

**STOP THE BLEEDING OR HOW TO REPAIR THE ILIT WITH A  
DAMAGED CRUMMEY POWER AND OTHER AILMENTS**

**By**

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November 9, 2012**

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### I. Introduction, Purpose, and Scope.

#### A. Introduction.

The irrevocable life insurance trust (hereinafter “ILIT”) with withdrawal right provisions has been an effective estate planning tool since the Ninth Circuit Court of Appeals rendered the famous opinion in Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968) . Thousands of ILITs are created every year providing generous tax free benefits to the insured’s family and other beneficiaries with little or no adverse tax consequences.

However, poor design, sloppy implementation, and/or negligent maintenance can undue most (if not all) of the benefits of the ILIT.

After more than thirty-four (34) years of an active estate planning practice, the author has encountered the following situations:

Example No. 1–Case of the Neglected Crummey Formalities. Sixteen years ago Client creates an ILIT and arranges for the Trustee of the ILIT to become the owner and beneficiary of a \$10 million whole life policy on Client’s life with an annual premium of \$100,000.00. The trust provides for the collective benefit of Client’s two children and six grandchildren. The terms of the ILIT require the Trustee (Client’s brother) to “notify” each beneficiary (or his/her natural guardian) after each gift to the trust. Each beneficiary has 30 days after receiving notice to withdraw his or her pro rata share of the gift. Except for the \$100,000.00 gift in the first year, none of the “Crummey-type” notice procedures have been followed. For the past fifteen years, Client has paid the premium directly to the insurance company.

Adverse Consequence: Client has arguably wasted \$1,500,000.00 of his gift tax applicable exclusion. *But see Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (August 30, 2011) (hereinafter cited as “Turner v. CIR.”*

Example No. 2–Case of the Two Life Policy in the One Life ILIT. Husband and Wife, residents of a community property state, create a “Spousal ILIT.” The Trustee of the ILIT plans to purchase a \$5 million life insurance policy on Husband’s life with Husband’s separate property. Wife is designated as Trustee of the trust. Under the ILIT, Wife will become a beneficiary of the trust after Husband’s death. At Wife’s death, the assets of the trust will be distributed to Husband’s and Wife’s children. Because of premium considerations, and without consulting with their lawyer, Husband and Wife arrange for the ILIT to purchase a \$5 million second-to-die policy and contribute community property to the ILIT to enable Wife, as Trustee, to pay the premium.

Adverse Consequence: Because one-half (½) of the gifts to the ILIT were made by Wife, one-half (½) of the ILIT will be included in Wife's estate for Federal estate tax purposes. Depending on the size of Wife's estate, this could result in unintended estate tax.

Example No. 3—Case of the Comfortable Child. The ILIT was drafted by in-house counsel with a form provided by the life insurance agent. After the death of Husband and Wife, the ILIT provides distributions for Child's health, education, maintenance, support, welfare and comfort and names Child as sole Trustee.

Adverse Consequence: Trust could be included in Child's estate at his death unless the state law governing has a codified savings provision. *See, e.g., Texas Property Code § 113.029 (b) which would limit the Child's power to distribute to himself to distributions for health, education, support, and maintenance within the meaning of IRC § 2041(b)(1)(a). This same provision would prohibit the Child/Trustee from making discretionary trust distributions to satisfy a legal obligation of support that a trustee personally owes to another person.*

Example No. 4—Case of the December Withdrawal Right. ILIT only allows for withdrawal rights during the month of December and Client makes ILIT gifts in July.

Adverse Consequence: Gifts in January through November are gifts of a future interest.

Example No. 5—Case of the Migrating ILIT. Husband (now age 70) and Wife moved from New York to Texas 15 years ago as a result of a corporate relocation. Two years before being transferred to Texas, Husband gave a \$2 million employer-provided supplemental term insurance policy to an ILIT for Child and Husband's Mother. Employer is self insured. Annual premium is currently \$25,000.00. In 10 years, annual premium will be \$60,000.00 and will be going up dramatically in each subsequent year. Initially, there were two withdrawal right beneficiaries, Child and Husband's Mother, but Husband's Mother recently died.

