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**Irrevocable Life Insurance Trusts**

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## Introduction

Life Insurance is typically purchased in an effort to transfer risk. For example, insurance can be purchased to transfer the risk associated with a premature death and provide for the surviving family. It can also be used to provide liquidity upon death so that assets will not have to be sold to pay for estate taxes. This need for liquidity is particularly acute when the major asset of an estate is an illiquid asset such as an operating business or real estate.

However, the use of life insurance in estate planning presents something of a dilemma for the estate planner because the insurance proceeds are themselves included in the estate and therefore subject to estate tax. This can be problematic with large estates. Thus, it is often desirable to arrange the use of life insurance so that it will NOT be includable in the insured's estate. This material explores techniques for achieving precisely that goal.

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| Objectives  This training content looks at one of the most popular estate planning techniques for protecting insurance proceeds from estate taxation: the Irrevocable Life Insurance Trust. By the conclusion of this module, you should be able to:   * Explainhow an Irrevocable Life Insurance Trust works * Illustratethe potential tax savings * Identifysituations where an Irrevocable Life Insurance Trust can be used * Implement or offer some solutions recommended by an estate planning attorney * Understandsome of the procedures necessary to keep a policy out of a client’s estate * Identifypotential risks involved in accepting and administering an Irrevocable Life Insurance Trust |

## Gifting Money to Purchase Life Insurance

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| The insured person must not have any incidents of ownership in the policy for it to be considered outside the insured’s estate. |

The value of a life insurance policy can appreciate dramatically upon death. Since life insurance benefits are included in the owner's taxable estate, it is no wonder that it is one of the first assets planners seek to exclude from estate taxation. But what must be done to exclude life insurance from one's estate?

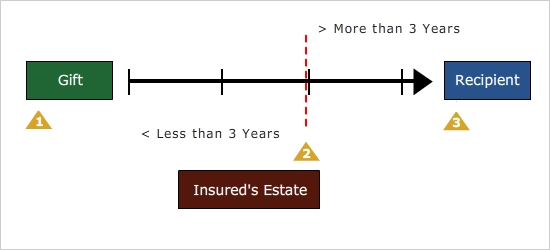
The answer is simple: **Don't own it or have any interest in it!** Generally speaking, if you never owned the policy and the proceeds are not payable to your estate, then it is not considered a part of your estate. For example, if an adult child makes the application for a new policy insuring a parent’s life, is the designated owner, pays the premiums, and receives the proceeds, then it should not be included in the parent’s estate.

Keep in mind that the parent can make a gift each year to the adult child who could, in turn, use the gift to pay the premiums. In 2016, as long as the annual gifts to the adult child are $14,000 or less ($28,000 for joint gifts by husband and wife), there would be no gift tax consequence, as gifts up to this amount (per donee) qualify for the annual gift tax exclusion. Additionally, as long as the insured does not have any of the rights associated with ownership of the policy, it should never be a part of the insured's estate. Rights typically referred to as ***incidents of ownership*** include the right to name the beneficiaries, the right to borrow against the policy, and the right to cash in the policy.

In the event that a person already owns an existing policy on his or her own life, one option is to gift the policy to another person or entity. This can be a bit complicated, as shown on the following page.

## Gifting Life Insurance

The procedure for gifting life insurance is depicted below.



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| **1**  The person gifting the policy must ***absolutely assign*** the policy to another person or entity. By making such an assignment, the transferor will forever surrender all the rights of ownership regarding the policy and retain no incidents of ownership.  In addition, the value of the policy may exceed the annual gift tax exclusion amount that was discussed on the prior page. The value, which is its “interpolated terminal reserve,” is approximately its “cash value.” If the value exceeds the annual gift tax exclusion amount, then the transferor will have to file a gift tax return. This does not necessarily result in payment of a gift tax because people are given a tax credit (“applicable credit amount”) that protects a sizeable amount of lifetime or at-death transfers from having to pay the tax (i.e., the credit offsets the tax that would otherwise be due). However, it *would* diminish the ability to use the credit to offset the tax on subsequent lifetime or at-death transfers. But that may be a small price to pay for the benefit of removing the policy from the estate. |

