



WRMarketplace

An AALU Washington Report

Thursday, July 2 2015

WRM# 15-24

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Crummey Powers – Crummy or Essential? It's More Than Just Moving Paper.

MARKET TREND: Crummey powers are instrumental in funding irrevocable life insurance trusts ("ILITs") with annual exclusion gifts.

SYNOPSIS: Annual exclusion gifts can help clients substantially fund ILITs while preserving their lifetime gift and estate tax exemption amounts. Qualifying a gift in trust as an annual exclusion gift to the ILIT beneficiaries, however, requires careful planning with regard to the selection of Crummey powerholders, the crafting of Crummey power provisions, and the administration of the notice and withdrawal provisions.

TAKE AWAYS: Crummey Notices often seem to be forgotten or simply viewed as the completion of standard forms. Despite recent favorable Tax Court decisions, however, the IRS continues to closely scrutinize ILIT contributions and their qualifications as annual exclusion gifts, emphasizing the importance of following best practices when implementing and administering ILIT Crummey powers. Accordingly, the proper administration of these notices can mean the difference between transferring property to an ILIT with only the use of recurring annual exclusion amounts versus paying gift taxes and/or losing lifetime gift/estate and GST tax exemptions due to the contributions.

According to a recent Tax Court case, a grantor was able to fund an ILIT absent payment of gift tax or the use of any lifetime gift tax exemption. In *Mikel v. Commissioner*,¹ which involved 60 trust beneficiaries and \$720,000 in gifts that qualified for the federal annual gift tax exclusion, the Tax Court affirmed the use and viability of beneficiary withdrawal rights ("**Crummey powers**")² as a means of funding ILITs with potentially significant amounts of annual exclusion gifts (see discussion of case facts in *WRNewswire #15.04.15*).

The IRS, however, continues to scrutinize the use of *Crummey* powers and annual exclusion gifts to trusts, and attempts to short-cut the administrative process or extend the use of *Crummey* powers beyond current limits may create adverse results. Accordingly, the following reviews the factors clients should consider when using annual exclusion gifts to fund their ILITs.

OVERVIEW - CRUMMEY POWERS & ANNUAL EXCLUSION GIFTS

Generally, a person's first \$14,000 of annual gifts to a donee is exempt from federal gift tax.³ A gift only qualifies for this annual gift tax exclusion if the donee has a "present interest" in the gift (as with an outright gift). As gifts to ILITs (or trusts generally) do not typically satisfy the present interest requirement, most ILITs will include *Crummey* powers that allow designated trust beneficiaries to withdraw all or part of the gift to the trust, up to the annual gift tax exclusion amount for each beneficiary, for a specified period of time. If not exercised within that timeframe (e.g., 30 days), the *Crummey* power lapses, and the transferred property remains in trust to be invested or is used by the trustee (e.g., to pay policy premiums).

Although a simple concept, *Crummey* powers actually require careful attention in administration, given the IRS's continued focus on their use. Failure to abide by best practices in handling *Crummey* powers may result in limits on the amount of annual exclusion gifts a client may make to the ILIT beneficiaries, characterization of all transfers to the ILIT as taxable gifts, the unanticipated imposition of gift tax, and/or the loss of gift and GST tax exemption.

PLANNING FOR CRUMMEY POWERS

- 1. Determine the ILIT's Annual Funding.** Generally, annual gifts to an ILIT depend on: (1) the amount and timing of insurance premiums and (2) the client's objectives. Funding an ILIT with annual exclusion gifts preserves a client's lifetime gift/estate tax exemption or provides additional gifting bandwidth for those who have already exhausted their exemption. Funding an ILIT solely through annual exclusion gifts requires that the ILIT have sufficient *Crummey* powerholders to manage the payment of annual insurance premiums.
- 2. Select the *Crummey* Powerholders.** Although more powerholders will allow more annual exclusion gifts to an ILIT, the recipients of those *Crummey* powers should be carefully considered. It may be advisable to exclude certain beneficiaries as powerholders, for example, if a beneficiary is estranged from the family, has difficulty with managing finances, or has creditor issues (especially since creditors may reach the property subject to the beneficiary's withdrawal right, depending on applicable state law). To address these possibilities, the trust agreement can limit the powerholders who can make withdrawals, allow the donor to exclude one or more trust beneficiaries from making withdrawals from his or her contribution, or provide the trustees with the power to exclude a beneficiary, or to vary the withdrawal rights of each powerholder.⁴

