The Irrevocable Life Insurance Trust and Crummey Powers

The primary purpose of using an irrevocable life insurance trust is to exclude the policy proceeds from taxation in the estate of the insured and the insured's spouse. This can be accomplished even though the surviving spouse derives certain benefits from the trust while living. (The trust must be irrevocable, since property of a revocable trust is included in the grantor's estate.) In the usual case, an unfunded irrevocable life insurance trust will rely on gifts from the trust grantor to provide the funds necessary to pay future premiums. Such gifts are subject to the gift tax. I.R.C §2503 (b) provides for a gift tax annual exclusion of up to $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)) per donee per year for gifts of present interests. Gifts of a "future interest" do not qualify for the annual exclusion. Consequently, a gift of a policy in trust or subsequent gratuitous transfers in trust of cash to pay future premiums would ordinarily be future interest gifts for which no annually excludable amount is available.

For example: Able transfers policies on his life to an irrevocable trust created for the benefit of Baker. Upon Able's death the proceeds of the policy are to be invested, and the net income paid to Baker for his life. Since the income payments to Baker will not begin until after Able's death, the transfer in trust represents a gift of a future interest in the property against which no exclusion is available. Reg. §25.2503-3(c).

# Preservation of the Annual Exclusion through Crummey Powers

Some years ago a clever tax planner drafted a trust provision which sought to convert the payment of insurance policy premiums by a trust grantor into a gift of a present interest which would qualify for the annual exclusion. The plan works essentially as follows. The grantor would make a gift of (assume $15,000) in cash to the trust. Upon receipt by the trust, each of the beneficiaries (assume three) would be given a right to withdraw one-third of the cash gift and pocket the money. If the power to withdraw were not exercised within a set period of time, the right would lapse. Assuming that none of the three power holders exercises his or her withdrawal right, the trustee would then be permitted by the trust instrument to use the money for the premium payment. By transferring the premium money to the trust, and giving each beneficiary at least a time-limited power to withdraw his or her designated portion, a present interest is created in each power holder to the extent of the amount which he or she may withdraw - in our example, $5,000 each. Thus, each of the three beneficiaries has received a present-interest gift which qualifies for the annual per-donee exclusion, each gift being less than $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)).

The Irrevocable Life Insurance Trust and Crummey Powers

This technique has become an important tool in estate planning, particularly in connection with life insurance trusts. The time limited power of withdrawal granted in order to create present interests in the donees have come to be known as "Crummey powers." One of the key provisions in an unfunded irrevocable life insurance trust is the "Crummey power." By inserting a special trust provision creating a presently exercisable power of withdrawal, the otherwise non-excludable gift of a future interest is transformed into a gift of a present interest. In *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the Ninth Circuit Court of Appeals held that an unrestricted right to the immediate use, possession and enjoyment of an addition to a trust, whether or not exercised (and whether or not likely to be exercised), makes the transfer a present interest for annual exclusion purposes.

In Rev. Rul. 81-7, the IRS held that, a Crummey power holder must have knowledge of his demand rights under a Crummey power and must have a reasonable opportunity to exercise the power before it lapses, otherwise, the grantor will be denied the gift tax annual exclusion. Thirty days seems to be the shortest reasonable period of time between notice of the withdrawal right and lapse. Notice should contain a detailed account of the existence and duration of the power and the conditions under which it can be exercised.

# Requirement of Beneficial Interest, the IRS View and the *Cristofani*, *Kohlsaat*, and *Holland* Cases

*Cristofani Est. v. Commissioner*, 97 TC 5 (1991), acq. in result only. The IRS has stated its view that the gift tax annual exclusion via *Crummey* is not available, if the power holder has no beneficial interest in a trust. PLR 9141008 explains the IRS position as follows: The pertinent factual question, according to the Service, is whether the beneficiaries ever expected that any of them (other than the donor's children) would enjoy any bona fide rights at all. For example, the trust provides that the grantor's children are to receive the principal benefits from the trust, but there are thirty-two other persons identified as potential remote future beneficiaries. 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 the example, it is understandable that the donor's children would not exercise their right

The Irrevocable Life Insurance Trust and Crummey Powers

of withdrawal. All of them had substantial future rights in the trusts derived from ultimate receipt of the life insurance death benefit. But it is significant that none of the other thirty-two 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.

