LIFE INSURANCE TRUSTS IN THE ESTATE PLAN

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TABLE OF CONTENTS

I. INTRODUCTION

Life insurance fills a number of estate planning needs. In particular, it provides liquidity to an estate and financial protection for beneficiaries. Additionally, it serves as an attractive vehicle for transferring wealth to subsequent generations.

The combination of several tax law changes over the past several years has driven estate planners in new directions, particularly in the area of life insurance.[1]

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1. The Tax Court and the United States Court of Appeals for the Sixth and Tenth Circuits have held the 1981 Economic Recovery Tax Act (ERTA) amendments to § 2035 specifically provide that the proceeds of a life insurance policy are not includable in the insured's gross estate unless the decedent possesses, at the time of his death or at any time in the preceding three years, any of the policy's incidents of ownership. Estate of Headrick, 93 T.C. 171 (1989), *aff'd*, 918 F.2d 1263 (6th Cir. 1990) (holding when the trustee of an irrevocable life insurance trust, or someone other than the grantor, purchases a new life insurance policy, the death of the insured within three years of the aquisition of the policy will not cause inclusion of the insurance proceeds in the insured's taxable estate); Estate of Perry, 59 T.C.M. (CCH) 65 (1990) (finding insured paid all the premiums but insured's children were the owners of the policy from the beginning, so insured never possessed any incidents of ownership over the policy; therefore 2035 did not apply); Estate of Chapman, 56 T.C.M. (CCH) 1451 (1989) (holding no portion of the proceeds of an insurance policy on the deceased insured's life was includable in her estate for estate tax purposes because she never possessed any interest in the policy that would have made 2035 applicable); Estate of Leder, 89 T.C. 235 (1987), *aff'd*, 893 F.2d 237 (10th Cir. 1989) (holding decedent had an interest in the

The availability of an unlimited marital deduction has reduced the need for liquidity of the estate of the first spouse to die. The complete integration of gift and estate tax provisions drives planners toward suggesting gifts and investments that stay below taxable gift exclusions (such as the annual $10,000 per donee exclusion) that eventually grow into a substantial sum. With the availability of installment payments for estate taxes based on the percentage of the estate consisting of an active trade or business, the need to provide a source of liquidity that will not concurrently reduce the deferrable taxes has arisen. For these and other reasons, estate planners have placed renewed focus on irrevocable life insurance trusts. This Article explores the benefits and drawbacks of such trusts.

II. THE BASICS OF IRREVOCABLE LIFE INSURANCE TRUSTS

Life insurance proceeds are included in the gross estate of the insured if the insured is the owner of the policy or has retained any incidents of ownership in the policy.[2] To avoid the taxable inclusion of life insurance proceeds from a currently owned policy in an estate, the insured may make an outright gift of the policy or transfer ownership of the policy to an irrevocable life insurance trust. As long as the insured survives for three years following this gift—and the transfer was for less than full and adequate consideration—the insurance proceeds will not be included in the insured's estate for estate tax purposes.[3] If the trust itself acquires a new policy using cash received by the insured to pay the premiums, there is normally no three year waiting period with regard to estate taxes.[4] In either case, the objective is to create a fund outside of the insured's taxable estate

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policy pursuant to § 2035, which would have resulted in the inclusion of proceeds under § 2042 had he retained the interest until his death).

2. I.R.C. § 2042 (1988). Section 2042 states in part:

> The value of the gross estate shall include the value of all property—
>
> (1) Receivable by the Executor—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.
>
> (2) Receivable by other beneficiaries—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent.

Id.

3. *See* I.R.C. § 2035(d)(2) (1988). Section 2035 nullifies the estate planning device in which the grantor of a trust effectuates, for purposes of avoiding the estate tax under §§ 2035, 2036, 2037, 2038 and 2042, a gift made late in life or sale of a retained power, income interest, or reversion. *See, e.g.*, United States v. Allen, 293 F.2d 916, 917-18 (10th Cir.) (holding a sale of the grantor's remaining life income interest in contemplation of the grantor's death was not effective to remove the value of the trust corpus from the grantor's gross estate), *cert. denied*, 368 U.S. 944 (1961).

4. Life insurance trusts designed to avoid having incidents of ownership in the insured escape the three year rule in § 2035. Estate of Leder v. Commissioner, 89 T.C. 235, 238 (1987), *aff'd*, 893 F.2d 237 (10th Cir. 1989).

that can provide liquidity for heirs and the estate—by purchasing assets from it—and help effectuate the transfer of wealth without further taxation.

A. *The Benefits of Irrevocable Life Insurance Trusts*

An irrevocable life insurance trust provides numerous estate planning benefits. First, it provides greater flexibility in managing the distributions and application of the insurance proceeds.[5] Second, it protects the surviving spouse by providing her a life interest in the insurance proceeds without increasing gift or estate taxes, while concurrently enabling the surviving spouse to avoid probate of the policy proceeds.[6] Third, with utilization of the withdrawal powers provided for by the Ninth Circuit's decision in *Crummey v. Commissioner*,[7] which are also known as the lessor five-and-five powers, no gift tax will be incurred when substantial transfers (gifts) are made to the trust.[8] Finally, an irrevocable life insurance trust significantly reduces the effective rate of federal and state transfer taxes.[9]

B. *Funding Irrevocable Life Insurance Trusts*

Various forms of life insurance policies, including term, group-term, survivorship, whole life, including second-to-die and split-dollar policies, may be used in conjunction with the trust.[10] An irrevocable life insurance trust normally is funded with a policy in one of two ways. Either the insured can transfer a currently existing life insurance policy to the trust, or the trustee can purchase a new life insurance policy on the life of the insured.[11] In either case, the trust must be irrevocable,[12] and the grantor must relinquish or avoid all incidents of ownership[13] in the policy within the trust in order to exclude policy proceeds

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5. 53RD N.Y.U. INSTITUTE, LIFE INSURANCE & ESTATES § 18.01[2] [b] (1995).

