Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique

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The ILIT option allows a decedent's family or successors to continue a business. ILITs also serve as an effective estate planning option where one's sole liquid assets consist of retirement accounts.

MANY INDIVIDUALS, when contemplating their estate planning, encounter a liquidity problem in determining how to pay for their funeral expenses, any estate or trust administrative expenses, federal and state estate tax expenses, inheritance tax where applicable, and their debts. This problem arises because most if not all of an individual's assets are illiquid (such as a closely held business) or subject to tax if reduced to cash (for example, IRAs or other retirement plans). Furthermore, the individual may have expressed a wish for surviving family members to continue the business or maximize income tax deferral after the individual's death. Also, he or she may own real estate, but such real estate may be "underwater," and thus the estate cannot liquidate the real estate in order to pay any estate expenses.

Most people elect to purchase term or cash value policies insuring their own lives individually or together with the life of a spouse to provide a nest egg for their loved ones and for a decedent's estate to promptly

obtain liquidity to pay any expenses and taxes. The insured owning a policy or transferring ownership to one's spouse outright compromise these purposes by increasing one's or one's spouse's gross estate for estate tax purposes, ultimately increasing liquidity needs for federal and state estate tax purposes.

To determine if a decedent's estate is subject to estate tax, one must first determine the value of the decedent's gross estate. 26 U.S.C. §2031. What many people often do not realize is that the value of a gross estate includes amounts receivable by a decedent's executor/personal representative as insurance under policies on the life of the decedent. 26 U.S.C. §2042(1). The gross estate also includes amounts receivable by all other beneficiaries of the insurance policies on the life of the decedent with respect to which the decedent possessed at his/her death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. 26 U.S.C. §2042(2) (Also includes reversionary interests to the extent such interest exceeds five percent of the value of the policy immediately before the death of the decedent).

Some individuals may not elect or may neglect to purchase life insurance, allow policies to expire, or believe that the surviving family members can liquidate the successful business to pay any estate expenses, or believe that the business will have enough cash or liquid assets to satisfy any debt. This creates additional issues such as: the sale of substantial business assets severely affecting continued business; potential income tax issues on the sale of business assets; underestimating the estate expenses; overestimating the cash available to pay such expenses.

AN EFFECTIVE SOLUTION: AN IRREVOCABLE LIFE INSURANCE TRUST ("ILIT")

• An ILIT is a trust primarily designed to hold life insurance. It is irrevocable, as the grantor cannot change or terminate it. The ILIT's trustee is the policy's owner and beneficiary. The ILIT's terms determine who receive the policy proceeds, however. At the insured's death, the policy proceeds are paid to the trust. An ILIT removes the life insurance proceeds from the gross estate of a decedent, thus reducing one's taxable estate.

An insured creates a trust with a trustee other than the insured during the insured's lifetime. The insured may transfer an existing insurance policy or policies to the trust or a sufficient amount of cash for the trustee to purchase a new insurance policy. This could work well in divorce proceedings and prevent an ex-spouse form having access to any trust proceeds.

Transfers to irrevocable trusts are usually subject to gift tax and therefore do not qualify for the $14,000 annual gift tax exclusion. However, this exclusion is available if the ultimate beneficiaries of the trust are given a limited right of immediate withdrawal from the trust. A parent or legal guardian (other than the grantor) can represent a minor child beneficiary. If the named beneficiaries do not exercise their withdrawal rights within the specified time period, the withdrawal rights lapse (how quickly is described further below). Assuming the withdrawal rights are not exercised, the trustee uses the deposited funds to pay the life insurance premiums.

At the insured's death, the trustee collects the policy proceeds from the life insurance company. If the estate of the grantor-insured needs cash to pay estate taxes or debts of the estate, the ILIT trustee has a some options. First, the trustee could buy assets from the estate for cash to provide liquidity for the estate and to allow the purchased assets to pass to the beneficiaries of the trust. The beneficiaries of the ILIT are usually the same as in the rest of the insured's estate plan. The trustee could also lend cash to the executor/personal representative of the estate. The ILIT trustee could also lend cash to a trustee of the grantor-insured's revocable living trust. The estate would repay the loan upon the sale

of estate assets or distribute the assets subject to the loan.

WHY ARE ILITs USEFUL? • One could buy insurance on another person's life, and the policy value would not become part of the insured person's estate. However, an ILIT is more advantageous for several reasons. One can structure an ILIT to continue after one's death and serve as a vehicle to manage and preserve one's wealth for children and other descendents. One can provide for an ILIT to continue beyond the lives of the insured's children, to otherwise benefit grandchildren.

Avoidance Or Reduction Of Estate Tax

An ILIT is a useful estate planning tool because it avoids federal estate tax when its assets pass to a person other than a spouse. 26 U.S.C. §2035(a). Pursuant to an allowance of Marital Deduction with limited exceptions, one can transfer his or her assets at death to a surviving spouse without paying estate tax. If the insured transfers an existing policy into an ILIT, the insured must survive a minimum of three years from the date of transfer to avoid any inclusion of the policy as part of a decedent's gross estate for calculation of any estate tax due. 26 U.S.C. §2056. Pursuant to an allowance of Marital Deduction with limited exceptions, one can transfer his or her assets at death to a surviving spouse without paying estate tax. Furthermore, an ILIT can increase the size of assets passing to beneficiaries without increasing the estate tax.