In an important taxpayer victory, the Tax Court rejected the foregoing IRS position in *Cristofani Est. v. Commissioner,* 97 TC 5 (1991), acq. in result only. In *Cristofani*, the IRS argued that the grandchildren could not have present interests because they had no other vested interests in the trust and it was never intended (by the decedent) that the grandchildren be benefited in any way. The Tax Court disagreed and stated that "the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment... Based upon the language of the trust instrument and stipulations of the parties, we believe that each grandchild possessed the legal right to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand."

In mid-1996 the IRS issued a revised Action on Decision (AOD 1996-10) announcement with respect to the important 1991 *Cristofani* case, along with a Technical Advice Memorandum (TAM 9628004) denying the $10,000 annual gift tax exclusion with respect to transfers in trust subject to nineteen separate Crummey withdrawal rights. Under the facts presented in the TAM, the Crummey withdrawal powers were found to be illusory. Subsequently, in May, 1997, the Service lost another case in the Tax Court (Estate of Kohlsaat, T.C. Memo 1997-212) in which Crummey powers held by 16 contingent trust beneficiaries were sustained. Less than two months after the Kohlsaat decision, the Tax Court again rejected the IRS's "substance-over-form" theory in Estate of Carolyn W. Holland v. Commissioner, T.C. Memo 1997-307. All of these rulings and cases are discussed in more detail below.

# When Does a Withdrawal Right Become Merely "Illusory"?

Although effective use of the Crummey technique is ultimately dependent upon the trust beneficiaries who hold Crummey withdrawal rights not exercising them (so as not to interfere with the grantor's insurance trust planning), to the extent that planners desire to limit the risk of a potential "rogue" exercise, Crummey powers are sometimes structured so that, although the withdrawal right is clearly stated, it is so limited or is so unlikely, as

The Irrevocable Life Insurance Trust and Crummey Powers

a practical matter, to be truly exercisable, that it is merely illusory. Here are some examples:

* Withdrawal power that expires in too short a time to be effectively exercisable.
* Withdrawal power granted to a beneficiary who is not notified prior to its expiration.
* A Crummey power holder who is a minor signs off on a notice of right to withdraw.
* A power to withdraw an amount from a trust which does not have sufficient liquidity during the exercise period to pay the withdrawal.
* The grantee of the power is made to understand that if the power is exercised he/she will be punished in some way (e.g., disinherited).

Over the years since the Crummey decision the IRS has encountered all of the foregoing situations, and has ruled on numerous factual variations, often holding that the purported withdrawal rights were not substantive, but merely illusory.

# Amplifying the Opportunity for Excludable Gift Giving through Multiple Crummey Power Holders.

Since the gift tax exclusion is $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)) per year per donee, it can be seen that the more donees who are given Crummey withdrawal powers, the greater the amount of premium-payment money that can be gifted tax-free to the trust. For example, if we are dealing with a very large insurance policy on which the annual premium is $140,000, if ten different people were given Crummey powers to withdraw up to $14,000 each (or five people at $28,000 each, where the $140,000 gift is joined in by the spouse of the grantor), the grantor's estate could be reduced by $140,000 per year free of transfer tax.

This raises the question as to who may be granted a Crummey withdrawal power. In the original Crummey case the withdrawal powers were granted to each of the four primary beneficiaries of the trust, all of whom were children of the grantor. Could the gift tax exclusion be multiplied by granting withdrawal rights to people who are only contingent beneficiaries of the trust, or to spouses of beneficiaries, or, for that matter, to people who have no other direct or indirect interest in the trust.

The Irrevocable Life Insurance Trust and Crummey Powers

In the important case of *Cristofani v. Comm'r.*, 97 T.C. 74 (1991), the trust grantor's two children were the primary beneficiaries of the trust. Crummey withdrawal rights for $10,000 each were granted not only to these primary beneficiaries, but also to the grantor's five minor grandchildren, who held only contingent interests in the trust (that is, they would receive their parent's share only in the unlikely event that the parent predeceased the grandparent/grantor). The Tax Court held that the Crummey powers granted to the five grandchildren represented present interests, qualifying for the annual exclusion, even though they were only contingent beneficiaries of the trust. In Action on Decision (AOD) 1992-9, the IRS announced disagreement with this court decision, and intention to continue to challenge Crummey powers granted to persons who had no other interest, or only a contingent interest, in the trust.