6. *Id.*

7. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

8. The *Crummey* power refers to a short-term power of a beneficiary to withdraw free from federal gift taxes a proportionate share of the annual contributions to an insurance trust. *See id.* at 83.

9. *See, e.g.*, I.R.C. § 2001(c) (1988). The federal transfer tax savings that can result from the exclusion of a one million dollar policy on the life of an individual with a three million dollar taxable estate is five hundred fifty thousand dollars. Moreover, if the arrangement is properly structured, the proceeds could be transferred to the insured's grandchildren without being subject to the fifty-five percent generation-skipping tax or, in effect, both the estate tax and the generation-skipping tax. *Id.*

10. *Id.*

11. *See* Estate of Headrick, 93 T.C. 171 (1989), *aff'd*, 918 F.2d 1263 (6th Cir. 1990).

12. The ability of the grantor to revoke is an incident of ownership. *See, e.g.*, Goodman v. Commissioner, 156 F.2d 218, 219 (2d Cir. 1946).

13. "Incidents of ownership" goes beyond the mere ownership of the life insurance policy. The right to receive "economic benefits" from the policy will destroy the ability to exclude the proceeds from the grantors estate. Treas. Reg. § 20.2042(c)(3) (1994). Incidents of ownership include the power to change the beneficiary or contingent beneficiaries, even if this right is exercisable only with the consent of the owner of the policy. *See, e.g.*, Nance v. United States, 70-2

from the grantor's estate.[14] Normally, it is preferable to have the irrevocable life insurance trust funded with cash and then acquire a new policy; section 2035(d) provides for the inclusion of life insurance proceeds within the grantor's estate when the grantor transferred the proceeds to an irrevocable life insurance trust within three years of the grantor's death.[15]

If actual incidents of ownership are retained or maintained by the grantor, the life insurance policy will be included in the insured's gross estate.[16] Retention of the following powers, which is evidence of actual incidents of ownership, will cause the proceeds to be included in the insured's gross estate: (1) changing the beneficiaries; (2) surrendering or cancelling the policy; (3) assigning or revoking an assignment of the policy; (4) pledging the policy for a loan; (5) obtaining from the insured a loan against the policy's surrender value; or (6) exercising any other power that the applicable state law provides as an incident of ownership.[17] Additionally, the insured should not retain any control over beneficial enjoyment of the trust, whether as grantor, trustee, or co-trustee.[18] To avoid

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U.S.T.C. ¶ 12,706, 430 F.2d 662 (9th Cir. 1970); Boroderick v. Keefe, 401 U.S.T.C. ¶ 9,470, 112 F.2d 293 (1st Cir. 1940); Estate of Newbold v. Commissioner, 4 T.C.M. (CCH) 568 (1945), *rev'd on other grounds*, 47-1 U.S.T.C. ¶ 10,524, 158 F.2d 694 (2d Cir. 1946). *But see* Tech. Adv. Mem. 88-19-001 (Jan. 6, 1988) (holding that an insured does not have an incident of ownership when life insurance trust provides that the insured has power to terminate the interest of his or her spouse in the event of divorce). Incidents of ownership also include the power to (1) surrender or cancel the policy; (2) assign the policy; (3) revoke an assignment; (4) pledge the policy for a loan; (5) obtain from the insurer a loan against the surrender value of the policy; (6) change the time at or manner in which proceeds will be received. *See* Treas. Reg. § 20.2042-1(c)(2) (1994); Estate of Lumpkin v. United States, 73-1 U.S.T.C. ¶ 12,909, 474 F.2d 1092 (5th Cir. 1973) (holding the insured who has power to elect optional modes of settlement has an incident of ownership). *But see* Estate of Connelly v. United States, 77-1 U.S.T.C. ¶ 13,179, 551 F.2d 545 (3d Cir. 1977) (having "sole power to select a settlement option with the mutual agreement of the employee and the insurer did not give" decendent a "substantial degree of control sufficient to constitute an incident of ownership"); Estate of Chapman v. Commissioner, 56 T.C.M. (CCH) 1451 (1989). Finally, incidents of ownership include the power to veto any change in beneficiary designation or an assignment or cancellation of the policy. Schwager v. Commissioner, 64 T.C. 781 (1975). If the insured maintains a reversionary interest in the policy, the insured is deemed to have incidents of ownership. Treas. Reg. § 20.2042-1(c)(3) (1994); *see, e.g.*, Rev. Rul. 79-117, 1979-1 C.B. 305.

14. A decedent's gross estate includes any policy of insurance where the decedent owned at death any of the incidents of ownership in the policy. I.R.C. § 2042(2) (1988).

15. I.R.C. § 2035 (1988). The insured may also purchase enough life insurance to guarantee the target amount of proceeds as well as adequate cash to cover estate taxes in the event the insured passes away within three years of purchasing the policy, which is normally a more expensive approach. TWENTY-NINTH ANNUAL PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, LIFE INSURANCE TRUSTS ¶ 401.4 (1994).