Liquidity And Providing For Beneficiaries

Second, ILITs can immediately provide liquidity to the decedent's estate and estate beneficiaries. Also, one can establish an ILIT without using any estate tax exemption equivalent of either spouse. At worst, only a minimal exemption equivalent amount would be used. Furthermore, family plans for the use of life insurance to provide education, support and maintenance for beneficiaries after the death of the insured are fulfilled through the use of an ILIT. This would be similar to a testamentary trust established in a Will. However, a testamentary trust does not provide the same protection from estate taxes as ILITs.

Protection From Creditors

Finally, an ILIT is generally not subject to creditors' claim against the insured's estate. Note that a transfer of assets into an ILIT may be subject to a state's Fraudulent Conveyance Act (or statute of similar title and content). For example, See the Maryland Uniform Fraudulent Conveyance Act of the Maryland Code, Commercial Law Article, §15-201 et seq. Neither an ILIT beneficiary nor a creditor of a beneficiary has a right to demand a distribution from the trust or the right to attach a beneficiary's interest in the trust. Also, a trustee could use trust assets to pay a beneficiary's expenses directly, such as car payments, rather than providing cash to the beneficiary that would be subject to creditors' claims. The ILIT could also purchase a car for use by a beneficiary. Since the ILIT owns the car, such asset is protected from creditors.

Flexible Legal Document

An ILIT can provide beneficiaries with special powers to appoint property to family members or charities during one's lifetime or at death. ILITs can also provide beneficiaries with the power to withdraw funds up to five percent of the trust principal without incurring any possible transfer tax. Beneficiaries or an independent trustee can change trustees. An independent adviser (sometimes called a "trust protector") can also change grantor trust status, change trust situs, terminate the trust, or keep the trust in compliance with any state law pertaining to trusts or any federal/state tax laws. The ILIT may also contain flexible investment and distribution provisions, including the choice of other professional advisers.

TYPICAL ILIT TERMS AND PROVISIONS • An ILIT typically provides a temporary "spray" of income and principal by a trustee to one's spouse and descendents as discretionary distributees. (Some forms provide for no distributions during the insured's life, because the intent is for the policy to accumulate to maximize the death benefit, but that ignores the possibility that the policy might be cashed in or sold.) Unless the trustee is independent, the trustee's discretionary power to use income or principal should be limited to an "ascertainable standard." 26 U.S.C. §2041(b)(1) provides that, for purposes of section 2041(a), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that (A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment. *See also,* Treasury Regulation §20.2041-1.

Ascertainable Standard

The ascertainable standard generally pertains to distributions for the health, education, support or maintenance of a trust beneficiary. Treasury Regulation §20.2041-1(c)(2). The terms "support" and "maintenance" are synonymous, and the meaning of such terms is not limited to bare necessities. *Id.* Power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. *Id.* In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised. *Id.* The treasury regulations also provide clauses such as "support in reasonable comfort" and "support in his accustomed manner of living." *Id.* Courts generally have permitted the ascertainable standard to include one's accustomed manner of living when it is able to make a concrete determination about the beneficiary's prior living situation. Treasury Regulation §20.2041-1(c)(2); *see also, Estate of Chancellor v. Commissioner,* T.C. Memo 2011-172 (July 14, 2011), citing *Estate of Strauss v. Commissioner,* T.C. Memo 1995-248.

The term "health" is defined broadly in the treasury regulations to include "medical, dental, hospital, and nursing expenses" as well as "maintenance in health and reasonable comfort." Treasury Regulation §20.2041-1(c)(2).The term "education" is narrowly defined to include expenses for college or professional education. *Id.* Note that the trust should include separate provisions for specific education related expenses such as travel costs incurred going to and from school. Other such expenses might include an education allowance.

Additional Suggested Language

An ILIT should also expressly state that it is irrevocable. Typical trustee provisions include a statement that the trustee shall be the absolute owner of all insurance policies held by the trust estate, a statement relieving the trustee from the duty to file a lawsuit to enforce payment of premiums without indemnification, a statement that the insured is not obligated to enter into any covenant to keep any insurance policies in force and a statement empowering the trustee to loan or purchase estate assets (this is not an exhaustive list). This provides liquidity for a decedent's estate. A spouse can serve as the trustee or co-trustee of an ILIT if the ILIT includes special safeguards such as a requirement that the spouse can only invade the principal of a trust under a previously mentioned "ascertainable standard."

Provisions To Avoid

One must not include certain provisions in the ILIT in order to be able to turn off grantor trust powers to the extent that life insurance is not directly or indirectly involved, and to preserve the estate tax benefit: The power to revoke the trust

(Code sections 676 and 2038); the grantor retaining any control over the beneficial enjoyment of trust property without approval or consent of an independent trustee (Code sections 674 and 2036(a)(2)); the power to borrow without adequate interest or security or voting stock and investment trust assets in a non-fiduciary capacity (Code sections 675 and 2036); a provision entitled the grantor to use trust income to discharge of a grantor's legal obligations other than the grantor's spouse may run afoul of grantor trust rules if the income is not used for such purpose (Code sections 677(a)(1)-(2) and (b), 2036(a)(1)); a reversionary interest in excess of five percent. 26 U.S.C. §§673, 2037(a)(2).