IRS's Pronouncements on Abusive Uses of the Crummey Technique

In mid-1996 the IRS issued TAM 9628004, dealing with a set of facts which were so obviously abusive that they could serve as a case study for tax planners as to how not to structure annual gifts with Crummey powers. In each of three consecutive years the grantor gifted $190,000 to two trusts, claiming the annual exclusion for the entire amount as a result of having granted $10,000 Crummey withdrawal powers to nineteen different people. Three of the power holders were the primary trust beneficiaries (the grantor's children); the other Crummey power holders were the donor's seven grandchildren (contingent trust beneficiaries), two great grandchildren, the three spouses of the primary beneficiaries, and four spouses of grandchildren. The two great grandchildren and the seven spouses had no interest in the trusts other than the purported Crummey withdrawal powers. Other abusive facts cited by the IRS were:

* The trust provisions did not require giving notice to the Crummey power holders of either their rights to withdraw or the receipt of additions to the trust (from which a withdrawal might be taken).
* In one year Crummey power holders were sent notices of their withdrawal rights, dated December 27, giving them until December 31 to exercise their rights. However, the grantor did not even attempt to fund the gift to the trust until December 30, and the funds were not actually received by the trust until January 2. A similar situation occurred at the end of the following year. Were these withdrawal rights illusory, or what!

The Irrevocable Life Insurance Trust and Crummey Powers

* None of the withdrawal rights were ever exercised, even by those parties who had no other interests in the trusts, and no economic reason not to take the money each year.

With respect to the Cristofani (multiple-power-holder) issue, the TAM states that "the Service generally does not contest annual gift tax exclusions for Crummey powers held by current income beneficiaries and persons with vested remainder interests," based upon the logic that these parties might have an economic reason not to exercise their withdrawal rights and leave the money in the trust. On the other hand, in the case of Crummey power holders who hold no interests at all, the IRS argues that there is no logical explanation for such parties consistently opting not to exercise their rights to withdraw their share of the gifted property. "Their non-exercise indicates that there was some kind of pre-arranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both."

Because of the instances in which there was inadequate advance notice of withdrawal rights and/or inadequate funding during the purported withdrawal window period, the IRS held that the grantor "did not intend gifts of present interests by granting the Crummey powers.” Referring to Supreme Court decisions establishing the doctrine that the substance of what was intended governs, rather than the form utilized in attempting to structure the transaction to qualify for favorable tax treatment, the Service concluded that the grantor "did not intend at the creation of the trusts to make bona fide gifts of present interests to any of the trusts' beneficiaries." Thus, the exclusion was denied with respect to all of the Crummey power holders, even the three current income and vested remainder beneficiaries, who, absent the obvious abuses here, would have qualified under even the Service's current treatment of Crummey power holders.

At the same time it issued TAM 9628004, the IRS issued a further Action on Decision [AOD 1996-10] with respect to the 1991 Cristofani case, reiterating that it disputes the court's reasoning and will continue to challenge Crummey powers which do not represent bona fide gifts of present interests, in the form of rights to immediate access to trust assets; the withdrawal rights must be in substance what they appear to be in form. This was again reiterated in April, 1997 in TAM 9731004.

The Irrevocable Life Insurance Trust and Crummey Powers

Estate of Kohlsaat

In the May, 1997 Tax Court memorandum decision, *Estate of Lieselotte Kohlsaat v. Commissioner*, T.C. Memo 1997-212, the IRS pressed several of the elements of its position set forth in TAM 9628004. In this case a commercial building valued at $155,000 was transferred to a trust in which the transferor's two children were the primary beneficiaries and sixteen grandchildren and great-grand-children held contingent remainder interests. The two primary beneficiaries and each of the sixteen contingent remainder beneficiaries were given $10,000 Crummey withdrawal rights, with an adequately-noticed thirty-day exercise period. The resulting aggregate of $180,000 in annual exclusions was more than enough to eliminate any transfer tax on the gift of the building. The IRS challenged the Crummey powers granted to the sixteen contingent remainder beneficiaries.

The Service argued that (i) understandings existed between the parties to the effect that none of the withdrawal powers would actually be exercised, (ii) the contingent beneficiaries believed they would be penalized if they exercised their withdrawal rights, and (iii) the trustees purposely withheld information from these beneficiaries; and therefore, under the substance-over-form doctrine, the withdrawal rights purportedly granted to the sixteen contingent beneficiaries should be ignored. Citing the Cristofani case, the court held for the taxpayer, rejecting the IRS's arguments, stating that the evidence did not support the allegations advanced to show that the form of the arrangement was other than its substance. Of course, it is important to note that the Crummey power planning in this case was infinitely cleaner than the case in TAM 9628004: There was a thirty-day exercise period; adequate notice was given; minor beneficiaries' rights were exercisable by their respective guardians. The only negative factor, which was not even mentioned in the opinion, was the fact that during the thirty-day withdrawal period the trust had no liquidity, its only asset being a commercial building.

