entire gift amount into the policy in one year, it should be spread out over a period of typically four to seven years.

The next issue to consider is the question of return on investment. To illustrate this point, let us examine the following examples.*

Example 1: Husband, age 54, and wife, age 56, gift $10 million into an ILIT, which will purchase a $50 million second-to-die life insurance policy. The policy is a guaranteed universal life (GUL) policy with a death benefit guaranteed to age 100. In the first of two scenarios, $5.5 million of the $10 million total goes toward the purchase of the insurance policy as a single premium. Even though this would presumably result in a MEC, let us further assume the client has decided to accept that risk. In addition, a GUL policy would not typically generate a large cash value. Consequently, withdrawal of cash is usually not an important issue. The balance ($4.5 million) is invested within the trust in an investment that will earn a hypothetical return of six-percent. We are also assume that the trust is a grantor trust, so the earnings will be taxable to the grantor and the full six-percent return will remain in the trust rather than being eroded by taxation.

Looking at the results of this scenario at one particular point in time—the life expectancy of the couple (ages 91 and 93, respectively)—this is what we see. First, the trust will receive $50 million from the insurance company, assuming both spouses have died. This represents a 6.15 percent return on the premiums paid. As for the side fund, in that same 37-year period, the $4.5 million would have grown to $38,862,392. Thus, the total amount paid to the family of the decedents would be just shy of $88.9 million.

Example 2: Let's assume the same facts as above with the following variations. In this scenario,

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only $2 million is put toward the insurance policy, while $8 million goes toward the side investment fund. In this case, premiums must be paid beginning in year 31 because the initial premium will not carry the policy through all 37 years as it did in the first example. The annual premium in year 31 would be $1,976,165. The premiums in year 31 and later years are expected to come from the side fund. An obvious risk under this scenario is that if the earnings fall below six percent it may not be possible to pay the premiums out of the side fund.

Just as in the first example, assume both spouses die by year 37. The trust will receive $50 million, but in this case the return on the premiums paid is 7.71 percent. The side fund grows to $51,505,832 for a total of over $101.5 million to be paid to the trust beneficiaries.

A conclusion one may draw from this comparison is the possible advantage resulting from deferring premiums for as long as possible. It really brings to mind the necessity to evaluate the allocation of the gift. It is not a foregone conclusion to simply allocate all of the gift to the purchase of insurance.

	Example # 1	Example # 2
Initial insurance premium	$5.5 million	$2 million
Initial side fund investment. Assumes 6% return	$4.5 million	$8 million
Premiums required in later years	No	Yes
Amount paid to family in year 37 assuming both spouses die	$88.9 million	$101.5 million

Variables and Risks

Before concluding this analysis I want to be clear that in examining any such example you have to be cognizant of the possible variables and risks involved:

1. The MEC issue—if later withdrawals from cash value are contemplated, this could be detrimental;
2. Age guarantee for duration of the life insurance—whatever age is chosen must be disclosed to the client so that he or she can decide if this is appropriate or if it should be longer or shorter;
3. Earnings assumption for side fund—it would be advisable to look at the results assuming several different possible rates of return;
4. Grantor's income tax burden—note that in our second scenario, the grantor is going to pay more in income tax. Is this the result the client wants?
5. Point of time—changing the point of time to make the comparison could illustrate vastly different results. For example, using our facts, if you take this illustration out to age 100, the two scenarios wind up flipping as to which ends up better for the family.
6. Credit worthiness of the insurance company—because you are counting on that to back up the guarantee on the policy.

CCH: Are there any final words you would like to leave our readers with on this subject?

Dr. Slavutin: I think it is an exciting time to contemplate these gifting strategies. We have received a number of inquiries in our office about making these large gifts and how to properly allocate the gift between insurance and other investments. Particularly with the possibility of the current large gift tax exclusion going away next year, it behooves us to at least broach the subject with our clients before it is too late.

ENDNOTES

* Illustrations courtesy of Robert Stuchiner, Synergy Life Brokerage, NY, NY