Note that certain classes of *Crummey* powerholders will require additional planning, including:

- **Spouses.** Spouses, as trust beneficiaries, can hold *Crummey* powers.⁵ However, if the donor intends to allocate generation-skipping transfer ("GST") tax exemption to the trust (which is quite common), to ensure timely allocation, the spouse's *Crummey* power should be limited to the greater of \$5,000 or 5% of the aggregate value of the trust's assets, and the withdrawal period should be no longer than 60 days.⁶
 - **Minor or Incapacitated Beneficiaries.** Consideration should be given to who may exercise *Crummey* powers on behalf of minor or incapacitated beneficiaries, rather than relying on state representation laws. Trust provisions should be drafted to specifically identify who may act on behalf of such a beneficiary and/or to give the trustee or another person the power to designate such an individual. The trust agreement should specifically prohibit the donor of the gift, whether as parent, guardian or designated agent for the beneficiary, from exercising a *Crummey* power on behalf of a minor or incapacitated beneficiary.
 - **Grandchildren.** Grandchildren and more remote descendants are considered "skip persons" for GST tax purposes. Providing grandchildren with *Crummey* powers expands the annual exclusion gifts that may be contributed to an ILIT.
 - Note, however, that with most typical ILITs (which are often structured as discretionary dynasty trusts for multiple beneficiaries), the gifts will **not** simultaneously qualify for the annual GST tax exclusion.⁷ As a result, the donor's GST tax exemption likely will need to be allocated to these gifts or GST tax will be imposed when ILIT property is distributed to a skip person or when the interests of all non-skip persons in the ILIT terminate. While the so-called "automatic allocation" rules may help in these cases, as they automatically allocate GST exemption to any contribution made to a "GST trust,"⁸ they are complex, and the client is responsible for tracking the GST tax exemption automatically allocated each year. Thus, clients may want to file a federal gift tax return solely to document the allocation of GST tax exemption to annual exclusion gifts to GST-exempt ILITs, even if a gift tax return is not otherwise required.
- 3. Ensure Powerholders Have a Beneficial Interest.** In addition to the *Crummey* withdrawal right, a *Crummey* powerholder must have a beneficial interest in the ILIT. Current income and principal beneficiaries of a trust clearly satisfy this requirement. The Tax Court also has held that a *Crummey* powerholder's contingent remainder interest in a trust is a sufficient beneficial interest for annual exclusion purposes.⁹ *Crummey* powers granted to individuals who have no other interest in the trust (so-called "naked powers"), will not qualify.¹⁰

- 4. Take Into Account Other Annual Exclusion Gifts.** For each donee, the annual exclusion applies, in chronological order, to all gifts made to that donee during the calendar year. Thus, clients need to consider whether they plan to make, or have made, other annual exclusion gifts to the selected Crummey powerholders apart from the ILIT contributions. For example, clients may have elected to make excess contributions to Section 529 plans for their children. This involves a large, up-front contribution to the plan and an election to allocate that contribution ratably over a five-year period, qualifying the allocated amount for the annual exclusion for each of those five years.¹¹ If a client also creates an ILIT that benefits the same 529 plan beneficiaries and provides them with Crummey powers, then the amount the client can contribute to the ILIT as annual exclusion gifts will be reduced by the annual exclusion gifts deemed made to the 529 plans.