Estate of Holland

Less than two months after the Kohlsaat decision, the Tax Court again rejected the IRS's position in *Estate of Carolyn W. Holland v. Commissioner,* T.C. Memo 1997-307. In this case there were eight Crummey power holders. The IRS had argued that because the family had discussed the intended use of the Crummey-gift funds, prior to any transfers by the grantor, there existed an informal agreement that the Crummey powers would not be exercised. The Court rejected the Service's argument that there was any legally effective agreement that no withdrawals would ever be demanded by simply concluding that there was no evidence that the trustee could have been

The Irrevocable Life Insurance Trust and Crummey Powers

prevented from paying over the funds if a demand had been made. Such a conclusion effectively rejects the Service's substance-over-form theory, since the Court seems to be requiring proof of an actual enforceable agreement between the grantor and the Crummey power holders that the latter will not exercise their power.

TAM 200341002 and Charitable Crummey Beneficiaries

This standoff makes the IRS's most recent salvo, in TAM 200341002 (October 10, 2003) all the more interesting, because its crux is the Service's contention that the beneficiary with Crummey powers had no legal right to exercise them. This attacks the Tax Court's position directly. Of equal interest is the fact that the TAM opens a new front in the battle, since this is apparently the first time the IRS has addressed a situation in which the Crummey beneficiaries are charities.

The trust in question was an irrevocable trust whose assets were two whole life policies and some cash. The settlor's oldest child was the trustee. That oldest child, her spouse, and the settlor's younger child were the individual beneficiaries. Four §501(c)(3) charities were charitable beneficiaries. During the settlor's life the trustee had absolute discretion to distribute all or part of the corpus to the beneficiaries for their education, health, maintenance, and support. The beneficiaries had Crummey powers to withdraw proportionate shares of any transfer made to the trust, up to $10,000 per calendar year. (The charities' proportions were 25%, 5%, 5%, and 5%.) When a transfer was made to the trust, the trustee was required to notify the beneficiaries, who then had 30 days to exercise their power to withdraw. In short, this was a typical Crummey arrangement.

The trustee never made any distributions to the beneficiaries during the settlor's life, and when the settlor died the assets were distributed proportionately to the beneficiaries. The settlor made some 11 distributions to the trust, and the trustee sent 44 notices of same to the charities. Several of the notices were defective in various ways. Some were undated. Others were sent so far in advance of the transfer to the trust that the Crummey power expired before the transfer was actually made. Some specified greater withdrawal amounts than the terms of the trust permitted, so that the trustee could not have satisfied withdrawal requests if all four charities had made them at once. Nonetheless, the taxpayer claimed that the transfers qualified for the gift tax charitable deduction under I.R.C. §2522, or, more to the point, for the §2503(b) gift tax exclusion.

The IRS's argument that the transfers do not qualify for the §2503(b) exclusion is based, a little curiously, on the common law of charitable organizations. "Under State law, a gift to a charity is considered as held in trust by the charity for its charitable uses. . . . Thus, a charitable gift must be applied by the charity to its charitable activities. The gift is

The Irrevocable Life Insurance Trust and Crummey Powers

inalienable by the charity for any other purpose. . . . “Since "a charity's officer or director is a trustee and fiduciary with respect to the charity and the charity's property. . . . The officer or director is duty-bound to use care to preserve the charity's property, protect the property against loss or dissipation, and hold the property exclusively for the charity's charitable purposes."

How does this black-letter law apply to the present case? The trustee had absolute discretion to distribute the trust assets, and the individual beneficiaries had ascertainable and therefore enforceable rights to distributions. From these facts the Service concludes: "Thus, any amounts the charities failed to withdraw could have been distributed to the individual beneficiaries during Decedent's life. . . . If a withdrawal right was not exercised, the forfeited amount would become Trust property and be thereby exposed to dissipation for the private interests of Decedent's family." Thus, the failure to exercise the right to withdraw was a breach of fiduciary duty, and "in view of the strict prohibition on the use of a charity's property for private purposes and the fiduciary obligations imposed on a charity and its directors, it is doubtful that any officer or director of a charity could properly participate in this kind of gamble, where funds charity purportedly controls are to be set aside for private utilization until some future date."