ESTATE TAX POTENTIAL PITFALLS • The first pitfall to keep in mind is the potential inclusion of assets in gross estate. As to the issue of life insurance proceeds received by a decedent's estate, one must be careful not to list his or her named executor/personal representative in one's Will as the beneficiary of the ILIT. Otherwise, any life insurance proceeds are included in the gross estate of the decedent-insured and subjected to the decedent's creditors' claims. 26 U.S.C. §2042(1). Also, insurance cannot be paid to any beneficiary subject to a legally binding obligation to pay expenses of a decedent's estate. Treasury Regulation §20.2042-1(b). Such expenses include an obligation to pay any taxes or debts. *Id.* An ILIT can still authorize a trustee to loan any proceeds to the decedent-insured's estate or to purchase assets from such estate without triggering estate tax. *Old Colony Trust Co. v. Comm'r,* 39 B.T.A. 871, 879 (1939); *see also,* PLR 200147039 (IRS ruled that the proceeds from a second to die policy were not included in a decedent's estate where the trustee had discretion but not the obligation to pay the decedent's estate taxes).This should only be a discretionary tool and not a required duty of a trustee, however. Treasury Regulation §20.2042-1(b)(1).

Incidents Of Ownership

If a decedent possessed any incidents of ownership, the policy proceeds are included in a decedent's gross estate. Treasury Regulation §20.2042-1(b)(1). The treasury regulations define "incidents of ownership" as an insured having sole or co-power to obtain a loan, pledge the policy for a loan, surrender or cancel the policy, change the policy beneficiary, assign the policy, or revoke or veto an assignment made by the owner of the policy. Treasury Regulation §20.2042-1(c)(2); *see also,* TAM 9128008 (IRS held that the right to repurchase a policy from an assignee was the equivalent of a right to revoke the assignment and was thus an incident of ownership). Power over choice of settlement options (i.e. power to change beneficial ownership, surrender the policy) is also an incident of ownership. Treasury Regulation §20.2042-1(c)(4). Furthermore, a five percent or greater reversionary interest is an incident of ownership. 26 U.S.C. §2042(a); Treasury Regulation §20.2042-1(c)(3). An insured who is a trustee of an ILIT possesses incidents of ownership. *Rose v. United States,* 511 F. 2d 259 (5th Cir. 1975); *see also,* Rev. Rul. 84-179 (Narrow set of facts where the IRS stated that the insured became an inadvertent fiduciary of the ILIT when the insured's spouse, who was trustee, bequeathed the policy under her Will to a residuary trust for the benefit of her adult child, the trust of which the insured served as the sole trustee. The IRS declared that the policy proceeds would not be included in the trustee-husband/wife-insured's estate). The ILIT should also not name the insured's estate as a contingent beneficiary on the policy.

INCOME TAX ISSUES: TRANSFER FOR VALUE • Income tax issues could arise over transfer for value questions, failure of a beneficiary to exercise the right of withdrawal, and potential gain to the policy owner. Life insurance contract proceeds received upon the death of an insured are excluded

from gross income. 26 U.S.C. §101-1(a)(1); Treasury Regulation §1.101(a)(1).

Under the transfer for value rules, a transfer or sale of a life insurance contract for valuable consideration could make the death benefit's exclusion from income tax unavailable. 26 U.S.C. §101(a)(2); Treasury Regulation §1.101-1(b). Amounts excluded from income include the actual value of consideration, premiums, and other amounts such as interest. *Id.; see also* Treasury Regulation §1.101-1(a)(1); 26 U.S.C. §101(c); Treasury Regulation §1.101-1. The IRS considered the transfer for value limitation of section 101(a)(2) in the context of one ILIT selling a policy to another ILIT. Rev. Rul. 2007-13. The IRS has ruled that a grantor who is treated for federal income tax purposes as the owner of both ILITs is treated as the owner of the contract for purposes of applying any transfer of value limitations under Code §101(a)(2), because there is no "transfer" of the contract within the meaning of such code section. *Id.*

Similarly, where the "old" life insurance trust transfers the life insurance contract that is not considered wholly owned grantor trust, the IRS has opined that there is a transfer of value. *Id.* Nevertheless, the IRS states that the transfer for value provisions do not apply, because the transfer to the "new" ILIT is treated as a transfer to a grantor-insured within the meaning of Code §101(a)(2)(B). *Id.*

USE OF GRANTOR TRUST • If the ILIT is a grantor trust under Code sections 671-677, the grantor-insured is taxed on trust income and loss. ILITs will qualify as grantor trusts if income may be distributed to or accumulated for the grantor's spouse, or may be used to pay life insurance premiums. 26 U.S.C. §677(a). The IRS has approved using a swap power to create grantor trust status when insurance is involved, without causing Code section 2036 or 2042 to apply. 26 U.S.C. §675(4)(C); *see also,* Rev. Rul. 2011-28.