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| **2**  But there is another issue to consider. If the IRS freely allowed such transfers, it would quickly become common practice for people to make deathbed assignments of insurance in anticipation of their pending deaths. Therefore, the IRS imposes a ***three-year rule*** on the transfer of insurance policies, directing that any insurance policy that is transferred by the owner within three years of death (plus any gift taxes paid on the transfer) will be brought back into the transferor’s taxable estate. |

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| **3**  Therefore, gifting a pre-existing insurance policy is only successful in removing it from the insured's estate if the insured lives for three years after the transfer. |

## Problems with Other Individuals Owning the Policy

There are numerous issues with naming another individual to own the policy.

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| **Loss of Control** |
| The owner of the policy is free to make all decisions regarding the policy, without input or approval of the previous owner. The owner can cash the policy in, borrow against it, or change beneficiaries. Any of these actions could defeat the original plans of the previous owner. Thus, the previous owner must place absolute trust in the intentions, integrity, and maturity of the new owner. |
| **Vulnerability of Assets** |
| Though life insurance does enjoy favorable treatment in certain legal proceedings such as bankruptcy, a life insurance policy may be vulnerable to certain legal actions brought against the owner of the policy. |
| **Adverse Tax Implications for the Owner** |
| If the owner of the policy predeceases the insured, then the value (interpolated terminal reserve) of the policy will be included in the owner's estate. This can sometimes pose a concern. |
| **Difficulty Finding a Suitable Owner** |
| Quite simply, there may not be an individual known to the insured who is mature enough or trustworthy enough to fulfill this role. |

For reasons such as these, most wealthy individuals prefer to have life insurance excluded from their estate by having an irrevocable trust own the policy. A trust is a legally constructed entity capable of owning property and is recognized by the IRS as a separate taxable entity. The trust document, drafted by an attorney, appoints a trustee to administer the assets that are owned by the trust and provides terms by which the trust is to be administered. The document will also designate ***beneficiaries*** and detail the terms by which the beneficiaries will receive benefits from the trust (i.e., income, principal, etc.).

## The Irrevocable Life Insurance Trust

Ownership of life insurance by a trust is achieved by either having the trust purchase the policy or absolutely assigning the policy to the trust (gifting). Obviously, it is preferable to have the trust purchase a new policy since this avoids the ***three-year rule***.

The trust MUST beirrevocable. An ***irrevocable*** trust cannot be altered once it is established. This helps avoid incidents of ownership. If the trust were not irrevocable, the policy can be includable in the insured's estate. For similar reasons, it is best that the insured is not a trustee. It is also advisable that the insured's spouse not be a trustee.

Though there are many types of irrevocable trusts, when an irrevocable trust agreement contains provisions specific to the administration of life insurance policies, the trust is known as an ***Irrevocable Life Insurance Trust (ILIT)***. Trusts that are designed to own life insurance are often referred to as ***Wealth Replacement Trusts*** or ***Asset Replacement Trusts*** as well. This is because they can be used to replace some of the wealth or assets that are eroded by estate taxes or perhaps by charitable gifts. Keep in mind, however, that because estate tax laws are changing, flexibility is paramount in planning. The client should carefully review any and all decisions (especially those that are irrevocable, such as an Irrevocable Life Insurance Trust) with his or her attorney or tax advisor.

Do not confuse an Irrevocable Life Insurance Trust with a “Revocable Life Insurance Trust.” In a ***Revocable Life Insurance Trust***, the grantor remains the owner of the policy, and the trust is merely the beneficiary. Such trusts are created to give the owner of the policy greater flexibility in directing the use of insurance proceeds upon death than could normally be provided for by the insurance policy's beneficiary designation. While it would be possible to create a trust by having the proceeds paid to the owner's estate, and establishing a trust under the will, a Revocable Life Insurance trust avoids the cost and time delays involved with probate. The revocable trust can also provide a degree of privacy. However, unto itself, the revocable trust does nothing to avoid estate taxes, as the policy would still be includable in the owner's estate.