The IRS's argument is clear enough, and it seems to lead to a clear and persuasive conclusion: a charitable beneficiary with Crummey powers must exercise those powers. Not to do so would put the charity's property rights at risk, constituting a breach of fiduciary duty. But this is not the conclusion the Service draws. Instead, it states: "we believe that there was a legal impediment prohibiting these withdrawal powers from ever becoming effective." There is no further argument for the existence of this "impediment" except for the insinuation that the charities' failure to withdraw "evidence that at least the charities' understood that they were legally precluded from actively participating in this withdrawal arrangement that allowed funds to enure for private purposes." Of course, this does nothing to establish the IRS's position. A Crummey arrangement is a "gamble" for a charitable beneficiary only if it fails to exercise its withdrawal rights. But this shows the very opposite of what the IRS contends: so far from being legally unable to exercise its Crummey powers, a charity is compelled to exercise them. Since the IRS does not even offer any further characterization of the alleged "legal impediment," it is hard to resist an uncharitable conclusion. The emphasis on what is legally permissible makes sense as a reaction to the Tax Court's position that to show that a Crummey power is illusory, the Service must show that it is legally unenforceable. Seen in this light, TAM 200341002 is another salvo in the Crummey war between the IRA and the Tax Court.

The Irrevocable Life Insurance Trust and Crummey Powers

The End of Charitable Crummey Trusts?

The collateral damage of this skirmish could be severe. If the IRS is right, no trust with Crummey powers can have a charitable beneficiary. Clearly, this would be a major upheaval in tax planning theory and would require the revision of many existing trust arrangements.

There is little chance that the IRS's position would be sustained if challenged in the Tax Court. Not only is it unmotivated, as explained above: it does not even fully meet the Tax Court's emphasis on legality. In Cristofani and its progeny, the Tax Court stresses not only the beneficiary's legal ability to exercise the power of withdrawal, but also the trustee's legal ability to refuse that power. The IRS addresses only the first of these in the TAM. The Tax Court could easily note that the trustee in this case had no legal power to resist a demand from the charities. (In fact, the trustee was required to maintain a reserve to meet withdrawal demands while withdrawal powers were active.) And it could conclude, as above, that the charities were legally required to exercise their Crummey powers, not legally precluded from doing so.

Of course, if that happened the IRS might lose the battle but win the war. For if it became an established principle that charitable beneficiaries are required to exercise their Crummey powers, tax planners will stop drafting Crummey trusts with charitable beneficiaries. For Crummey powers, as noted, are designed not to be exercised. Thus, though there is no reason to expect the Tax Court and the IRS to resolve their differences about Crummey powers any time soon, but the TAM may still lead to a significant change in tax planning.

Summary

Irrevocable life insurance trusts are an important estate planning tool, and Crummey powers represent an important technique for the gifting of annual premium monies to the trust free of gift tax. TAM 9628004 and the updated AOD on the Cristofani case reflect an expansion of the IRS's approach to dealing with abuses of Crummey powers. Although the facts in TAM 9628004 were egregiously abusive, and the Crummey powers which involved inadequate notice and time for exercise, and those which were granted to persons having only remote interests or no interests in the trust, could have been rejected by merely following prior IRS pronouncements on these abuses, the TAM and the AOD go a considerable step further, bringing to the forefront of Crummey power scrutiny a more overtly subjective approach, involving questions such as:

The Irrevocable Life Insurance Trust and Crummey Powers

* substance over form: a prearranged understanding rendering the withdrawal rights paper rights only;
* whether a bona fide gift of a present interest was ever really intended.

Since Crummey withdrawal rights are typically exercisable only during a brief time period, it is fathomable that the IRS would infer that the donor does not really want them to be exercised, and that the gift to the trust is primarily intended for some other use by the trustee. On the other hand, who is to say what the true intentions were in any given case? In effect, the IRS would have the burden of proving the fatal intentions. This in turn points out the heightened importance of structuring Crummey arrangements with great care so that nothing can be pointed to as evidence of either a prearranged plan or an intention on the part of the grantor, that no withdrawals should ever be taken. This point is very well illustrated in the Kohlsaat and Holland decisions. The IRS advanced the positions set forth in TAMs 962004 and 9731004 and AOD 1996-10, but lost the case because the court did not find adequate evidence that the withdrawal rights were not what they purported to be.