Example. H formed an ILIT in 2011 for the benefit of his son, daughter, and three grandchildren, who all hold *Crummey* powers. In 2012, H contributed \$50,000 to his son's 529 plan and elected to allocate the contribution over a five-year period (\$10,000/year). Assuming H and W agree to split gifts and H has made no other gifts to his children and grandchildren, H may make total annual exclusion gifts to the ILIT of \$130,000 in 2015 (\$28,000 for each of the beneficiaries, less the \$10,000 contribution allocated to his son's 529 plan).

- 5. Plan for Gift-Splitting, if Required/Desired.** Spouses often seek to leverage the annual exclusion gifts by electing to use gift-splitting, which allows the gifts made by one spouse to be treated as if made by both.¹² This, in effect, allows a married donor to double the annual exclusion gifts to the ILIT. The non-donor spouse must consent to gift-splitting (which consent will apply to all gifts made during the year). However, subject to limited exceptions, a spouse cannot consent to split a gift to a trust if he or she has a non-ascertainable (i.e., discretionary) interest in the trust. Thus, if the non-donor spouse will be an ILIT beneficiary, the ILIT agreement must provide that any discretionary spousal interest is subordinate to the exercise of *Crummey* powers held by third parties (e.g., descendants). In this case, transfers to the ILIT that are subject to the third-party *Crummey* powers should be treated as gifts to those powerholders, rather than gifts to the ILIT in which the spouse has a discretionary interest. Those gifts should then qualify for split-gift treatment.¹³
- 6. Structure the *Crummey* Power.** Although *Crummey* powers have significant planning utility for the grantor, they also have the potential to create adverse results for the beneficiary. For example, *Crummey* powers are considered general powers of appointment with regard to a beneficiary's portion of a gift in trust.¹⁴ If the beneficiary passes away during the withdrawal period, his or her interest in the gifted property may be includible in his or her estate. Further, when a beneficiary allows the power to lapse, the beneficiary will make a taxable gift to the ILIT if the value of the lapsed power exceeds the greater of \$5,000 or 5% of the aggregate value of the assets out of which the lapsed power could be satisfied (the "**5 or 5 amount**").¹⁵

To address the lapse concern, many ILITs use so-called "hanging" *Crummey* powers, which lapse each year only to the extent of the 5 or 5 amount. The right to withdraw the excess continues into the next year (or years) until the value of the ILIT assets become sufficient to absorb the lapse (i.e., the lapsed amount does not exceed 5% of the trust principal).

Example. In year 1, X creates an ILIT for the benefit of his five children and funds it with a gift of \$70,000. Each child has a *Crummey* power to withdraw a pro rata share of the gift, up to \$14,000. Each child's power, if unexercised, lapses only to the extent of the greater of \$5,000 or 5% of the trust principal. Assuming the ILIT principal is \$70,000, each power lapses by \$5,000, leaving \$9,000 "hanging" for each child. In year 2, X again gives \$70,000 to the trust. If the ILIT principal is now \$140,000, each power lapses by \$7,000 (5% of \$140,000), leaving an aggregate of \$16,000 hanging for withdrawal (\$9,000 from year 1 plus \$7,000 from year 2). If X makes no further gifts to the ILIT and the principal remains at \$140,000, each child's powers will lapse by \$7,000 each year until exhausted (\$7,000 in year 3; \$7,000 in year 4; the balance of \$2,000 in year 5).

If deciding to use a hanging *Crummey* powers in a trust, clients should understand that these hanging powers, while successful at protecting the beneficiary against a taxable lapse in the year of the gift, may still present issues. For example, the hanging withdrawal amounts may accumulate over time, particularly if the grantor is only making annual exclusion gifts to an ILIT equal to the premium payment amounts. In such case, the ILIT may be left with a principal value insufficient to absorb the hanging amounts over time, eventually giving the *Crummey* powerholder the ability to make substantial withdrawals from the ILIT. Also, as noted above, if the beneficiary dies while holding the right to withdraw the hanging amount, the excess will be included in the beneficiary's estate for estate tax purposes.¹⁶ For instance, in following with the example above, if one of X's

children passed away in year 2, after the \$70,000 gift was made to the trust, the hanging \$16,000 would be included in the deceased child's estate for estate tax purposes, even though it was never withdrawn.