Adverse Consequence: Potential serious depletion of Husband's and Wife's gift [and estate] tax applicable exclusion.

Example No. 6—Case of the Skimpy Withdrawal Right. Nine years ago, Client, age 70, created an ILIT and arranged for the Trustee to purchase and be the beneficiary of a \$2 million 10-year convertible term policy with a level annual premium of \$8,000.00. Trust is for the benefit of Client's two adult children. Client is now uninsurable and the Trustee of the ILIT must convert the policy to permanent coverage within the next twelve months or lose the coverage. The ILIT is well drafted, meets Client's objectives and provides that three years after Client's death, the assets of the ILIT shall be distributed to Children, outright and free of trust. However, each Child's annual withdrawal right is limited to \$5,000.00 per year (sufficient to handle the \$8,000.00 per year annual premium). However, if the

Trustee converts the term policy to a \$2 million whole life policy, the annual premium will be \$40,000.00 per year.

Adverse Consequence: Annual \$40,000.00 gifts will waste applicable exclusion to the tune of \$30,000.00 per year.

1. Consequences of Poor Drafting, Implementation, and Maintenance. As indicated by the above cases, a poorly drafted, implemented, and/or maintained ILIT with Crummey demand powers can have many bad consequences including but not limited to:
  - a. Wasting of the grantor's applicable exclusion,
  - b. Wasting of the beneficiary's applicable exclusion,
  - c. Inclusion of trust assets in grantor's estate,
  - d. Inclusion of trust assets in a beneficiary's estate,
  - e. Subverting the grantor's objectives,
  - f. Etc.
2. Mitigate and/or Prevent The Damage. In each of the above cases, it may be possible to mitigate and/or eliminate the adverse tax consequences.

B. Purpose. This outline has two objectives as follows:

1. To Demonstrate How the Annual Exclusion Can be Salvaged When the Crummey Withdrawal Power is Poorly Drafted, Poorly Maintained And/Or Nonexistent.
2. To Demonstrate How the Poorly Drafted and Designed ILIT Can Be Repaired or Efficiently Abandoned.

C. Scope. We will accomplish the above purposes by:

1. Reviewing Current State of the Law with Regard to Crummey Powers.
2. Discussing Techniques to Salvage the Annual Exclusion When the Crummey Power is Defective or the Crummey Procedures Are Ignored.
3. Discussing Techniques to Rescue the Poorly Designed and Drafted ILIT.

For an excellent treatment of dealing with the "problem ILIT," see Donaho, Stephanie E., "FIXING BROKEN ILITs," State Bar of Texas 27th Annual Advanced Estate Planning and Probate Course.