## Why the ILIT is a Better Solution

The Irrevocable Life Insurance Trust can be a preferable solution because it specifically addresses each of the issues that were identified in having another individual be the owner of the policy.

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| **Control** |
| Trust agreements can be extremely flexible documents and can be drafted to meet a wide variety of goals. For example, it might provide income for the surviving spouse, with the remainder to the children upon the surviving spouse's death. It might provide liquidity with which to offset the impact of estate taxes. Or it might prevent the beneficiaries from receiving the insurance proceeds prior to a specific age. Thus, the grantor (the creator of the trust), who cannot make changes to the trust agreement after it has been executed, has dictated the ultimate purpose and use of the trust assets. |
| **Protection of Trust Assets** |
| The assets of the trust are separate and distinct from the trustee's other assets. Thus, they are protected from the trustee’s personal creditors. |
| **No Adverse Tax Implications for Trustee** |
| The trust is a unique tax entity, distinct from both the insured and the trustee. If the trustee dies, the policy is not part of the trustee’s estate and, therefore, has no adverse impact upon the trustee’s estate. |
| **Abundance of Suitable Trustees** |
| There are many choices regarding the selection of a trustee. The trust creator may select any responsible individual or group of individuals to act as trustee or co-trustee, or may select a corporate trustee. Because a trustee is bound to adhere to the administrative terms contained in the trust agreement, the trust creator is relying on the law, not on individual judgment. Furthermore, the trust creator can predetermine successor trustees in anticipation of the death of an individual trustee.  Corporate trustees bring the advantages of experience and expertise. They also bring the advantage that, unlike an individual trustee, a corporate trustee does not die. However, corporate trustees are generally going to charge for their services, whereas an individual trustee (particularly a relative) may not. |

## Funding an ILIT

Generally speaking, there are two types of ILITs when referring to the assets owned by the trust.

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| **Funded Irrevocable Life Insurance Trust** |
| In this scenario, the trust is funded with the insurance policy **and** additional assets, which can be used to pay premiums. This arrangement is used infrequently because of the possible gift tax consequences of contributing the additional assets to the trust. Often, the additional assets will exceed the annual exclusion amount (if available), resulting in the use of the applicable gift tax credit amount or perhaps even a cash payment for taxes. |
| **Unfunded Irrevocable Life Insurance Trust** |
| Actually, this name is a misnomer because the trust **is** funded with the life insurance policy. But it is not funded with any other assets. Each year, the grantor must make annual contributions to the trust to provide the funds needed to pay the premiums. This is customarily the way an Irrevocable Life Insurance Trust is structured because it typically keeps the annual contributions within the annual exclusion amount (if available). |

In either case, funding the trust requires a transfer of assets, which can potentially trigger a transfer tax.

Thus far, we have seen that, in certain circumstances, a client can make tax-free annual exclusion gifts to the policy owner to provide funds for payment of insurance premiums, while keeping the policy out of the client’s estate. However, a gift to an irrevocable trust, unto itself, quite often does not qualify for the annual gift tax exclusion!

Obviously, this presents a serious issue to the planner. If we cannot use the annual gift tax exclusion, then both the initial and future contributions (which are used to make premium payments) would be taxable gifts that would use up some of the tax credit (applicable credit amount) we previously discussed.

Why can't the gift tax exclusion be used with irrevocable trusts? Is there an exception? Fortunately, there is a solution. However, before continuing, let's review the material already covered.

## Review Exercise

1. **The simplest way to keep life insurance out of your estate is to:**

* Not to own it.
* Not be named as a beneficiary
* Not be able to name a beneficiary
* Not be able to borrow against the policy

1. **The three-year rule states that insurance must be transferred within three years of purchase if it is to be excluded from the owner’s estate:**

* True
* False

1. **A trust arrangement where the owner of the insurance policy names an unfunded trust as the beneficiary but does not transfer ownership is typically referred to as a(an):**

* Irrevocable Life Insurance Trust
* Revocable Life Insurance Trust
* Wealth Replacement Trust
* Asset Replacement Trust

1. **When an Irrevocable Life Insurance Trust is funded solely with a life insurance policy, the trust is said to be a(an):**

* Funded Irrevocable Life Insurance Trust
* Unfunded Irrevocable Life Insurance Trust

The answers to these questions are found on the following page.