16. I.R.C. § 2042(2) (1988).

17. Treas. Reg. § 20.2042-1(c)(2), (5) (as amended in 1979).

18. Section 2036(a)(2) includes in the gross estate the value of property the decedent transferred by trust and retained "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." I.R.C. § 2036(a)(2) (1988). Section 2038 includes in the gross estate the value of property the decedent transferred by trust and retained the power, or relinquished the power within three years of death, "to alter, amend, revoke, or terminate" the enjoyment of the property, either alone or in conjunction with another person. *Id.* § 2038(a)(1).

disputes with the Internal Revenue Service (IRS) and the related risks and costs of litigation, the insured should not retain the power to remove and replace the trustee, even if the power is limited to appointing another independent trustee.[19]

In addition, the insured should appoint a corporate fiduciary as trustee, rather than the insured or the insured's spouse.[20] Normally, the trust will be irrevocable and funded with cash in excess of the initially needed premium. The trustee should then apply for an insurance policy on the insured, who will, presumably, make future contributions to the trust. The trustee should be authorized, but not required, to use these future contributions to pay premiums. In effect, this approach eliminates the requirement that the insured survive for three years to avoid inclusion of the policy in the insured's estate.[21]

While case law appears to favor taxpayers, concerns arise when the cash contributions to the trust equal the amount of the required insurance premium, particularly in situations in which the insured has transferred the policy to the irrevocable life insurance trust. Taxpayers fear that a court will accept either a constructive transfer or agency argument and include the insurance proceeds in the grantor's estate.

The constructive transfer theory involves application of section 2035 before it was amended by the Economic Recovery Tax Act of 1981 (ERTA), which eliminated the three year inclusionary rule for all transfers other than those described in section 2035(d)(2).[22] Prior to the amendment, the IRS and several courts held an insured could be deemed to have transferred an interest in a life insurance policy for purposes of section 2035 when the insured was significantly involved in the issuance and maintenance of the policy.[23] This proved true even when the insured neither ever actually owned the policy, nor held incidents of ownership.[24]

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19. *See* Rev. Rul. 79-353, 1979-2 C.B. 325 (ruling a trust was includable in the grantor's gross estate under §§ 2036(a)(2) and 2038(a)(1) because the grantor could remove the corporate trustee without cause and designate a successor, even though the successor had to be another corporate trustee).

20. Although as long as second-to-die insurance (including the spouse as an insured) is not utilized, § 2042(2) should not require inclusion in either spouse's estate when the non-insured spouse did not transfer the policy and simply acts as trustee with distribution rights limited by strict standards. Rev. Rul. 84-179, 1984-2 C.B. 195.

21. Estate of Headrick v. Commissioner, 93 T.C. 171, 178-80 (1989), *aff'd*, 918 F.2d 1263 (6th Cir. 1990).

22. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 424(a), 95 Stat. 172, 317 (1981).

23. *See* TWENTY-NINTH ANNUAL PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, LIFE INSURANCE TRUSTS ¶ 401.4 (1994); *see also* Priv. Ltr. Rul. 85-09-005 (Nov. 28, 1984).

24. First Nat'l Bank v. United States, 488 F.2d 575, 577 (9th Cir. 1973) (applying a form over substance analysis to decedent's payment of premiums on policies owned by decedent's spouse); Harwood v. United States, 89-2 U.S.T.C. § 13,825 (S.D. Fla. 1989) (holding the trustee was acting as the insured's agent in the purchase of the policy and thus the insured was deemed to have transferred the policy to the trust so as to cause the inclusion of the proceeds in her estate under § 2035); Traub v. United States, 86-2 U.S.T.C. § 13,673 (D. Or. 1986). *Cf.* Hope v. United States, 691 F.2d 786, 789 (5th Cir. 1982) (holding there can be a practical difference between buy-

The constructive transfer theory was first interpreted by the Fifth Circuit in *Bel v. United States*.[25] In *Bel*, the court held the insured's estate included his community share of the policy proceeds of an accidental death policy for which the insured paid all of the policy premiums, but did not own or retain any of the incidents of ownership.[26] This theory was extended in *Detroit Bank & Trust Co. v. Commissioner*[27] to include the situation in which an insured created a trust that held a life insurance policy on the insured's life.[28] The justification for the extension rested on the insured's retention of control over the trustee such that the trustee was effectively acting as the insured's agent in acquiring the policy and paying any attendant premiums.[29] In *Estate of Kurihara v. Commissioner*,[30] the Tax Court again held when an insured contributed to a trust by means of a check made out in the exact amount of the policy's premiums, and the check specified that the contribution was to be used to pay such premiums, the trustee was deemed to be the insured's agent.[31]

Since its ruling in *Estate of Leder v. Commissioner*,[32] the Tax Court and the United States Courts of Appeals for the Sixth and Tenth Circuits have rejected the constructive transfer theory. These decisions rest on the ground that the ERTA amendments to section 2035 specifically provide for the exclusion of the proceeds of a life insurance policy from the insured's gross estate unless the descendent possesses, at the time of his death or at any time in the preceding three years, any of the policy's incidents of ownership.[33] Generally, courts have

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ing insurance for someone and giving someone money to buy insurance). *Contra* Estate of Tracy v. United States, 82-2 U.S.T.C. § 13,499 (W.D.N.C. 1982).

25. Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972).

26. *Id.* at 692.

27. Detroit Bank & Trust Co. v. Commissioner, 467 F.2d 964 (6th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

28. *Id.* at 965.

29. *Id.* at 966, 969.

30. Estate of Kurihara v. Commissioner, 82 T.C. 51 (1984).

31. *Id.* at 60-61.

32. Estate of Leder v. Commissioner, 89 T.C. 235 (1987), *aff'd*, 893 F.2d 237 (10th Cir. 1989).

33. Estate of Nepstad v. United States, No. CIV.A.3-89-54, 1991 WL 117430, at *2 (D.N.D. Jan. 8, 1991) (finding that by specifically cross-referencing § 2042 in § 2035(d)(2), Congress intended to eliminate payment of premiums as a factor in determining taxability of insurance proceeds under § 2035(d)(2) as well); Estate of Litman v. United States, No. 89-1302, 1990 WL 208682, at *2 (W.D. Pa. Apr. 23, 1990) (holding the court must first find a transfer of the type of property that would be includable as part of the estate under § 2042 in order to include the proceeds of the insurance policy as a part of the estate via the resurrection of the three year rule); Estate of Richens v. Commissioner, 61 T.C.M. (CCH) 1706, 1706-07 (1991) (concluding the subject life insurance proceeds were not includable in the decedent's taxable estate because the decedent did not possess incidents of ownership in the policy within the meaning of § 2042); Estate of Perry v. Commissioner, 59 T.C.M. (CCH) 65, 67 (1990) (holding the proceeds of the insurance policies are not includable in decedent's gross estate under § 2042 when decedent never held any incidents of ownership, economic, or other contractual rights in the policies), *aff'd*, 927 F.2d 209 (1991); Estate of Ard v. Commissioner, 59 T.C.M. (CCH) 869, 870 (1990) (holding the proceeds of the insurance policy were not includable in decedent's gross estate because the facts in the case were not distinguishable from previous cases dealing with incidents of ownership within the meaning of 2042); Estate of Headrick v. Commissioner, 93 T.C. 171, 176-78 (1989) (holding "the

held that proceeds of a life insurance policy will not be included in the gross estate under section 2035, unless the proceeds would otherwise be included under section 2042 because section 2035(d)(2) specifically refers to section 2042.[34] Because section 2042 does not include the proceeds of a life insurance policy in the insured's gross estate unless the insured retains incidents of ownership in the policy, the three year inclusionary rule applies only if the incidents of ownership are transferred within three years of death.[35]

In spite of the attractiveness of acquiring a new policy, certain conditions may instead dictate the transfer of an existing policy. When a policy has been transferred into a trust, the possible impact of the throwback rules under section 2035 are reduced if the beneficiary makes the premium payments for the next three years.[36] Consequently, the insured's estate can reduce the includible portion of the total premiums paid by the insured in proportion to the premiums paid by the beneficiary.[37] In addition, if the trust and its beneficiaries meet one of the exceptions for transfer for value under Internal Revenue Code section 101(a), the grantor or others can fund the trust with cash, and the trust may purchase the policy from the grantor for full and adequate consideration.[38] Furthermore, the health of the individual may impact the policy value.[39]

C. *Drawbacks of Irrevocable Life Insurance Trusts*

The primary drawback of an irrevocable life insurance trust is that the insured retains no power to alter terms of the trust. Specifically, the insured may not change the named beneficiary of the trust.[40] The insured's only recourse may

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premium payment test is 'now abandoned' under § 2042" even though decedent contributed cash annually to an irrevocable inter vivos trust in an amount sufficient to meet the trusts cumulative monthly premium obligations), *aff'd*, 918 F.2d 1263 (6th Cir. 1990); Estate of Chapman v. Commissioner, 56 T.C.M. (CCH) 1451, 1456-57 (1989) (holding the proceeds of the insurance policy are not includable in the gross estate under either § 2042 or § 2035(d)(1) because the decedent never had any property interest in the insurance policy to transfer); Estate of Leder v. Commissioner, 89 T.C. 235, 238-42 (1987) (holding the § 2035(d)(2) exception to § 2035(d)(1) inapplicable because § 2035(d)(1) overrides § 2035(a), therefore the proceeds of the policy were not includable under § 2042), *aff'd*, 893 F.2d 237 (10th Cir. 1989).

34. Estate of Nepstad v. United States, 1991 WL 117430 at *2.

35. *See, e.g.*, Estate of Headrick v. Commissioner, 93 T.C. at 180 (1989); Estate of Leder v. Commissioner, 89 T.C. at 244 (1987).

36. *See generally* Estate of Silverman v. Commissioner, 61 T.C. 338, 342 (1973), *aff'd*, 521 F.2d 574 (2d Cir. 1975).

37. *See id.* at 342-43; Estate of Friedberg v. Commissioner, 63 T.C.M. (CCH) 3080, 3081-82 (1992).

38. § 101(a) excludes receipt of life insurance proceeds from gross income. I.R.C. § 101(a) (1994). When a life insurance policy is transferred for valuable consideration, § 101(a)(2) excludes from gross income "an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferal." *Id.* § 101(a)(2).

39. *See* Estate of Pritchard v. Commissioner, 4 T.C. 204, 208-09 (1944) (stating that an assignment made when the insured is uninsurable makes the policy worth more than the cost of a similar policy because of the insured's shorter life expectancy).