## II. Crummey v. Commissioner—Past and Present.

### A. Basic Statutory Provisions.

1. General. A donor may make gifts of cash and/or other property of up to \$13,000.00 per donee each calendar year without having to pay a gift tax or even file a gift tax return. If a donor-spouse makes gifts of separate property and the non donor-spouse joins in the gifts (as authorized by I.R.C. § 2513), or if a married couple, domiciled in a community property state, makes gifts of community property, the couple can give away up to \$26,000.00 per donee per year. To qualify for the exclusion, the gifts must be gifts of a present interest. I.R.C. § 2503(b).
2. Present and Future Interest Defined.
  - a. Gift of a Present Interest. A gift of property to a beneficiary is a gift of a “present interest” if the beneficiary has the unrestricted right to the immediate use, possession, or enjoyment of the gifted property. Treas. Reg. § 25.2503-3(b).
  - b. Gift of a Future Interest. A gift of property to a beneficiary is a gift of a “future interest” if the beneficiary’s enjoyment of the property is limited to commence in use, possession or enjoyment at some future date or time. Treas. Reg. § 25.2503-3(a); Fondren v. Commissioner, 324 U.S. 18 (1945); see also Rev. Rul. 83-108, 1983-1 C.B. 14, 15 (IRS points out that if a trustee has discretion to accumulate the trust income even for a brief period, the gift of an income interest is a gift of a future interest.).
  - c. Transfer of Life Insurance Policy. An outright transfer of a life insurance policy is a gift of a present interest even if the policy has no cash value. Treas. Reg. § 25.2503-3(a); Rev. Rul. 55-408, 1955-1 C.B. 113.
3. Value of Gift of Policy. The value of a life insurance policy for gift tax purposes is generally based on the sale of comparable contracts. Treas. Reg. § 25.2512-6.
  - a. New Policy. If the grantor-insured makes a gift of the policy immediately after its purchase, the gift tax value is the gross premium for the policy. Treas. Reg. § 25.2512-6(a), Example (1).
  - b. Existing Policy. If the policy is an existing policy that is not paid-up, the gift tax value is the date-of-gift value of the sum of the policy’s interpolated terminal reserve and the unearned premium minus the date-of-gift value of the outstanding loan on the policy. *Id.*, Example (6).

- c. Single Premium Policy. If the policy is a single premium or paid-up policy, the gift tax value is the single premium charged currently for a comparable contract of equal face value on a person of the insured's age at the time of assignment. *Id.*, Example (3).
  - d. Term Policy. The value of a term policy is probably equal to the policy's unearned premium at the time of the gift. But see Rev. Rul. 76-490, 1976-2 C.B. 300 (IRS held that insured-employee's interest in group term life insurance policy has no ascertainable value.).
  - e. Policy Subject to Split Dollar Agreement. The gift tax value of a policy subject to a split dollar agreement is the interpolated terminal reserve plus the value of the unearned premium on the date of the gift, minus the date-of-gift value of the employer's interest in the policy. Rev. Rul. 81-198, 1981-2 C.B. 188.
4. Gift Tax Consequences Re: Premium Payments - General. If a donor gives a life insurance policy to a donee but continues to pay the premiums on that policy, each premium payment is a gift by the donor to the donee. Treas. Reg. § 25.2503-3(c), Example (6); Rev. Rul. 76-490, 1976-2 C.B. 300 (Insured irrevocably assigned his group term insurance to a trust. IRS held that each time the employer made a premium payment on the group term coverage, the employer premium payment resulted in an indirect gift to the trust by the employee.).
  5. Group Term Insurance - Employer Premium Payments. With respect to the assignment of group term coverage, the value of the gift can be computed with reference to the premiums under Table I of Treas. Reg. § 1.79-3(d)(2) so long as the company's plan of group term insurance meets the non-discrimination requirements of I.R.C. § 79(d) or so long as the employee-assignor is not a key employee within the meaning of I.R.C. § 79(d)(6). Rev. Rul. 84-147, 1984-2 C.B. 201.
  6. Split Dollar Arrangements. With respect to insurance subject to a split dollar arrangement, Rev. Rul. 78-420, 1978-2 C.B. 67 holds that employer premium payments on a policy on the employee's life owned by the non-employee wife and subject to a split dollar insurance arrangement would result in a gift equal to the P.S. 58 cost (or the company's one-year term rates, if lower) less the wife's contribution toward premiums. If the policy is a "second-to-die" policy and both insureds are alive, the "very economical" P.S. 38 rates can be used in place of the P.S. 58 rates. See also TAM 9604001.
- B. The Crummey Case and Subsequent Pronouncements.
1. General Rule. Gifts to discretionary trusts will, without more, be gifts of a

future interest unless the trust meets the requirements of I.R.C. § 2503(c), or unless the trust grants the beneficiaries Crummey withdrawal rights.