Based upon IRS pronouncements prior to TAM 9628004, careful adherence to the following guidelines would probably make it sufficiently difficult for the Service to establish the existence of the proscribed intent or pre-arrangement:

The exercise period should be at least thirty days.

* The trust instrument should require, and the trustee should diligently deliver, timely written notice to each power holder every time there is a new withdrawal right.
* The trust should have on hand adequate liquid assets during the exercise period to make reasonably prompt payment in the event of an exercise.
* If any Crummey power holder is a minor the trust instrument should require the trustee to arrange for the appointment of a legal representative  insufficient time to act for the minor during the exercise period.

Conservatively abiding by the IRS's announced position, Crummey powers would be granted only to trust beneficiaries who are income beneficiaries or hold vested remainder interests in the trust. Unless the IRS abandons its recently reiterated position, Crummey powers held by contingent beneficiaries may be subject to potential challenge, even in an otherwise "clean" factual case. However, the Cristofani and Kohlsaat decisions provide support for granting powers to multiple contingent

The Irrevocable Life Insurance Trust and Crummey Powers

beneficiaries, despite the IRS's position. Additional support for the taxpayer's position would likely be gained by granting the trustee discretionary power to make distributions to such contingent beneficiaries.

In light of [TAM 200341002](http://advisorfx.com/articles/f8_1_21_1040.aspx?action=13#tam%20200341002), prudent planners will think very carefully before granting Crummey powers to charitable beneficiaries, if they do so at all.

Potential Gift and Estate Tax Exposure of Holders of Crummey Powers

While the use of Crummey withdrawal powers, to the extent of $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)) per donee/beneficiary can shelter the donor from gift tax, a Crummey power in excess of $5,000 or 5 percent of the value of the trust principal in any year can have gift tax consequences, as well as possible estate tax consequences), to the beneficiary/power holder. This additional complication is caused by the fact that a Crummey demand power technically falls within the definition of a general power of appointment over the property that is subject to the demand right. The possession of a general power of appointment over property is deemed to be equivalent to ownership of the property for transfer tax purposes.

In effect, the lapse of a Crummey power will be considered a gift made by the power holder to the extent that the power is for an amount that exceeds the greater of $5,000 or 5 percent of the value of the trust principal. Hence, if the powers of withdrawal are limited to the 5 and 5 limitations of IRC §§2041(b)(2) and 2514(e), adverse transfer tax consequences upon lapse are avoided (i.e., as long as property subject to a power of withdrawal does not exceed the greater of $5,000 or 5% of the value (at the time of such lapse) of the aggregate assets out of which the exercise of the lapsed powers could have been satisfied). For example, assume that the Crummey power holder allows a right to withdraw $7,000 to lapse and that during the period when the withdrawal right could have been exercised the total value of the trust was $80,000. The five and five rule will treat $5,000 (the greater of $5,000 or $4,000 (5 percent of $80,000)) as a nontaxable lapse and the remaining $2,000 as a release of a general power of appointment (in effect, as if the power holder had transferred $2,000 of his own assets to the trust). Whether or not this will result in a taxable gift will depend upon the terms of the trust and general principles of gift taxation.

The Irrevocable Life Insurance Trust and Crummey Powers

Planning Approaches for Lapse Amounts in Excess of the 5 and 5 Limitation

Testamentary Powers of Appointment

The IRS has applied Reg. §25.2511(b) to irrevocable life insurance trusts containing Crummey powers that gave the sole beneficiary of each trust a general power of appointment over all trust property (including the lapsed property). Under this regulation, lapse of a withdrawal right is not a completed gift because of the beneficiaries' retained power to control the disposition of the trust at death. PLRs 8229097 and 8517052. A limited power of appointment should yield the same "incomplete gift" tax result. PLR 9030005.

Vested Trust

If the trust provides that a single beneficiary, or his estate, is to receive all distributions from the trust, a lapse will not cause a gift; the gift is never deemed complete because of the beneficiary's retained power to alter the ultimate takers under his will. Code Reg. §25.2511-2(b). However, the entire trust would be includable in the beneficiary's gross estate.