7. **Provide Notice and Opportunity.** The IRS and the Tax Court have taken conflicting approaches regarding the requirements for providing powerholders with notice of, and the opportunity to exercise, *Crummey* powers to qualify a gift for annual exclusion treatment. The IRS has taken the position that *Crummey* powerholders must receive prompt notice of their withdrawal powers with regard to any annual exclusion gift to the trust,¹⁷ and that a 30-day withdrawal period is sufficient.¹⁸ The Tax Court, on the other hand, has ruled that actual knowledge or notice of withdrawal rights did not affect the *Crummey* powerholders' legal right to demand withdrawals,¹⁹ and that a withdrawal period of 15 days was reasonable.²⁰ Generally, a withdrawal period of 30-60 days prior to lapse should be adequate for purposes of giving the beneficiary sufficient notice and opportunity.
 - **Planning Point.** Despite the Tax Court's rulings, the IRS continues to review and challenge ILIT contributions and their qualifications as annual exclusion gifts during audits. Thus, clients generally should still be advised to give actual written notice to *Crummey* powerholders upon each gift to a trust. If these administrative recommendations are not followed but the client has otherwise made the beneficiaries aware of their withdrawal rights, confirmatory *Crummey* notices should be provided to the beneficiaries as contingency planning. Such notices reaffirm that a beneficiary was made aware of his or her withdrawal rights and elected not to exercise such right with regard to each gift.
8. **Provide the Trustee with Ability to Satisfy Withdrawals.** During the withdrawal period, ILITs should have the ability to satisfy *Crummey* withdrawal rights, if exercised. Otherwise, the *Crummey* powers may be deemed illusory. This situation occurs when the grantor pays the premiums on a ILIT-owned policy directly to the insurance carrier or in an employer group policy setting, when the employer pays the premiums directly to the carrier, which means no funds ever pass through the ILIT during the *Crummey* withdrawal period. Ideally, contributions will be made to the ILIT trustee, who would hold the contribution in trust for the designated withdrawal period. If this is not possible or does not occur, the ILIT agreement may provide a "back-up" if it allows exercised *Crummey* powers to be satisfied by distributions of cash, other property (including interests in the insurance policies), or borrowing against the insurance policies' cash values.²¹

TAKE AWAYS

Crummey Notices often seem to be forgotten or simply viewed as the completion of standard forms. Despite recent favorable Tax Court decisions, however, the IRS continues to closely scrutinize ILIT contributions and their qualifications as annual exclusion gifts, emphasizing the importance of following best practices when implementing and administering ILIT *Crummey* powers. Accordingly, the proper administration of these notices can mean the difference between transferring property to an ILIT with only the use of recurring annual exclusion amounts versus paying gift taxes and/or losing lifetime gift/estate and GST tax exemptions due to the contributions.

NOTES

TCO 361353802v4

¹ T.C. Memo. 2015-64 (April 6, 2015).

² Named after *Crummey v. Commissioner* 397 F.2d 82 (9th Cir. 1968).

³ Internal Revenue Code ("Code") § 2503(b)(1). This amount is indexed for inflation. Code § 2503(b)(2).

⁴ PLRs 9030005, 8103074.

⁵ The power will qualify the withdrawal amount for the gift tax marital deduction. Code § 2523.

⁶ Treas. Reg. § 26.2632-1(c). These restrictions create an exception to rules of the estate tax inclusion period ("ETIP"), during which (1) a gift to a trust is includable in the gross estate of the donor or the donor's spouse and thus (2) prevents the donor's current allocation of GST tax exemption to the trust. If the donor's spouse has a *Crummey* power, the spouse effectively has a general power of appointment over part of the trust, which would cause inclusion in her estate, resulting in an ETIP. Limiting the spouse's *Crummey* power as provided above qualifies for an exception to the ETIP rules and allows the donor to allocate GST tax exemption to the trust.