40. The trust may refer to the beneficiary generically. This will prevent the trust from becoming undesirable in the event the insured divorces and remarries and the spouse is the named beneficiary of the trust.

be to discontinue contributions to the trust for the payment of policy premiums. Depending on the type of policy, the policy may lapse, and the trust may either terminate, continue to hold assets in the amount of the cash value of the policy, or acquire paid-up insurance of a lesser face value amount.

The second drawback of an irrevocable life insurance trust is that, in most cases, gifts to such trusts are gifts of future interest. As such, the gifts do not constitute present gifts, and therefore, do not qualify for the annual exclusion available for present gifts. As a result, each gift would use up a portion of the $600,000 credit equivalent that would otherwise be excludable from estate tax.[41] Powers set forth in *Crummey*, however, and the so called "five-and-five" powers can provide limited present gifting power to the grantor.

III. THE *CRUMMEY* POWER

A trust may be drafted to give each beneficiary, and possibly contingent beneficiaries, the right to demand and receive unrestricted and immediate ownership of some or all of the annual contributions made to the insurance trust. The withdrawal right of the beneficiary's pro rata share enables these gifts to be characterized as "present" gifts, thereby preventing the taxation of those contributions to the donor under the federal gift tax laws if they are within the $10,000 exclusion—$20,000 if the donor and his or her spouse join in the gift. These withdrawal powers are often termed the *Crummey* powers, referring to *Crummey v. Commissioner*.[42] If the ultimate beneficiary of the trust is the *Crummey* beneficiary power holder, then a second gift tax issue arises as to that beneficiary if the withdrawal right exceeds the five-and-five power.[43] Normally, the beneficiary is given a set number of days—typically thirty—during which the beneficiary may use the withdrawal powers.[44]

The *Crummey* power gives each beneficiary a present interest in his or her proportionate share of the contributions made to the trust, rendering the gift eligible for the annual gift tax exclusion under section 2503(b).[45] Each year, the

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41. I.R.C. § 2503 (1988).

42. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). The I.R.S. initially affirmed its acceptance of the *Crummey* power provision. Rev. Rul. 73-405, 1973-2 C.B. 321; *see also* Naumoff v. Commissioner, 46 T.C.M. (CCH) 852, 853-55 (1983) (stating that a demand clause granting both minor and adult beneficiaries the right to demand their trust share creates a present interest).

43. This result follows because the *Crummey* power holder is deemed, in turn, to have made a gift back into the trust. If such beneficiary is not, in turn, to ultimately receive the trust assets, then the assets in excess of the § 2514(e) five- and-five power will be treated as a future gift by that beneficiary.

44. *See* Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).

45. I.R.C. § 2503(b) (1988). Section 2503(b) states in pertinent part:

> In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year.

Id.

grantor may contribute up to $10,000 to the trust per beneficiary free of gift tax.[46] If the grantor is able to split the gift between spouses, the grantor may contribute, free of gift tax, up to $20,000 per year.[47]

The *Crummey* power allows the beneficiary the right to demand that the trustee immediately distribute the gift from the trust to the beneficiary, turning the beneficiary's future interest into a present interest.[48] The estate planner should note, however, that the *Crummey* withdrawal right must be actual and real.[49] The beneficiary should be afforded both actual notice of the right and time to exercise the option.[50]

If the grantor makes payment to a trustee, who immediately uses the funds to pay an insurance premium on a policy owned by the trust, the risk that the withdrawal right will be viewed speciously arises; in turn, the payment will not be treated as a present gift. As a result, the $10,000 exclusion will not apply to the transaction and the grantor's gift will be subject to taxation. In Revenue Ruling 81-7, the Internal Revenue Service (IRS) held a gift will be treated as a future gift, subject to tax, where the gift was made on December 29, and the withdrawal right lapsed on December 31.[51] Based on this ruling, the trustee should avoid placing a gift in the trust and allowing the beneficiary to immediately apply the gift to insurance premiums. If these precautions are not taken, the IRS may find that the right of withdrawal right never actually existed. In order to avoid this problem, *Crummey* gifts should be made within a reasonable time—thirty days—either before paying the premium or the end of the calendar year. The trustee should notify the beneficiary in writing of the intention to exercise the withdrawal right.[52] The beneficiary should then respond in writing, either declining or electing the withdrawal. The trustee should maintain all correspondence between the beneficiary and the trustee.

A second concern, apart from the previously discussed tax issues, arises when the grantor makes a gift to the trust and is using *Crummey* withdrawal rights to qualify the gift as a present gift to the donor. If a beneficiary has the unrestricted right to demand immediate ownership and the benefit of the trust corpus, the beneficiary has a present interest in the trust.[53] When the trust has a remainderman that is a person other than the "income" or current beneficiary with the *Crummey* withdrawal rights, the lapse of withdrawal rights may well constitute future gifts. A future gift subjects such remainderman to gift taxation

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46. *Id.* § 2513.

47. *Id.* § 1015(d)(3).

48. Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968).

49. The trust must maintain liquid assets in the trust during the withdrawal period so that such power may be exercised.

50. Priv. Ltr. Rul. 92-32-013 (May 4, 1992); Priv. Ltr. Rul. 88-06-063 (Nov. 19, 1987); Priv. Ltr. Rul. 80-24-084 (Mar. 21, 1980); Priv. Ltr. Rul. 80-07-080 (Nov. 26, 1979); Priv. Ltr. Rul. 80-04-172 (Nov. 5, 1979); Priv. Ltr. Rul. 79-46-007 (July 26, 1979).