For an unfunded ILIT that produces no income, it is irrelevant whether the ILIT is a separate tax entity or a grantor trust. Funded ILITs (front-end loaded to pay premiums, or an ILIT owning other assets that purchases a policy) have potential income tax ramifications, however.

A grantor's payment of income tax on trust income attributable to a grantor under the grantor trust rules does not constitute a gift from the grantor to the ILIT. Rev. Rul. 2004-64. Trust provisions requiring the ILIT to reimburse a grantor for the payment of income tax cause the full value of the ILIT's assets are includible in a grantor's gross estate, however. Treasury Regulation §20.2036-1(b)(2); *see also,* Rev. Rul. 2004-64, citing *Estate of Douglas v. Commissioner,* 143 F. 2d 961 (3rd Cir. 1944) and *Estate of Mitchell v. Commissioner,* 55 T.C. 576 (1970). There may also be issues for beneficiaries from lapsed *Crummey* powers. Any grantor of a grantor trust is subject to income tax, notwithstanding the existence of any *Crummey* power. 26 U.S.C. §678(b). *See* PLR 200949012.

POWER OF SUBSTITUTION OF ASSETS OF EQUAL VALUE • An ILIT may also include a power to substitute assets of equivalent value if one has non-fiduciary powers exercisable without the consent of a fiduciary. Regarding estate tax liability, the insured-grantor may substitute life insurance policies of equal value for those owned by the ILIT without causing inclusion in the insured-grantor's gross estate. Rev. Rul. 2011-28. A trustee may elect to trade a high basis or high cost asset (thus taking such asset out of the ILIT — "substituted asset") for a low basis or low cost asset without any step-up basis (thus the ILIT owns the low basis asset — "transferred asset") to reduce a grantor-insured's income tax. Also, an ILIT may need to sell liquid assets such as securities to provide cash for payment of taxes.

Revenue Ruling 2011-28 clarifies issues regarding the trustee power of substitution of a life

insurance policy. A grantor's power to acquire an insurance policy held in a trust by substituting other assets of equal value will not cause inclusion of the policy in the grantor's gross estate under Code section 2042, as long as certain guidelines are met. This is significant because ection 2042 includes as a taxable asset in one's gross estate any share of life insurance proceeds to which the decedent possessed at the decedent's date of death any incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

The Ruling held that substituting an asset of equal value for life insurance held in a trust was not an incident of ownership when the decedent was prohibited from serving as trustee of the trust. Further, the trust explicitly stated that the decedent's power to substitute assets of equivalent value is held in a non-fiduciary capacity. In addition, the Revenue Ruling stated that the grantor had to receive insurance equivalent in value to the assets transferred to the trust. The ruling further assumed that the trustee had a fiduciary obligation to ensure the grantor's compliance with the terms of the substitution power by satisfying itself that the properties acquired and substituted by the grantor are in fact equivalent in value. The trustee could also not substitute assets if the trustee's exercise of such substitution power caused a shifting of benefits among trust beneficiaries.

Grantor trust attributes also include a power to substitute assets of equivalent value if one has non-fiduciary powers exercisable without the consent of a fiduciary. 26 U.S.C. §675(4). Regarding estate tax liability, the insured-grantor may substitute life insurance policies of equal value for those owned by the ILIT without causing inclusion in the insured-grantor's gross estate. 26 U.S.C. §2036; 26 U.S.C. §2042; *see also, Estate of Jordahl v. Commissioner,* 65 T.C. 92 (1975). The *Estate of Jordahl* case pertained to the insured holding fiduciary powers, however. IRS private letter rulings, while ruling that there is no estate tax inclusion and citing *Estate of Jordahl,* have been unclear about the fiduciary/non-fiduciary distinction in Revenue Ruling 2011-28. PLR9413045.

GIFT TAX ISSUES • An advantage of gifting a life insurance policy to an ILIT is leverage. The value of the policy at the date of the gift and subsequent premium gifts are often within the annual gift tax exclusion. At the insured's death, the value is much larger due to built-in appreciation. The built-in appreciation at death is shielded from estate tax.

Valuation Of Gift

Valuations of life insurance policy gifts are generally valued at the replacement value of the policy on the date of the gift. Treasury Regulation §25.2512-6(a). Certain types of policies have different types of replacement values, however. The replacement value of a brand new cash value policy is the initial premium payment. *Id.* See Example 1. The replacement value of an existing single premium or paid up policy is the amount an insurer would charge for the same policy on the life of a person of the age of the insured as of the date of the gift. *Id.* See Example 3.

If the cash value is substantially higher than the replacement premium, then the cash value is used as the value of the gift. *Id.* See Example 4. For existing cash value policies, the replacement value is derived from a formula incorporating an interpolated terminal reserve as of the date of the gift plus a proportionate part of the gross premium paid before the date of the gift that covers the period extending beyond such date. *Id.* The replacement value of an existing term policy includes the portion of the last premium that covers the period beyond the date of the gift. The replacement value for group term insurance includes the unused premium paid for the period. Generally, one obtains from the life insurance company IRS Form 712 to determine the replacement value.