⁷ A gift in trust will qualify for the annual GST tax exclusion if the trust has only one beneficiary, and the trust assets must be paid to that beneficiary during life or included in the beneficiary's gross estate at death.

⁸ See Treas. Reg. § 26.2632-1.

⁹ See *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 1, 1996-2 C.B. 1 (The grantor created a trust for the benefit of two children who were the primary beneficiaries, and five grandchildren, the contingent remainder beneficiaries. The Tax Court allowed the grantor to claim all seven annual exclusion gifts because each beneficiary was a *Crummey* powerholder, and there was a possibility that the grandchildren would have received a substantial benefit from

the trust if a child predeceased); *Estate of Kohlsaar v. Commissioner*, 73 T.C.M. (1997) (*Crummey* powers were given to 16 children, grandchildren and great grandchildren, of which only the two children had a vested interest in the income and principal of the trust - grandchildren and great grandchildren were contingent remainder beneficiaries. The Tax Court held that despite the grandchildren and great grandchildren's contingent remainder interest, their right to demand trust principal during the withdrawal period is a present interest in the gift, qualifying it for the annual exclusion).

¹⁰ See TAM 9628004.

¹¹ Code §529(c)(2). Gifts to §529 qualified tuition programs are treated as completed, present interest gifts.

¹² See Code §2513.

¹³ See also PLRs 200130030, 8138102, 8112087, and 8044080. But see PLRs 200616022 and 200422051, which depart from the IRS analysis in those prior PLRs regarding split-gifts to trusts with non-donor spouses as trust beneficiaries. Commentators seem to think that these PLRs are ambiguous and constitute an aberration from the prior position of the IRS. See, e.g., See Diana S.C. Zeydel, "Gift-Splitting—A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 J. Tax'n 334 (June 2007); William R. Swindle, "Obtaining Split-Gift Treatment for Transfers to Trusts," Est. Plan. Journal (WG&L) (Jan 2008).

¹⁴ See, Code § 2041.

¹⁵ Code § 2514(b), (e).

¹⁶ See Code § 2014; Treas. Reg. § 20.2041-3(d)(1); Code § 2036(a)(2).

¹⁷ Rev. Rul. 81-7, 1981-1 C.B. 474.

¹⁸ PLR 93111021.

¹⁹ *Estate of Turner, Sr. v. Commissioner*, T.C. Memo 2011-209 (2011) (The Tax Court allowed indirect gifts to an ILIT (i.e., grantor's direct payments of premiums on a trust-owned policy to the carrier) to qualify for the annual exclusion, even though the trustee did not provide notice to the trust beneficiaries of their withdrawal rights in these indirect gifts. The Tax Court's decision relied in part on the fact that the ILIT gave each beneficiary the absolute right to demand withdrawals after each "direct or indirect" transfer to the ILIT, making the question of whether the decedent transferred money directly to the ILIT "irrelevant." The Tax Court also stated that the beneficiaries' knowledge (or lack thereof) of their withdrawal rights did not affect their legal right to demand withdrawals).

²⁰ 97 T.C. 74. The IRS has privately ruled, however, that a withdrawal period of four or less days does not provide the *Crummey* powerholders with an adequate opportunity to exercise their rights (see TAM 9628004).

²¹ See e.g., PLR 8111123 (contribution qualified for the annual exclusion where beneficiaries had withdrawal rights that could be satisfied with any trust assets, including any life insurance policies). It is unclear, however, whether this provision would protect a trust that only holds a life insurance policy with minimal or no cash value for purposes of surrenders, withdrawals or policy loans (e.g., term, group term, or certain guaranteed products).

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the *Essential Wisdom Series*, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

WRM #15-24 was written by Greenberg Traurig, LLP

Jonathan M. Forster

Martin Kalb

Richard A. Sirus

Steven B. Lapidus

Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012