51. Rev. Rul. 81-7, 1981-1 C.B. 474.

52. Priv. Ltr. Rul. 92-32-013 (May 4, 1992); Priv. Ltr. Rul. 91-41-008 (Oct. 11, 1991); Priv. Ltr. Rul. 88-13-019 (Dec. 24, 1987).

53. Crummey v. Commissioner, 397 F.2d 82, 85 (9th Cir. 1968); *see* Rev. Rul. 73-405, 1973-2 C.B. 321.

on the remainder interests.[54] Internal Revenue Code section 2642(c)(2) provides that nontaxable gifts are not subject to generation-skipping taxes.[55] If, however, the donee is the only person who can receive the property during the donee's life, then the property will be included in the grantee's estate upon the grantee's death.[56] Accordingly, separate trusts for each grandchild are generally used when trying to take advantage of non-taxable gifts into trusts that would constitute generation-skipping trusts.[57] Typically, all irrevocable trusts grant general powers of appointment to the income beneficiaries to minimize this problem.[58] The *Crummey* power will not be invoked when generation-skipping provisions, which include non-skip individuals, as beneficiaries are utilized by the trust.[59]

From an insured's perspective, the goal of an irrevocable insurance trust is utilization of the annual exclusions, attained through the use of *Crummey* withdrawal powers granted to trust beneficiaries, in excess of the amount which must be contributed to the trust annually. This enables the trustee to pay premiums on the insurance owned by the trust. If the estate is very large, the premium for appropriate insurance may be correspondingly large, and even the $20,000 annual exclusion may not be enough. In such a case, the insured may name multiple beneficiaries,[60] including individuals who have no other interest in a trust other than the withdrawal power.

In response to attempts to multiply the available annual exclusions for gifts to trusts, Private Letter Ruling 87-27-003 specifically held that powers given to beneficiaries who had no continuing interest in the trust, other than withdrawal right, would be regarded for annual exclusion purposes.[61] A beneficiary must have a sufficient interest in the trust for the annual exclusion to apply.[62]

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54. I.R.C. § 2041(b) (1988). Under § 2041, the lapse of a withdrawal power may be taxed because it is a power of appointment. *Id.* The failure to exercise a power of appointment created after October 21, 1942, within a specified time such that the power lapses, constitutes a relapse of the power. Treas. Reg. § 20.2041-3(d)(3) (as amended in 1986).

55. I.R.C. § 2642 (1988). The generation skipping transfer tax provides that in the case of a direct skip transfer, to the extent that the transfer qualifies for the gift tax annual exclusion under § 2503(b), it is not subject to the generation-skipping tax, provided the trust funds benefit only the skipped person, and the trust property is included in *that* person's estate (or at least in some *skip* person's estate). *Id.*

56. *Id.* § 2642(c)(2) (1988).

57. For a description of more sophisticated devices, see Richard S. Rothberg, *Crummey Powers Enhance the Usefulness of Trusts for Minors and Life Insurance Trusts*, 15 EST. PLAN. 322 (1988); Roy M. Adams & Scott Buber, *Making "5 and 5" Equal 20: Crummey Powers After ERTA*, TR. & EST., Sept. 1983, at 22.

58. *Id.*

59. *See infra* Part IV.

60. Estate of Cristofani v. Commissioner, 97 T.C. 74, 82-83 (1991) (approving the use of *Crummey* withdrawal powers by five contingent remainder beneficiaries created by a grandmother for the primary benefit of the parents of the remainder beneficiaries).

61. Priv. Ltr. Rul. 87-27-003 (Mar. 16, 1987).

62. *See* Priv. Ltr. Rul. 91-41-008 (Oct. 11, 1991); Priv. Ltr. Rul. 90-45-002 (Nov. 9, 1990); Priv. Ltr. Rul. 88-06-063 (Nov. 19, 1987).

The IRS adopted the position that the annual exclusions would be limited to the primary beneficiaries of the trust, or others that actually exercised such powers, and not recognized for persons with no other beneficial interest.[63]

IV. THE FIVE-AND-FIVE POWER

Internal Revenue Code section 2041(b)(2) provides that an annual lapse of a right to withdraw an amount not exceeding the greater of $5000 or five percent of the trust corpus will not be deemed a gift by the beneficiary who does not exercise the withdrawal power.[64] This is commonly know as a "five-and-five power." Internal Revenue Code section 2514(e) makes the same provision for gift tax purposes.[65] Even though the insured may exclude a $10,000 contribution, or $20,000 if the insured is able to split the gift with a spouse, the insured may be advised to make only a $5000 contribution per *Crummey* powerholder to avoid potential adverse gift and estate tax consequences to the non-withdrawing trust beneficiaries. This approach is mandatory in generation-skipping trusts with non-skip beneficiaries.[66]

There are several ways to draft a trust to overcome the five-and-five rule limitation when the gift to the trust exceeds the $5000 threshold. The insured may limit the amount for which the withdrawal right will lapse in any given year to the greater of $5000 or five percent of the trust principal, with a residual power continuing to apply to the excess.[67] The value of the trust principal will increase to the point at which a beneficiary's share of the annual premium, plus the amount for which the right to withdraw has not previously lapsed, equals no more than five percent of the trust principal.[68] The right of withdrawal can then fully lapse each year without creating a gift or estate tax liability for the holder of the withdrawal power.[69]

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63. *Id. But see* Estate of Cristofani v. Commissioner, 97 T.C. at 83-84 (stating that the *Crummey* power does not require that the beneficiaries have a vested present interest in the trust corpus or income in order to obtain the annual exclusion. Rather, the inquiry must look to the beneficiary's ability in a legal sense to obtain the benefits).