- a. The Crummey Case -- Crummey v. Commissioner 397 F.2d 82 (9th Cir.1968). FACTS: Taxpayer-donors established irrevocable trusts for the benefit of each of their four children. Each time a gift was made to a trust, the beneficiary was given the right to demand at any time, up to December 31st of the year in which the gift was made, the lesser of \$4,000.00 or the amount of the gift. If the beneficiary was a minor at the time of the gift, his guardian could demand the money on his behalf. If no demand was made by the beneficiary or his guardian, the gift irrevocably became a part of trust corpus.

HELD: Although conceding that demands by the minors were not likely to be made, the Ninth Circuit held that the gifts, coupled with the demand rights, constituted gifts of a present interest. In Crummey, no guardians had officially been appointed for the years when the gifts under scrutiny were made and, in fact, there could be no demand made by the minors. The court also noted that it was unlikely that the minor beneficiaries knew (or would ever know) about the gifts.

- b. Significance of Holding. Because of Crummey, it is possible to structure an irrevocable trust for a beneficiary that qualifies for the annual gift tax exclusion even if the trustee has absolute discretion over distributions.
- c. Comments--9th Circuit Did Not require Notice. Immediately following the 9<sup>th</sup> Circuit's decision in Crummey, there were only two requirements for the gift to a discretionary trust to qualify for the annual gift tax exclusion. Those requirements were, and may still be, as follows:
  - i. There must be a gift; and
  - ii. The instrument must give the beneficiary the right to withdraw the gift.

2. The Doctrine Since Crummey. Through a series of public and private rulings, the IRS has limited the scope of the Crummey decision. However, as noted below, the Courts have resisted many of those changes. Consider the following:

- a. General Rule -- Minor Beneficiaries. If a gift is made to a discretionary trust for a beneficiary who is a minor and that minor beneficiary is given the right under the trust instrument to demand

distribution of that gift to himself, the gift shall be a gift of a present interest as long as the trust instrument or local law does not prevent the appointment of a guardian who could exercise the withdrawal right in the minor's behalf. Rev. Rul. 73-405, 1973-2 C.B. 321; Mary Hull Naumoff, 46 T.C.M. 852 (CCH 1983).

- b. Adult Beneficiaries Must Have Notice of Withdrawal Right. The IRS has held that after a gift is made to a Crummey-type trust, each adult beneficiary must have (a) actual notice of his withdrawal right and (b) an adequate or reasonable opportunity to exercise the withdrawal right prior to its lapse. Otherwise, no annual gift tax exclusion will be available with respect to gifts in trust for the benefit of that adult beneficiary. Rev. Rul. 81-7, 1981-1 C.B. 474; see also Ltr. Ruls. 8019038; 8121069; 8813019; 9232013; 9532001 and 9625031.
- c. Notice Need Not Be In Year of Gift. However, in Rev. Rul. 83-108, 1983-1 C.B. 14, the IRS held that a gift made at the end of 1981 to a Crummey trust which granted the beneficiary a withdrawal right that did not lapse until the following year constituted a gift of a present interest in 1981. This is because the beneficiary had a reasonable opportunity to exercise the withdrawal right. Note, in this ruling, the beneficiary did not receive notice of the gift and withdrawal right until the beginning of 1982.
- d. Actual Notice to Minor Beneficiaries Not Necessary A parent-donor can receive notice of a gift and exercise (or decide not to exercise) a withdrawal right in the minor child-beneficiary's behalf. In Ltr. Rul. 8008040 (11/28/79), the IRS held that such an arrangement did result in a gift of a present interest. See also Estate of Carolyn W. Holland, 73 T.C.M. (CCH) 3236 (1997); Ltr. Rul. 8022048 (3/4/80); and Ltr. Rul. 7944019 (7/31/79).
- e. Enough Time to Appoint Guardian for Minor. A minor or incompetent beneficiary should have enough time after the gift to have a guardian appointed to make the election. See Ltr. Rul. 8813019; 8134135; and 8103074.
- f. The Naked Withdrawal Right. In Ltr. Rul. 8727003 (3/16/87), the Service held that a beneficiary must have more than a mere withdrawal right over the trust before the annual exclusion would be allowed as to gifts to that trust. The Service concluded that a "gift coupled with a withdrawal right" would qualify for the annual exclusion only if the withdrawal right was actually exercised or if the beneficiary had a continuing [i.e., more than a nominal] interest in the trust. See also TAM 9045002 (IRS held that beneficiaries whose only interests in the trust were mere withdrawal rights or contingent remainder interests did not receive gifts of a present