***CRUMMEY* WITHDRAWAL RIGHTS/ TRANSFER OF PRESENT INTEREST** • To qualify for the annual gift tax exclusion, a transfer of an asset must be a transfer of a present interest. Transfers to ILITs typically include the initial transfer of the life insurance policy itself (or other liquid assets used to buy a new policy), the annual transfer of cash to fund required premium payments, and indirect gifts from the insured in the form of group term life insurance premiums paid be the grantor-insured's employer (after the grantor-insured irrevocably assigns a policy to the trust).

Fortunately, there is an exception to the rule. An ILIT may provide what is known as *Crummey* withdrawal rights. *Crummey v. Comm'r,* T.C. Memo 1966-144, *aff'd in part and rev'd in part* 397 F. 2d 82 (9th Cir. 1968). *Crummey* withdrawal rights provide trust beneficiaries with the right to withdraw, for a limited period of time, any amounts transferred to the trust. This invasion right is triggered only if the insured makes a contribution to the ILIT in a particular year, and the grantor-insured can specify at the time of the gift that the individual beneficiaries receive the power of withdrawal and the amount. Regarding minors, the ILIT can state that any natural or court-appointed guardian of a minor, other than the grantor-insured, shall have the withdrawal power on behalf of such minor.

The *Crummey* Case

In *Crummey*, the settlors created an irrevocable living trust for the benefit of their four children, some of whom were minors. *Id. See also, Estate of Cristofani v. Commissioner,* 97 T.C. 74, 79 (1991). The trustee was required to hold the property in equal shares for the beneficiaries. *Id.* Under the terms of the trust, the trustee, in his discretion, could distribute trust income to each beneficiary until that beneficiary obtained the age of 21. *Id.* (Between the ages of 21 and 35, the trustee was required to make such distributions, and after the age of 35, the trustee was authorized to make distributions to the beneficiary to his or her issue). Upon the death of a beneficiary, his or her trust share was to be distributed to that beneficiary's surviving issue subject to certain age requirements. *Id.* If a beneficiary died without issue, then his or her trust share was to be distributed equally to the trust shares of the surviving children of the grantors. *Id.* In addition, each child was given an absolute power to withdraw up to $4,000 in cash of any additions to corpus in the calendar year of the addition, by making a written demand upon the trustee prior to the end of the calendar year. *Id.*

The *Cristofani* Case: Interpreting *Crummey*

Although not required by case law, it is recommended that the trustee provide prompt written notice to the trust beneficiaries of such withdrawal rights. *See* PLR 8008040 ("actual knowledge" is sufficient without written notification). It is typical to provide the beneficiaries with a 30-60 day window for which to exercise their right of withdrawal. It is recommended to provide beneficiaries with a minimum of 30 days in which to exercise such withdrawal right. PLR 9311020. In one case, the Tax Court held for a taxpayer who provided a 15-day notice period of the exercise of the right of withdrawal, however. *Estate of Cristofani,* supra, at 74.

In *Cristofani,* the donor claimed gift tax exclusions for seven years based upon transfer of funds to an irrevocable trust that benefitted her children and grandchildren. *Id.* at 75. The grandchildren's interest did not vest unless their parents either predeceased or failed to survive the decedent by 120 days. *Id.* at 76. The grandchildren did possess a 15-day right of withdrawal from the children's trust following a contribution by their grandmother to such trusts. *Id.*

The IRS claimed that the gifts to the decedent's grandchildren did not constitute a present transfer of property and were therefore subject to $49,486 gift tax. *Id.* at 77, 80. The IRS also claimed that

the decedent never intended to benefit her grandchildren and provided her grandchildren with the withdrawal right only to take advantage of the annual exclusion. *Id.* at 84.

The Tax Court, in holding for the taxpayer, stated that one determines the existence of a present interest in the context of gift tax by determining the ability of a beneficiary to exercise the right to a withdraw from the trust corpus, and the ability of a trustee to legally resist a beneficiary's demand for payment. *Id. See also,* 26 U.S.C. §2503(b). The Court noted that, even though the decedent's children were in good health at the time of execution of the trust, this did not "remove the possibility that the decedent's children could have predeceased" their mother. *Id.* Additionally, the grandchildren possessed the power to withdraw up to an amount equal to the amount allowable for the gift tax annual exclusion. *Id.* The trustee could not refuse such a request.

Application Of *Crummey* And *Cristofani* To ILITs

Beneficiary withdrawal rights are general powers of appointment possessed by the power holder, and the annual lapse of such powers will be treated as gifts to the trust that do not qualify for the annual gift tax exclusion (26 U.S.C. §2514) which might also cause Code section 2036 issues if the power holder might receive distributions before death. However, if the *Crummey* power for each beneficiary does not exceed the "5-and-5" power described below, such lapse does not constitute a gift by the beneficiary. 26 U.S.C. §2514(e).

In order to not defeat the purpose of the trust, the ILIT beneficiaries, should not actually exercise their *Crummey* withdrawal rights, but should let their rights lapse. 26 U.S.C. §2514(e). The lapse is not considered to be a gift if it falls within the "5 and 5 exception" (see below). 26 U.S.C. §2042(b)(2). The beneficiaries should never waive or execute any document waiving such rights of withdrawal; otherwise, the 5 and 5 exception does not apply.