64. I.R.C. § 2041(b)(2) (1988). Section 2041(b)(2) states:

> The lapse of power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:
>
> (A) $5,000, or
>
> (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

Id.

65. *Id.* § 2514(e).

66. *See* 53RD N.Y.U. INSTITUTE, LIFE INSURANCE & ESTATES § 18.03 (1995).

67. David N. Barkhausen, *When to Trust in a Trust*, COMPLEAT LAWYER, Fall 1992, at 29.

68. *Id.*

69. *Id.*

The insured may grant the trust beneficiaries a general or limited power of appointment over their trust shares to prevent the withdrawal right from being treated as a gift by the IRS.[70] The insured may also make each separate trust share payable to the beneficiary's estate.[71] The expiration of the withdrawal right and consequent lapse of the general power of appointment with a resulting benefit to a beneficiary's estate avoids the treatment of a transfer by the beneficiary as a gift.[72] The insured also has the option of naming additional five-and-five powerholders, reducing the need to contribute more than $5000 per powerholder each year.[73] Finally, in generation-skipping trusts with non-skip beneficiaries, the skip beneficiaries can be given the *Crummey* rights for all gifts in excess of $5000 per nonskip beneficiary.[74]

V. GENERATION-SKIPPING TRUSTS

In larger estates, the goal is often not just to transfer wealth to the next generation, but also to transfer some of that wealth to grandchildren without estate taxation at the children's level. Normally, two or more trusts are involved when both goals are present.

The first trust simply involves a transfer to a traditional irrevocable life insurance trust designed to benefit the insured's children. This non-skip transfer is used to allocate property to the grantor's children and to provide cash for the parents' estate liquidity needs, such as estate taxes and probate or administration fees. These transfers must be structured using *Crummey* provisions to ensure that no gift taxes are incurred with the transfer of cash to the trust.[75] If transfers exceed the annual gift exclusion, a gift tax liability results.

Most of the previous discussion regarding irrevocable life insurance trusts also applies to trusts designed to benefit future generations. The funding flexibility may, however, be substantially reduced. If a trust is established to benefit both the children and grandchildren and is intended to bypass the child's estate, it is critical that any *Crummey* power granted to an insured's child be limited to the five-and-five powers' rule. Failure to limit this power will result in child taxation of the excess of future gifts to the grandchild. The child will also be deemed a partial owner of the trust corpus during the child's lifetime for income tax purposes.[76] In addition, because these are not "direct skips," there

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70. *Id.*

71. *Id.*

72. *Id.*

73. *See* Estate of Cristofani v. Commissioner, 97 T.C. 74, 82-83 (1991).

74. I.R.C. § 2514(e) (1988); *see also* Prop. Treas. Reg. § 26.2654-1, 57 Fed. Reg. 61356, 61370 (1992) (to be codified at 26 C.F.R. pt. 26) (proposed 12-24-92)(providing for treatment of certain trusts as seperate trusts).

75. Allocations to the trust must meet the requirements under I.R.C. § 2632 (1988) and Prop. Treas. Reg. § 26.2632-1(b)(2)(i), 57 Fed. Reg. 61356, 61363 (1992) (to be codified at 26 C.F.R. pt. 26) (proposed 12-24-92).

76. I.R.C. §§ 671, 678 (1988); Rev. Rul. 67-241, 1967-2 C.B. 225; Priv. Ltr. Rul. 87-01-007 (Sept. 30, 1986); Priv. Ltr. Rul. 83-26-074 (March 29, 1983). Section 671 states that a grantor or other person must include in taxable income the income from a trust of which the grantor or per-

will be no automatic allocation of generation-skipping trust exemptions, and therefore, gift tax returns are needed to avoid unduly exhausting the $1,000,000 generation-skipping exemption.[77]

Generally, generation-skipping trusts intended to benefit only grandchildren are established separately for each grandchild and provide for the inclusions of at least a portion of the corpus in each child's estate.[78] Each separate trust could provide the grandchild a *Crummey* withdrawal power of up to $10,000.[79] After the Technical and Miscellaneous Revenue Act of 1988 (TAMRA),[80] the grandchild's *Crummey* withdrawal power will not satisfy the statute's requirement that the trust principal be included in the grandchild's gross estate, unless each grandchild is also given a testamentary general power of appointment over the trust property. This requirement must be met in case the grandchild passes away before the trust estate is fully distributed.[81] Neither the income nor the principal of the trust may be distributed to someone other than the beneficiary of the trust.[82] If the trust has multigeneration beneficiaries, then there is no generation-skipping transfer tax (GST) unless there is a distribution made to the grandchild.[83] In spite of the potential $10,000 withdrawal power, consideration should be given to limiting the *Crummey* right of withdrawal to $5000 or five percent of the trust corpus to eliminate confusion as to whose GST exemption to allocate.[84] Upon each transfer to the trust during the transferor's life, the automatic GST exemption applies if the only beneficiary is a skip beneficiary.[85] These gifts are used by the trustee to pay the insurance premiums and continue until the insured and the insured's spouse exhaust their GST exemptions or until the transferor affirmatively elects out of such allocation.[86] As a result, care should be taken so that these withdrawal rights do not continue beyond a single calendar year.