## Review Exercise – Answer Key

1. **The simplest way to keep life insurance out of your estate is to:**

* **Not to own it.**

**Correct**!

* Not be named as a beneficiary

**Incorrect**. Try again.

* Not be able to name a beneficiary

**Incorrect**. Try again.

* Not be able to borrow against the policy

**Incorrect**. Try again.

1. **The three-year rule states that insurance must be transferred within three years of purchase if it is to be excluded from the owner’s estate:**

* True

**Incorrect**. The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

* **False**

**Correct**! The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

1. **A trust arrangement where the owner of the insurance policy names an unfunded trust as the beneficiary but does not transfer ownership is typically referred to as a(an):**

* Irrevocable Life Insurance Trust

**Incorrect**. Try again.

* **Revocable Life Insurance Trust**

**Correct**!

* Wealth Replacement Trust

**Incorrect**. Try again.

* Asset Replacement Trust

**Incorrect**. Try again.

1. **When an Irrevocable Life Insurance Trust is funded solely with a life insurance policy, the trust is said to be a(an):**

* Funded Irrevocable Life Insurance Trust

**Incorrect**.

* **Unfunded Irrevocable Life Insurance Trust**

**Correct**!

## The Present Interest Requirements

For a gift to qualify for the annual gift tax exclusion, the IRS requires that the gift must be of a **"present interest."** In other words, the person receiving the gift must enjoy an immediate benefit and the unrestricted right to use, possess and enjoy the property. Generally, no annual exclusion will be granted for a ***"future interest"*** where the right to use and enjoy the property does not take place until some future time, although there are exceptions for certain trusts that are for the benefit of minor children. Nor will it be granted for an interest that is **"contingent"** upon the occurrence of an event or subject to the discretion of another person.

But most beneficiaries of irrevocable trusts do not have a present interest in the trust assets. They might have a current income interest, but they typically have no right to the assets of the trust until some future event or subject to the discretion of a trustee. In fact, the objective of an Irrevocable Life Insurance Trust is precisely to leave the insurance policy in the trust until the death of the grantor/insured, at which time the beneficiaries can begin receiving benefits from the trust.

That is a real "catch 22." We only want the beneficiaries to have a future interest in the trust, but we must give them a present interest in order to utilize the annual gift tax exclusion. How can we do both things?

## Don't Confuse Crummey with Crummy

This was precisely the situation that was faced by a couple with the last name of Crummey. They desired to make gifts into an irrevocable trust for the benefit of their children. To create a present interest, they stipulated in the trust that the children would have the right to withdraw gifts made to the trust for a limited period of time. This, their attorney contended, created a "present interest." At the end of that time, if the funds were not withdrawn, the children's power to withdraw the property would lapse and the contributions would be governed thereafter according to the terms of the trust.

The IRS challenged this in court and lost the case. Henceforth, such temporary powers that are designed to generate a present interest have been termed **“Crummey powers,”** after the case that established the precedent.

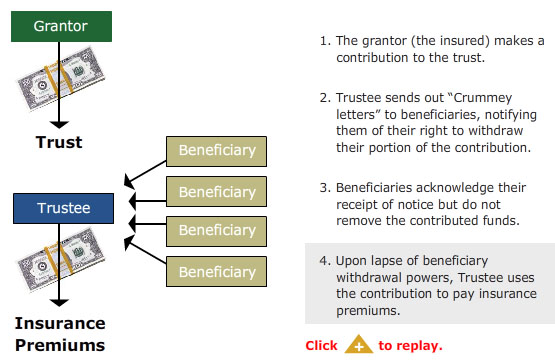
Crummey powers make it possible to apply the annual gift tax exclusion to transfers to an irrevocable trust. This allows the grantor to:

* Make annual tax-free gifts to fund payment of the premiums of the policy.
* Determine (upon creation of the trust) how the assets are to ultimately be used.
* Eliminate the value of the insurance policy from his taxable estate.