The "5 And 5" Exception

The "5 and 5 exception" exempts lapses from any gift or estate tax consequences to the donee-beneficiary where the ILIT limits the lapse to the greater of $5,000 or five percent of the fair market value of the assets held by the ILIT.

If the non-exercise of the withdrawal right is not exempted by the 5 and 5 amounts, the non-exercise is considered a "release" of a general power of appointment and thus a gift that potentially triggers adverse estate tax consequences. See PLR 9541029 (Lapse of *Crummey* power in ILIT not considered to be a taxable gift under 26 U.S.C. §2514(e) since the amount was within the 5 and 5 exception).

The $5,000 component of the 5 and 5 power is a cumulative annual limit for each beneficiary who lets the *Crummey* withdrawal power lapse. Rev. Rul. 85-88. Thus, if a person is a beneficiary for separate trusts, the lapses for that beneficiary with respect to all trusts need to be coordinated. *Id.* This is best done by setting a separate date for each lapse in a trust and saying that the lapse occurs to the extent that the lapse would not constitute a taxable gift under Code section 2514.

Consider coordinating gifts to a beneficiary of the $14,000 annual gift exclusion amount with the 5 and 5 exception amount. A grantor has three options for taking the annual gift exclusion approach: providing a special power of appointment to a sole beneficiary over the beneficiary's trust property (Treasury Regulation §25.2511-2(b)) providing a general power of appointment to a sole beneficiary, or making the beneficiary's estate the ultimate trust beneficiary. PLR 8517052. The general power of appointment would cause all trust assets to be included in the beneficiary's estate at death, however. Although these powers of appointment can be used for ILITs with multiple beneficiaries, there are drafting difficulties associated with this.

Use Of "Hanging Powers"

The best option might be a "hanging power," a tool used to a void gift tax on trust beneficiaries who elect not to exercise their withdrawal rights. Hanging powers are an option where the ILIT has multiple *Crummey* beneficiaries and the value of the ILIT exceeds the greater of $5,000 or percent of the trust value. A gift of the entire amount subject to withdrawal, even if greater than this limitation, is still considered a gift of present interest. At some point, such as upon collection of the death benefit, the value of the ILIT will be large enough to wipe out any beneficiary hanging powers, however.

The use of these hanging powers prevents classification of these excess amounts as gifts of future interests from the beneficiary possessing the right of withdrawal to the other ILIT beneficiaries. This potential gift to the other beneficiaries of future interest is not subject to the annual gift tax exclusion.

The amount of only the 5 and 5 ceiling lapses each year, and the excess amount carries over into future years. Any carryover powers lapse in subsequent years to the extent the gifts in such years are less than the 5 and 5 ceiling. If the power holder dies before the ILIT terminates, the hanging power in existence at the date of such person's death will be included in that person's gross estate.

If the power holder is not the beneficiary of the trust assets upon termination of the trust, such as when a grandchild has a hanging power but the trust terminates in favor of a child after the death of a parent, the gift is postponed for such unlapsed hanging power until the termination of the trust unless the power holder receives a distribution greater than or equal to the hanging power. There are GST consequences in such a case, however. One may want to delay terminating the trust until all hanging powers have lapsed to prevent this.

Hanging powers may create valuation issues with term policies. It is difficult to determine the value of the policy (except that the powers typically lapse when the insured dies, as the death benefit causes very large trust assets to spring into being and provide a very significant five percent lapse).

IRS Perspective

The IRS generally will not contest annual exclusions for *Crummey* powers if one has documentation of the notices. It may be advisable to file annual gift tax returns reporting these gifts and claiming the annual exclusion (attaching the trust and stating that the withdrawal rights qualify the gifts for the annual exclusion). If the grantor-insured accurately reports and adequately discloses the gifts on the return, the three-year statute of limitations runs, after which period, the IRS can no longer challenge the valuation and whether the gift is a present interest that qualifies for the annual exclusion. Treasury Regulation §20.2001-1(b); Treasury Regulation §25-2504-2(b).

The IRS will contest such powers if it suspects that the withdrawal rights are subject to a pre-arranged understanding that the beneficiaries will not exercise such rights. IRS Action on Decision 1996-010. *But see Estate of Holland,* T.C. Memo 1997-302 (Although trustees did not provide written notice as provided in the trust agreement, the Court held that this did not preclude a finding that the beneficiaries did not have a present interest in the gifts, and the failure to provide written notice did not require a finding that the trustees did not provide notice) and *Estate of Kohlsaat,* T.C. Memo 1997-212 (Evidence did not establish that there was an agreement between the parties that the beneficiaries would not exercise their withdrawal rights, and the contingent beneficiaries received actual notices). Accordingly, the trustee, not the donor, should field any questions from the beneficiaries regarding withdrawal rights.

GENERATION SKIPPING TRANSFER TAX ISSUES • Generation Skipping Transfer ("GST") Tax applies to any transfers to family members (other than spouses) more than two generations below the grantor or to anyone more than 37.5 years younger than a grantor. Such beneficiaries are generally referred to as "skip persons." 26 U.S.C. §2613(a). A trust with all beneficiaries (for future distributions or termination of the ILIT) who fit into these definitions would also be a skip person. *Id.* The transfer to such a trust is referred to as a "direct skip." 26 U.S.C. §2612(c)(1). Transfers to trusts having both non-skip and skip persons are not considered direct skips.