interest because in the IRS' view, adding beneficiaries with such limited rights was nothing more than an attempt to avoid the Federal gift tax through a proliferation of annual exclusions.)

- g. Cristofani to the Rescue. However, in Cristofani v. C.I.R., 97 T.C. 74 (1991), acq. in result only, the Tax Court approved of Crummey-type powers even though (a) the withdrawal period was only 15 days, (b) none of the donees had any interest in the trust until after the insured's death and (c) some of the grandchildren/donees were merely contingent remaindermen. See also Ltr. Rul. 9030005.
  
- h. Continued Attack on "Naked Withdrawal Rights" Despite Cristofani. Despite the taxpayer victory in Cristofani, the Internal Revenue Service continued to attack what it viewed as abusive arrangements designed to improperly expand the availability of annual gift tax exclusions. In TAM 9141008 (June 14, 1991), the IRS addressed a situation which it felt epitomized "abusive Crummey trusts." The decedent, prior to her death, established three irrevocable trusts, one for the benefit of each of her three children. Each trust lasted for a child's lifetime and provided that all income was to be distributed to that child on a quarterly basis. Upon the death of the child, that child was given a limited testamentary power of appointment to appoint the trust to his or her spouse. Any unappointed property was to be held in further trust for the child's then living issue. Each trust further provided that when the donor made gifts to the trust, each of that child, his or her children and grandchildren and spouse had a Crummey type withdrawal right as to a pro rata portion of the gift.

At the time that the trust was established, the decedent had three children and 32 grandchildren and great-grandchildren. From 1984 through 1987, the decedent made gifts of partnership interests having a value of \$350,000.00 per year (\$10,000.00 multiplied by 35 beneficiaries). Gift tax returns were filed each year claiming 35 annual exclusions.

The IRS held that only the gifts to the children would qualify for the exclusion and in effect held that unless a beneficiary has more than a contingent interest in the trust, his or her failure to exercise the withdrawal right is, in fact, evidence of a pre-arrangement not to do so despite the fact that the beneficiary has a legal right to do so. With this ruling, the IRS begins its onslaught on Crummey withdrawal rights under the "prearranged plan" theory.

- i. AOD 1992-09, AOD 1996-010, and TAM 9628004.

The IRS continued to "promote" the "prearranged plan" theory through three subsequent announcements.

In AOD 1992-09, 1992-2 C.B. #1, 1992 TNT 74-31, the IRS announced it would litigate cases “whose facts indicate a greater abuse of the Crummey power than those of Cristofani, preferably outside the Ninth Circuit.”

In AOD 1996-010, 1996-2 C.B.1, 96 TNT 137-21, the IRS rejected the Cristofani opinion to the extent it extended invasion powers to persons other than holders of income interests or “vested” remainder interests. The IRS said that absent the power holders having “continuing economic interests” in the trust, the Crummey doctrine did not apply. The Service went further by stating the IRS would deny annual exclusions if it concludes that in substance there was a prearranged understanding that the withdrawal right would not be exercised or that doing so would result in adverse consequences to its holder.

In TAM 9628004, the IRS denied annual exclusions for interests in irrevocable trusts under the theory that the donor did not intend to make bona fide gifts. These trusts granted three children, their spouses and seven grandchildren Crummey type withdrawal rights but under the instrument, there was no requirement that the trustee provide notice of gifts to the beneficiaries. Nonetheless, in most years, notice of the gifts and corresponding withdrawal rights were made in late December and the withdrawal rights lapsed at the end of December. The IRS completely denied annual exclusions for all transfers to the trusts. The Service’s position was that many beneficiaries had no genuine interest in the trust other than invasion rights. The Service opined that there was no logical reason for them not to exercise their invasion rights and therefore the IRS argued that there must have been a prearranged understanding among all the beneficiaries that these rights were “naked withdrawal rights” because by exercising them, bad consequences would flow to the holders of the power.