## How an Irrevocable Life Insurance Trust Works

Here is how an irrevocable trust with Crummey powers works each year as contributions are made to make the premiums.

**Important: Please note that contributions are made to the trust and the trustee makes the premium payments. It is very important that the grantor not send the premiums directly to the insurance company. Doing so might open the arrangement up to challenge by the IRS.**



## Is it Worth the Trouble?

Of course, there is a lot of work and expense involved in setting up an Irrevocable Life Insurance Trust. Is it worth the trouble? The following example serves to illustrate just how significant this estate planning technique can be.

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| Meet Mr. Brown  Mr. Brown is 58 years of age. His primary source of income is an office building that he built 15 years ago and has operated ever since. He is a widower, his former wife fully utilized the applicable exclusion amount in her estate, and he wishes to leave everything to his two children. He desires for his son to receive the office building and his daughter to receive the home, with the rest of the assets used to equalize their inheritance. His 2016 estate consists of the following assets:   |  |  |  |  | | --- | --- | --- | --- | | Home | $1,750,000 | | | | Office Building | $4,400,000 | | | | Investment Securities | $300,000 | | | | Cash | $40,000 | | | | Land | $1,620,000 | | | | Personal Property | | | $160,000 | | **Total Estate** | | **$8,270,000** | | |

Let’s assume Mr. Brown is making plans in 2016. If Mr. Brown were to die in 2016, and assuming no prior taxable transfers, the tax on his estate would be calculated as follows:

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| |  |  |  | | --- | --- | --- | | **Taxable estate of $8,270,000 (2016)** | | | | Tentative tax |  | $3,253,800 | | Less applicable credit amount |  | (2,125,800) | | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | | | | Estate tax | = | $1,128,000 | |

How to Pay the Tax?

Mr. Brown is faced with two problems. First, his estate lacks sufficient liquidity with which to pay the estate tax. Second, even if the taxes were not an issue, he lacks sufficient funds with which to equalize the children's inheritances.

**What if Mr. Brown Purchases a $2,000,000 Life Insurance Policy?**

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| In real life, Mr. Brown will have to consider the cost of the insurance policy itself and where the funds will come from. Will it be paid from current income or will it require use of some of his assets? However, to keep the illustration as simple as possible, we shall ignore the cost of the policy itself and all estate settlement expense other than the federal estate tax. Here is what happens if Mr. Brown purchases the policy himself.  https://learning.greeneconsults.com/topclass/greene/irrev/images/ilit_12a_v01.gif  Because the insurance policy was owned by Mr. Brown, and included in his estate, it increased his taxable estate by $2,000,000 and increased his estate tax by $800,000 (40% of $2,000,000). The end result is that he can pay the tax without selling either the business or the house, but does not have enough assets remaining to equalize the inheritance of his son and daughter. If his son receives the office building, then his daughter receives a smaller inheritance. |

**What if the Policy is purchased in an ILIT?**

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| Here is what happens if the policy is purchased by and held in an Irrevocable Life Insurance Trust:  https://learning.greeneconsults.com/topclass/greene/irrev/images/ilit_12b_v01.gif  By simply making use of the irrevocable trust to keep the insurance out of his estate, the following can be accomplished:   * An option is frequently included in the trust agreement that allows the trustee to use the insurance proceeds to purchase assets from the estate or make a loan to the estate, thereby providing liquidity to the estate without increasing the estate tax bill. * Mr. Brown can save $800,000 in federal estate taxes. * Mr. Brown can accomplish his goals of leaving the business to his son and his home to his daughter, while equalizing the inheritance of each. |

## Proceed with Caution

As the preceding example illustrates, this can be a very powerful technique for saving estate taxes. So much so that some people have become quite aggressive in their application of Crummey powers. Creative attempts have been made to maximize the annual gift tax exclusion by providing Crummey powers to as many people as necessary to cover the gift, even naming a non-related person who had no interest at all in the trust other than the temporary Crummey powers.