Generation skipping transfers occur if one or more children die before the grantor and the ILIT provides that such deceased child's descendants receive such child's share. 26 U.S.C. §2632(d)(1) (there may be retroactive allocation under such circumstances). Generation skipping transfers also occur if the ILIT provides that a child's interest does not vest until the child reaches a certain age and such child dies before one or more gifts are made to the trust.

However, if a gift or bequest is made to or for the benefit of a grandchild whose parent has died before such transfer, the grandchild steps into the child's shoes with respect to that transfer. Each individual is entitled to a federal exemption from GST in the amount of $5,250,000 for tax year 2013 ($5,000,000 indexed for post-2011 inflation). 26 U.S.C. §2631; *see also,* 26 U.S.C. §2010(e). The exemption may be allocated by a transferor against lifetime gifts on Form 709 or by the transferor's executor on Form 706.

One can allocate the above-referenced GST exemption, even if the beneficiaries include unborn skip persons. 26 U.S.C. §2632(c). The allocations are made to three types of transfers: direct skips; terminations; and distributions. 26 U.S.C. §2611(a). GST exemption allocations where there is no potential for GST taxation are void. Treasury Regulation §26.2632-1(b)(4).

Calculation Of GST Tax Rate

One calculates the effective GST tax rate by multiplying the "inclusion ratio by the maximum federal tax rate." See 26 U.S.C. §2641, 26 U.S.C. §2642(a) (defining inclusion ratio). The inclusion ratio is the percentage of property to which the GST exemption has not been allocated. A zero inclusion ratio means that there is no GST tax. The inclusion ratio should be either zero or one (either wholly exempt or wholly taxable). One achieves a zero inclusion ratio by allocating remaining exemption amount equal to the value of the transferred property or by making only transfers to which the GST annual exclusion applies.

A fractional inclusion ratio results in wasting of the exemption and the likelihood of unnecessary GST tax; instead, one's forms should always require that each trust be automatically divided into a separate GST exempt (inclusion ratio of zero) or nonexempt (inclusion ratio of one) trust. When one allocates additional GST tax exemption or contributes additional property to the ILIT, one must recalculate the inclusion ratio. Treasury Regulation §26.2642-4. It is advisable to transfer property to which GST tax applies during one's lifetime to take advantage of any post-allocation accumulated appreciation, which is exempt from GST tax.

Allocation Of GST Tax Exemption

GST exemption is allocated automatically to direct skips and lifetime indirect skips to GST trusts if the transferor or executor fails to elect otherwise. 26 U.S.C. §§2632(b), 2632(c). Relatively confusing rules determine whether a trust qualifies as a "GST trust" gifts to which constitute indirect skips that automatically attract GST exemption,

The allocation amounts depend upon the timing of valuation of the assets. For the first gift, or for any later gift when the inclusion ratio is zero, the trust obtains an inclusion ratio of zero if the donor allocates GST exemption to the trust equal to the transfer's value on a timely filed gift tax return. Although a transferor or the transferor's executor may allocate the GST exemption at any time form the date of the transfer through the date of filing the estate tax return, the deemed effective date of transfer determines the allocation amount. Treasury Regulation §26.2632-1(a). Automatic allocations to lifetime direct skips or GST Trusts are effective as of the date of transfer. Treasury Regulation §§26.2632-1(b)(ii), 26.2632-1(b)(iii)(2).

If one makes the allocation other than on a timely filed gift tax return reporting the transfer, the allocation becomes irrevocable on the date of the return. 26 U.S.C. §2642(b)(1). The value of the property for purposes of using the exemption is the value on that later date, including any changes in value, *Id.*; however, one may use the value of the trust's assets on the first day of the month in which the filing occurs, unless a major valuation event has occurred, such as the insured dying between the first of the month and the date the return is filed.

Annual Exclusion Amount

The annual exclusion amount is $14,000.00. The GST exclusion applies only to direct skips that are outright transfers directly to skip persons and transfers to certain trusts that have as the sole beneficiary only one skip person. 26 U.S.C. §2642(c). The trust must have only one beneficiary, and that beneficiary must have a testamentary general power of appointment. If direct skips to an individual are protected by the gift tax annual exclusion (on a first-in, first-out basis), no GST exemption allocation or election is necessary. The same rule applies for medical or tuition payments that are paid directly to medical providers and qualified educational organizations.

Certain Transfers Excluded

Certain transfers do not qualify for the annual exclusion, however. The GST annual exclusion does not apply to direct skip transfers in trust for beneficiaries unless the ILIT provides: Distributions cannot be made to any person other than a single skip person beneficiary during that skip person's life; and, if the skip person dies prior to the termination of the ILIT, the ILIT assets must be included in the skip person's estate. 26 U.S.C. §2642(c). Otherwise, one must allocate GST tax exemption to shield the transfer from GST tax. GST annual exclusion amounts are also inapplicable to most *Crummey* trusts. If a child dies before the transferor, the ILIT might terminate in favor of a grandchild, thus exposing the ILIT to GST tax if the child did not have a general power of appointment, even if the transferor has unused GST exemption.