Hanging Crummey Powers

Another technique for avoiding gift tax on lapsed Crummey powers in excess of the 5-or-5 limit involves the preservation of the Crummey withdrawal right to the extent that it exceeds the 5-or-5 limit, and carrying it forward (i.e., leaving it open for exercise by the demand power holder) into future calendar years (cumulatively with similar excesses from other years); the cumulative carry forward amount would be reduced, and hopefully, eventually eliminated through lapses within the annual 5-or-5 limitation in future years in which lapses of Crummey powers, if any, fall below the 5-or-5 limitation. In TAM 8901004 the IRS described a particular hanging power arrangement and ruled, in effect, that it was ineffective and that the beneficiaries holding powers had made gifts to the extent the total amount subject to withdrawal power exceeded the portion sheltered by the 5-or-5 rule. The ruling relied on the principle of *Proctor v. Comm'r*. 142 F.2d 824 (4th Cir. 1944). In the facts of that case a transfer was made subject to a condition subsequent to the effect that if the transfer were later determined by a court to be a taxable gift the transfer would be canceled and the property returned to the transferor. The court held that such a condition was void since it violated public policy by requiring a court to rule on an issue that by virtue of the court's ruling could become moot. While the application of this rationale to a properly drafted hanging power provision is highly questionable, and probably incorrect, TAM 8901004 has never been tested in court. In any event, it would be inapplicable in the case of a hanging power

The Irrevocable Life Insurance Trust and Crummey Powers

provision drafted so that the determination of the extent to which the withdrawal demand right does not lapse and is carried forward is keyed to a mechanical numerical formula (applying the 5-or-5 rule) without the use of language which conditions it specifically to potential tax consequences.

Estate Tax Consequences to the Crummey Power Holder upon Lapse of the Demand Power

In general, IRC §2041(a)(2) includes the value of property subject to a general power of appointment that was released or exercised prior to decedent's death in decedent's gross estate if the result of the release or exercise is the creation of a retained interest described in I.R.C §§2036, 2037, or 2038. For example, in the case of a Crummey power granted to a spouse, if the demand power is not limited by the 5 or 5 limitation, the lapse of the spouse's Crummey power is treated for transfer tax purposes as a release of a general power of appointment. Under these circumstances, if the post death dispositive provisions give the surviving spouse a life-income interest in trust assets, an estate tax problem is created in that the spouse has made a transfer (i.e., a transfer of the lapse amounts in excess of the 5 or 5 limitation) with a retained life income interest. See IRC §2036.

Crummey Powers and the Code Section 2036 Tax Trap

Family wealth transfer planning frequently includes a trust in which the spouse of the grantor holds a lifetime income interest, and the couple's children and/or grandchildren accede to the property following the death of the income-beneficiary/spouse. One of the principal planning objectives is to avoid having the trust assets included in the gross estate of the income beneficiary when he or she dies. Inclusion in the gross estate would result if the income beneficiary had a degree of control over trust property that was the practical equivalent to ownership. Thus, for example, the income beneficiary may not hold a general power of appointment over the trust property. If the income-beneficiary/spouse is also the trustee, as is commonly the case, the trustee's authority to make discretionary distributions of principal to himself must be limited by an ascertainable standard (e.g., "health and maintenance in reasonable comfort").

While taxpayers and their advisers are usually well-attuned to these restrictions in order to avoid inclusion of a trust in the gross estate of the income beneficiary, they may be less likely to realize a potential adverse impact of gratuitous transfers (gifts) to the trust by the income beneficiary. To illustrate, consider the following scenario: H and W are married and have three children. W establishes a trust by the transfer of property owned by her. The trust provides that trust income is payable to H for life, with trust corpus distributable in equal shares to the children upon the death of H. H is named trustee of

The Irrevocable Life Insurance Trust and Crummey Powers

the trust. H does not have a general power of appointment over the trust property, and his discretionary authority to distribute corpus is limited by an ascertainable standard.

The §2036 Trap

The couple anticipates that additional funds will be contributed to the trust in the future by both H and W. Therein lies a potential tax trap! Under I.R.C. §2036, one of the so-called "strings-attached" provisions of the estate tax, lifetime transfers of property in which the transferor retains a life income interest are, in effect, treated as incomplete transfers. If the transferor still retains the income interest as of the date of death (or within three years prior to death), the property will be includable in his/her gross estate. Thus, in the foregoing example any contribution by H to the trust in which he is the life income beneficiary will be subject to §2036, and upon H's death at least some portion of the trust will be includable in his gross estate.