The IRS has been fairly aggressive in challenging situations that it considered shams, where excessive measures were being taken to transfer large amounts. In one case, the IRS even argued that the mere fact that assets are not withdrawn constitutes evidence that the donor's *intent* was for the beneficiaries to not remove the gift and that a prior arrangement had been made to prohibit the beneficiaries from making such withdrawals. So far the courts have not been willing to look at the intent of the donor in establishing the trust, nor have they been willing to infer a prior arrangement simply because the beneficiaries did not exercise the Crummey powers, as long as:

1. There was an immediate and unfettered present interest for the beneficiaries.
2. There is no evidence (beyond the beneficiaries’ failure to exercise the Crummey powers) of a prearranged understanding with the beneficiaries to not exercise the Crummey powers.

The primary point to remember is that you should proceed with caution in using Crummey powers. The IRS may be quick to act against actions that it believes are overstretching or mere shams. If a client desires to transfer a business or real estate through the use of Crummey powers, such possibilities should be explored carefully with an attorney. While the use of Crummey powers in ILITs has become fairly routine, and numerous private letter rulings have approved their use in ILITs, numerous precedents have been established that should be observed by both the attorney and the trustee. Essentially, these are safeguards to make sure that no actions on the part of the grantor or the trustee give the appearance of a sham.

## Considerations in Structuring the Trust

Since the IRS is not particularly enamored with Irrevocable Life Insurance Trusts, a slip up in structuring and administering an ILIT can cause the insurance proceeds to be included in the estate. This could not only frustrate the objectives of the grantor, but could cause considerable liability exposure to the trustee as well.

A qualified attorney should draft the trust. The following considerations are positions that have been frequently expressed by attorneys practicing in the field. In no way should this list be taken as legal advice. However, familiarity with these considerations should assist in reviewing the document and intelligently discussing its terms.

****Trust Structuring Considerations****

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| **1. Do not title the trust as an "Irrevocable Life Insurance Trust"** |
| Doing so might make it possible to argue that the title is an indication that the sole purpose of the trust was to avoid estate taxes and that there was an agreement by all parties to work together to accomplish precisely that goal. |
| **2. The trust document should not "direct" the purchase of insurance** |
| For reasons similar to the preceding consideration, insurance should simply be one of the permissible investments in which the trustee can invest. The choice to purchase insurance should be one that the trustee can freely make. |
| **3. Grantor (the insured) cannot be trustee** |
| The grantor cannot also be the trustee because of the control that would be retained over the policy. Furthermore, to avoid any claim that the grantor maintained indirect control over the policy, it is also generally advisable that the spouse not be trustee. |
| **4. Grantor (the insured) must have "no incidents of ownership"** |
| Incidents of ownership include the power to change beneficiaries, to cash in the policy, and to borrow against the policy. Generally speaking, the power to cancel a policy would constitute an incident of ownership. While the grantor would no longer be able to contact the insurance company and cancel the policy once it is placed in the ILIT, he or she could effectively cause the policy to lapse by failing to make contributions that could be used to pay premiums. But the grantor is never under any obligation to make contributions to the trust, and the failure to do so does not constitute an incident of ownership. |
| **5. Trustee cannot be compelled to pay estate taxes** |
| Generally speaking, the trustee of an ILIT cannot be compelled to pay the estate taxes of the ILIT grantor. However, the trustee is frequently given the discretionary power to pay estate taxes, although the amount used to pay estate taxes would be includable in the insured's estate. An option is also frequently included in the trust agreement that allows the trustee to use the insurance proceeds to purchase assets from the estate or make a loan to the estate, thereby providing liquidity to the estate without increasing the estate tax bill. |
| **6. Crummey powers should exist for 30 days or more** |
| For the annual gift tax exclusion to apply, the trust must contain language that creates Crummey powers. But the IRS has never dictated a specific time period that must exist before those powers lapse. Yet the IRS has approved time periods as short as 30 days, therefore 30 days has become the most common time period used in such trusts. |
| **7. Multiple Crummey beneficiaries permissible** |
| Generally speaking, the attorney will probably exercise caution in giving a Crummey power to someone whose interest is otherwise tangential to the trust. For example, the IRS may consider the Crummey power to be ineffective if given to someone who has no rights to the trust beyond the Crummey power itself. |
| **8. Crummey gifts to minors are permissible** |
| This is true, provided there is an adult with the power to make the withdrawal on the minor's behalf. It is probably advisable that the grantor not be the adult who has the power to act on behalf of the minor. |
| **9. No pre-arranged understanding** |
| There should be no pre-arranged understanding on the part of the beneficiaries that they will not exercise their withdrawal power. For example, the grantor might be inviting a challenge by the IRS if he or she wrote a letter to the beneficiaries threatening to write them out of the will if they ever removed a cent from the trust. |
| **10. Generally best that the spouse NOT be given a Crummey power** |
| While it is technically possible to give the spouse a Crummey power, this is generally not desirable because it could cause a portion of the trust to be included in the spouse’s estate if non-exercise of a withdrawal right is treated a deemed transfer from the spouse to the trust. |
| **11. Surviving spouse can be a beneficiary** |
| It is perfectly permissible for the surviving spouse to be a beneficiary of the trust as long as the surviving spouse is given no powers over the trust that would cause its inclusion in the surviving spouse's estate. |
| **12. Avoid triggering a gift by the beneficiaries** |
| If a beneficiary is given a present interest in the gift to the trust, and decides to leave it in the trust, doesn't the act of leaving it in the trust (i.e., allowing the power over the asset to lapse) constitute a gift to the trust from the beneficiary? The answer is that it could possibly result in a taxable transfer by the beneficiary. To avoid this possibility, the attorney might take one or more of the following steps:   * Limit the Crummey power to the greater of $5,000 or 5% of the trust. This is known as a "*5 x 5 power*." The reason for this is that when you have the power to remove an asset from a trust but you allow it to lapse, it is only considered a taxable transfer by the power holder to the extent that the asset exceeds $5,000 or 5% of the trust. Thus, by limiting the power to this amount, you avoid the possibility of the beneficiary making a taxable gift. * If the beneficiary's interest in the contribution exceeds that amount, then give the beneficiary the right to direct the disposition of the excess in his/her will. This retained power will cause the excess to be included in the beneficiary’s estate rather than be considered a gift. * Alternatively, provide what is known as a "*hanging*" Crummey power that lapses in stages. A hanging power is one that, if not fully used in one year, carries over to the next year. By making the 5 x 5 power a "hanging" power, any amount greater than $5,000 or 5% of the trust would carry over to the next year. This would be repeated until there were no excess amounts to carry forward. |