Effective Date Of Allocation

Transfers and GST termination allocations are not effective or valued until the end of the period during which they are includable in the grantor's or grantor's spouse's estate: the "estate tax inclusion period" ("ETIP"). Treasury Regulation §26.2632-1(c)(1) and (c)(3). The delayed automatic allocation can cause a transferor or the executor to allocate more exemption than necessary. The ETIP rules permit one to wait until the termination of the ETIP to make the allocation when the exact amount of the property is known. An exception is that ETIP does not apply if Code section 2035 is the only reason for inclusion, which means that the application of the three-year rule will not create an ETIP.

Elections Regarding The "Deemed Allocation" Rule

In making an election, one should elect to treat a trust as a GST trust or not as a GST trust to provide clarity. In most cases, the election should state that it applies to transfers during the current year

and to all future transfers until the donor elects otherwise. This helps one attain the desired results even if future years' returns are late or not filed at all.

There are several reasons to elect out of the deemed allocation rule: One may be able to allocate GST exemption to future transfers — usually to future transfers of property that is likely to appreciate. One may allocate the exemption to a trust that accumulates income and contains appreciated assets. The indirect skip deemed allocation rule does not necessarily identify any trusts where the allocation is most beneficial to the transferor or transferor's executor. If the trust property decreases in value post-transfer without likelihood of recovery, a later allocation will use up less GST exemption.

Procedure Regarding Direct And Indirect Skips

GST tax is applied differently to direct skips than indirect skips. The direct skips incur tax only on amounts received by the trust. This causes grandchildren to move up a generation and not be skip persons, although great-grandchildren would be skip persons. Skip persons are liable for GST tax on taxable distributions and terminations and are therefore subject to GST tax on the full amount. Allocation of the GST exemption amounts to direct skips is important where one has only a limited amount of remaining GST exemption available.

One who wishes to make a late election (for example, to a policy whose initial value has been depleted by commissions and other charges) would elect on a yearly basis not to have the automatic allocation rule apply so that a late allocation may be made to a smaller value. One may also make an election not to have the automatic allocation rule apply to any future transfers to that trust.

To elect out of the deemed allocation rules for direct skips, one may elect out for a specific transfer of assets. 26 U.S.C. §2632(b)(3). To elect out of the deemed allocation rules for indirect skips, one may also elect out for a specific transfer of assets. 26 U.S.C. §2632(c(5)(A)(i)(I). One may also use a blanket election to opt out for any future transfers to a specified GST trust. 26 U.S.C. §2632(c(5)(A)(i)(II).

Relief For Inadvertently Missed GST Allocation

There is relief for inadvertently missed GST allocations, allowing one to allocate the GST tax exemption based upon the value on the date of transfer. 26 U.S.C. §2632(d)(2). The IRS will often grant extensions of time for which to make such allocations. Treasury Regulation §301.9100. One risk of late allocations is appreciation of trust assets, using more GST exemption. Another risk is that, if the transferor dies before the late allocation, a larger exemption amount may be needed to get a zero inclusion ratio to prevent GST tax.

Allocation In The Context Of Term Insurance Policies

Regarding term life insurance, although one can document the allocations on a timely filed form 709 and Notice of Allocation, if the grantor-insured outlives the policy, one will waste any available GST exemption amounts.

For term policies with monthly paid premiums, the policy value might be considered to be zero at the end of each month, when another premium payment becomes due, unless there is a secondary market for the policy. So long as the policy has no value at the end of each term, it is possible for one to wait several years before making an allocation to make the trust wholly exempt.

One should use anniversary dates for term policies before the April 15 filing date to prevent coverage extending beyond the filing date of the gift tax return. The timely allocation of current-year premiums would equal 100 percent of the combi-

nation of the policy value before the gift plus the current gift tax exemption.

Allocation In The Context Of Non-Term Insurance Policies

The value is the replacement cost of the policy on the date of the gift. Treasury Regulation §25.2512-6(a); GCM 38110. For single-premium or paid-up policies, the value is the amount that the life insurance company would charge for a single premium contract of the same specified amount on the life of a person at a certain age. Treasury Regulation §25.2512-6(a) Example 3. Late allocations are advantageous because the value of such policies is lower after one pays the premium. Therefore, one may use less GST exemption when doing a late allocation.

Statute Of Limitations

The statute of limitations period on GST exempt status of an ILIT and other trusts begins to run when the distribution is made. Treasury Regulation §26.2642-5.

CONCLUSION • ILITs are an excellent estate planning tool for decedents whose estate assets consist primarily of an ownership interest in a business, including real estate development. This tool is available in the event the estate lacks the liquidity to pay estate taxes and other estate administrative expenses. This option allows a decedent's family or successors to continue the business. ILITs also serve as an effective estate planning option when one's sole liquid assets consist of retirement accounts. If the estate withdraws funds from a retirement account to pay estate taxes or other estate expenses, the estate is also subject to income tax caused by such withdrawal. An ILIT alleviates the effects of this potentially catastrophic tax consequence (income and estate tax in the same year) by lending money to an estate to pay estate tax.

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