Such a result can occur through lack of awareness of the §2036 rule, perhaps several years after the trust was initially established, by which time the couple might simply have forgotten their estate planner's warning concerning transfers to the trust by H. Of course, this result can be avoided by having all transfers to the trust made from the separate assets of the grantor-spouse, with none originating from the income-beneficiary-spouse.

Application to Crummey Trusts

The §2036 tax trap is very well illustrated by the facts of a private letter ruling involving a Crummey trust. In Ltr. Rul. 200130030 H and W were married with 3 children. W established a trust by the transfer of property owned by her. The trust provides that trust income is payable to H for life, with trust corpus distributable in equal shares to the children upon the death of the last to die of W and H, provided that all of the children are over 25 at that time. H was named trustee of the trust. H did not have a general power of appointment over the trust property, and his discretionary authority to distribute corpus to himself and to the children was limited by an ascertainable standard.

The trust granted to each descendant of W Crummey withdrawal rights for a thirty-day period following each gift to the trust. Withdrawals were limited to the gift tax annual exclusion amount with respect to each eligible beneficiary. If not exercised, the withdrawal rights would lapse with respect to the greater of $5,000 or 5 percent of the assets subject to withdrawal (the so-called "5 or 5" rule). Any unexercised withdrawal right that does not lapse would carry forward (so-called "hanging powers") to future years, lapsing in each succeeding year to the extent of the 5-or-5 limitation in each year. Thus, this was a typical Crummey-power trust. (In order for gifts to the trust for the

The Irrevocable Life Insurance Trust and Crummey Powers

benefit of the children to qualify for the $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)) per-donee annual exclusion from gift tax, these gifts had to be gifts of current interests. Under the rule established in the Crummey case, they qualified as current interest gifts because of the beneficiaries' powers of withdrawal, even though these powers may never be exercised (as is usually the case, through informal pre-arrangement within the family).

In order to take maximum advantage of the Crummey trust arrangement, the couple intended to make annual transfers of the maximum that could be excluded from gift tax through utilization of the $14,000 ([as indexed](http://advisorfx.com/articles/default.aspx?action=35&filename=f55_1_54_1010.htm)) per donee annual exclusion. Since there were three children who all held Crummey withdrawal powers, if H and W each transferred $14,000 with respect to each child, the couple could transfer a total of $84,000 each year free of transfer taxes. But, beware of the §2036 tax trap! H held a life income interest in the trust. Thus, as explained above, any transfers by H to the trust would eventually cause at least some portion of the trust to be includable in H's gross estate.

Avoiding the Trap through Gift-Splitting

However, as confirmed in Ltr. Rul. 200130030, the §2036 tax trap can be avoided in such a situation through statutory gift-splitting under Code §2513(a). Instead of H and W each transferring $42,000 to the trust ($14,000 with respect to each child/beneficiary), W would transfer $84,000 from her separate property, and H would consent to a gift-splitting election. Code §2513 provides that, for gift tax purposes, a gift made by one spouse to any person other than his or her spouse shall be considered as made one-half by each spouse, provided that both spouses signify their consent in compliance with the requirements of Code §2513(b). Thus, through an effective gift-splitting election, H and W will each be deemed to have made $14,000 gifts to each of the three children.

If §2513(a) deems such a split gift to have come 50 percent from H, does this trigger the §2036 trap?  No, according to the letter ruling, citing several published Revenue Rulings. Although W and H file an election under §2513 to treat the gifts to the trust made by W as if made one-half by each spouse, W will be treated as the transferor of the entire value of the gifts to the trust for purposes of the strings-attached estate tax provisions (sections 2036, 2037 and 2038). Thus, the ruling states that §2036 does not apply to property interests that the decedent did not actually own, and thus did not actually transfer.

The Irrevocable Life Insurance Trust and Crummey Powers

The foregoing discussion illustrates how easily a couple might fall into the §2036 tax trap, even while engaging in otherwise sophisticated tax-saving estate planning techniques. With Crummey trusts now in such widespread use as a device to leverage the annual per-donee gift tax exclusion—and the leverage effectively doubled when both spouses are transferors—the risk of running afoul of §2036 looms large. However, a properly advised couple can easily avoid this trap if transfers to the trust come exclusively from separate assets of the spouse who is not the income beneficiary, the other spouse simply joining in a gift-splitting election under §2513.