## Considerations for the Trustee

Most fiduciary institutions have established policies and procedures regarding the acceptance and administration of trusts. Many will have policies and procedures that are specific to Irrevocable Life Insurance Trusts. The following considerations are in no way exhaustive, nor should they be considered legal advice regarding the administration of Crummey Trusts. But they are considerations that are frequently incorporated into operating procedures.

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| **The trust should make the insurance application** |
| If a new policy is to be purchased, the trust should make the application rather than the grantor. This preserves the independence of the trust in making the decision to invest in insurance rather than in other assets. |
| **Change ownership and beneficiary designations of pre-existing policies** |
| Failure to make sure that the ownership and beneficiary designation of a transferred policy are changed to the trust could have major repercussions. In at least one actual case, the beneficiary designation was changed but the ownership was not. This resulted in the proceeds being paid to the trust, but the policy was still includable in the grantor's estate. To further complicate the situation, there was a surviving spouse who could have received the assets, at least making it possible to defer taxation on the policy. But since the assets were paid to the trust, no marital deduction was available and the estate had to pay estate taxes on the life insurance policy proceeds. |
| **Grantor should never pay premiums** |
| The IRS could potentially use the payment of premiums by the grantor as an incident of ownership. |
| **Notice of contributions should be in writing** |
| There is no predetermined format for notices to beneficiaries, but such notices should inform the beneficiaries of the contribution and their right to withdraw. These notices should be in writing; hence they are normally referred to as "Crummey Letters." It is also a good idea to have the beneficiaries provide signed acknowledgement of receipt. |
| **Notice should be given immediately upon each contribution** |
| Again, there is no specific guideline, but in one IRS private letter ruling the IRS gave indication that notices should be sent out within 14 days of contribution. There are also other indications by the IRS that such notices should be done ***each time*** a contribution is made and that beneficiaries cannot waive their right to future notices. |
| **Observe the prudent investor rule** |
| Remember that the trustee is bound by the prudent investor rule, which requires the trustee to make trust investments in a prudent manner. The trustee is responsible for both the selection and purchase of the policy, as well as for the ongoing investment management of the policy. Is the policy competitively priced? Is the insurance company financially sound? These are the types of questions to be asked when deciding to make the purchase. And on a periodic basis the trustee should examine whether or not the policy is performing competitively. |