VI. INSURANCE PRODUCTS

Although a detailed description of insurance products is beyond the scope of this Article, certain concepts have become important to insurance products with irrevocable life insurance trusts. With the advent of the unlimited marital deduction, it has become apparent that liquidity in the estate of the spouse who is

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son is treated as the owner. I.R.C. § 671 (1988). Sections 673 through 678 are the rules that determine when the grantor or other person is treated as the owner of a trust. *Id.* §§ 673-678.

77. I.R.C. § 2631 (1988).

78. *Id.* §§ 2036, 2038.

79. *Id.* § 2624(c)(3)(A).

80. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

81. *Id.*; *see* Tech. Adv. Mem. 89-01-004 (Jan. 6, 1989).

82. I.R.C. § 2624(c)(2) (1988).

83. Priv. Ltr. Rul. 89-22-062 (June 2, 1989); Prop. Treas. Reg. § 26.2612-1(d)(2), 57 Fed. Reg. 61356, 61361 (1992)(to be codified at 26 C.F.R. pt. 26)(proposed 12-24-94).

84. I.R.C. § 2631 provides for an exemption of $1,000,000 to be allocated to an individual or his executor for any property with respect to which such individual is the transferor. I.R.C. § 2631 (1988).

85. *Id.*

86. I.R.C. § 2632(b)(1), (3) (1988).

first to die is of less importance.[87] Insurance companies have responded by providing products that insure two lives and pay benefits only after the second named individual has passed away.[88] These products allow the insured to purchase insurance at favorable rates, saving substantially on an annual basis.[89] In addition, based on various actuarial assumptions, many of the second-to-die policies are designed with riders to acquire additional permanent paid-up insurance. Earnings from the cash surrender value also may be used until the end of the premium requirement.[90] One can expect the total contribution to the trust for coverage to end within that time period, if the actuarial assumptions of earnings prove correct.

One of the advantages of the lower premiums is the ability to stay within present gifting requirements of either the *Crummey* trust provisions or the lesser five-and-five power requirements.[91] In certain situations, split-dollar arrangements between the trust and the grantor's closely held business utilization of second-to-die policies can provide substantial benefits relative to the ability to make small "gifts" to the trust each year, enabling the grantor to stay within the five-and-five powers necessary for generation-skipping trusts.[92] The term costs or "gift" acquired into an irrevocable life insurance trust on a single life policy subject to split dollar is normally the lower of the insurer's term cost or the I.R.C. set P.S. 58 rate.[93] When joint survivor policies are used rather than the P.S. 58 rate, the P.S. 38 rates are available to calculate the gift.[94] Since the P.S. 38 rate is an effort to determine the "term" cost based on the likelihood that two separate individuals will die within that particular year, such rates are often a very small percentage of the P.S. 58 rates for the same coverage for the same year.[95]

The downside of split-dollar policies on second-to-die insurance policies is the risk that one of the parties will die before the vanishing premium point is met. Or alternatively, the insured employee may die, terminating the split-dollar arrangement and requiring the trust to reimburse the employer for the previous premiums paid by the employer. Partial solutions to these cash needs are obtained by having the irrevocable life insurance trust acquire a smaller first-to-die policy to minimize the risk and provide the needed cash.

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87. *See* 1994 INSTITUTE ON ESTATE PLANNING, LIFE INSURANCE TRUSTS ¶ 403.2 (1994).

88. *See* Rev. Rul. 61-328, 1964-2 C.B. 11.

89. Realization of the insurance proceeds, of course, will normally be delayed as well.

90. These provisions are referred to a "vanishing premiums" and are not guaranteed but rather are dependant on the validity of the actuarial assumptions.

91. *See* Rev. Rul. 81-198, 1981-2 C.B. 188.

92. The measure of the gift is the economic benefit to the insured, not the premium paid by the employer, reduced by the employer's interest in the policy. Rev. Rul. 81-198, 1981-2 C.B. 188; Rev. Rul. 78-420, 1978-2 C.B. 67.

93. *See* Rev. Rul. 81-198, 1981-1 C.B. 188; Rev. Rul. 78-420, 1978-2 C.B. 67.

94. *Id.*; *see* Georgiana J. Slade, *Some Advanced Uses of Life Insurance in Financial and Estate Planning*, 2 N.Y.U. INST. ON FED. TAX'N § 18.01, § 18.04[5] (1995). The P.S. rates are set by the IRS in tables which measure the economic value of the death benefit to the participant. Rev. Rul. 55-747, 1955-2 C.B. 22

95. *Id.*

VII. CONCLUSION

While no single technique or approach is likely to have a favorable effect in all estate planning concepts, individuals with relatively substantial estates should seriously consider the use of irrevocable life insurance trusts, particularly when paired with second-to-die insurance products. This is not so much to provide "protection" or even liquidity but, rather, is a highly attractive tool to transfer wealth to one or more generations without incurring meaningful estate or generation-skipping taxes. While there is no free lunch and "gifts" to the grandchildren of premium amounts might also grow as large with proper investments, such complex programs are seldom followed. When an individual's estate planning includes considerations of numerous children, grandchildren and providing liquidity for the estate, alternative estate plans seldom equal the irrevocable life insurance trust.