## Review Exercise

1. **In deciding whether or not the use of a Crummey power is merely a sham to avoid taxes, the courts tend to focus on:**

**A. Whether or not the trustee is obligated to deliver assets to the beneficiaries if demand is made.**

**B. Whether or not the beneficiary has an immediate and unfettered present interest in the gifted property**

**C. The intent of the donor**

* A only
* B only
* C only
* A and B only
* A, B and C

1. **Attorneys typically advise titling a trust as an "Irrevocable Life Insurance Trust" when it is for the purpose of keeping life insurance outside of the grantor's estate.**

* True
* False

1. **The Grantor and Trustee of an ILIT should not be one and the same.**

* True
* False

1. **If the purpose of an ILIT is to provide liquidity for the payment of estate taxes, the document should explicitly direct that the insurance proceeds be used for that purpose.**

* True
* False

1. **The lapse of a Crummey power could potentially result in a taxable transfer on the part of the beneficiary who allows the power to lapse.**

* True
* False

1. **It doesn't matter who pays the premiums for a policy held in an ILIT. Either the grantor or the trustee may pay them, so long as the trustee sends the Crummey letters.**

* True
* False

1. **The courts have generally held that beneficiaries may waive their right to future notices regarding Crummey powers.**

* True
* False

1. **Which of the following is an incident of ownership:**

* Ability to change beneficiaries
* Ability to cash in the policy
* Ability to borrow against the policy
* All the above.

The answers to these questions are found on the following page.

## Review Exercise – Answer Key

1. **In deciding whether or not the use of a Crummey power is merely a sham to avoid taxes, the courts tend to focus on:**

**A. Whether or not the trustee is obligated to deliver assets to the beneficiaries if demand is made.**

**B. Whether or not the beneficiary has an immediate and unfettered present interest in the gifted property**

**C. The intent of the donor**

* A only

**Incorrect**. Try again.

* B only

**Incorrect**. Try again.

* C only

**Incorrect**. Try again.

* **A and B only**

**Correct**!

* A, B and C

**Incorrect**. Try again.

1. **Attorneys typically advise titling a trust as an "Irrevocable Life Insurance Trust" when it is for the purpose of keeping life insurance outside of the grantor's estate.**

* True

**Incorrect**.

* **False**

**Correct**!

1. **The Grantor and Trustee of an ILIT should not be one and the same.**

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**Correct**!

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**Incorrect**.

1. **If the purpose of an ILIT is to provide liquidity for the payment of estate taxes, the document should explicitly direct that the insurance proceeds be used for that purpose.**

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**Incorrect**.

* **False**

**Correct**.

1. **The lapse of a Crummey power could potentially result in a taxable transfer on the part of the beneficiary who allows the power to lapse.**

* **True**

**Correct**!

* False

**Incorrect**.

1. **It doesn't matter who pays the premiums for a policy held in an ILIT. Either the grantor or the trustee may pay them, so long as the trustee sends the Crummey letters.**

* True

**Incorrect**.

* **False**

**Correct**!

1. **The courts have generally held that beneficiaries may waive their right to future notices regarding Crummey powers.**

* True

**Incorrect**.

* **False**

**Correct**!

1. **Which of the following is an incident of ownership:**

* Ability to change beneficiaries

**Incorrect**. Try again.

* Ability to cash in the policy

**Incorrect**. Try again.

* Ability to borrow against the policy

**Incorrect**. Try again.

* **All the above.**

**Correct**!

## Conclusion

This concludes the material for this subject. At this time, you may return to any sections in which you feel the need for further study.