- j. Estate of Lieselotte Kohlsaas--Tax Court to the Rescue. In Estate of Lieselotte Kohlsaas, 73 T.C.M. (CCH) 2732 (1997), the IRS finally had an opportunity to argue its “prearranged plan” doctrine in a case which it believed represented the “quintessential abusive Crummey trust” situation. In Kohlsaas, the taxpayer, before her death, transferred a building worth \$155,000.00 to two trusts. Each trust was for the primary benefit of one of her two children, who were also co-trustees of the trusts. Under each trust, each child was entitled to receive all income and could receive discretionary distributions of principal (however, a child who is also a trustee could not distribute to himself or herself). Each child was also given a special power of appointment (exercisable during life and at death) to appoint property among his or her issue. Unappointed property would pass to the child’s issue, per stirpes.

Under the trust, each of the two children plus sixteen adult and minor grandchildren (who were contingent remaindermen) were given Crummey type withdrawal rights. None of the beneficiaries exercised their withdrawal rights. Eighteen annual exclusions were claimed. These gifts were disclosed on the decedent's Federal estate tax return.

The IRS denied the annual exclusions with regard to the gifts to the grandchildren holding that the withdrawal rights were illusory because of a prearranged plan. The IRS argued that a prearranged plan should be found if any one of the following facts existed: (1) the beneficiaries failed to exercise the withdrawal right; (2) the beneficiaries are led to believe they would be penalized if they exercised their withdrawal right; (3) the trustees failed to thoroughly explain all aspects of the withdrawal rights to the beneficiaries in a manner sufficient to allow them to make an intelligent and informed decision; **or** (4) the beneficiaries are led to believe their exercise of withdrawal rights would create family disharmony and/or disrupt the donor's estate plan.

The Tax Court rejected the Service's prearranged plan argument and refused to deny any of the annual exclusions. In so doing, the Court held: (1) there was insufficient evidence to establish that an understanding existed between the donor and contingent beneficiaries that the latter would not exercise the withdrawal rights; (2) failure to exercise the withdrawal rights, without more, would not give rise to the implication of a prearrangement; and (3) the contingent beneficiaries had actual notice from the trustees regarding their withdrawal rights. 73 T.C.M. at 2734.

Although the Tax Court did not preclude the possibility of denial of the exclusions under the "prearranged plan doctrine," it appears clear the primary focus was whether the taxpayer, pursuant to the terms of the trust, conferred unrestricted rights of withdrawal on a beneficiary (regardless of his contingent or vested status) and whether the beneficiary had notice of those rights with respect to each gift.

- k. Estate of Carolyn W. Holland--Another Taxpayer Victory. Estate of Carolyn W. Holland, 73 T.C.M. (CCH) 3236 (1997), is a Tax Court case dealing with a multiplicity of issues. However, the decision of the Court arguably imposes important limits on the scope of the "prearranged plan" argument.

In the facts relevant to this discussion, donor established eight trusts, one for each of her eight great-grandchildren. Except for the name of the beneficiary, each trust was identical and gave each beneficiary

a sixty day “Crummey” withdrawal right with respect to each gift to the trust. The co-trustees of each trust were two of the donor’s grandchildren, Jack and Lewis. Several of the trusts were for Jack’s minor children and another trust was for one of Lewis’ minor child.

The IRS denied the annual gift tax exclusions with respect to gifts to these trusts because (1) written notice of the gift was not provided to the beneficiaries (or their natural guardians) as required under the trust instrument and (2) the IRS concluded a prearranged plan existed not to exercise the withdrawal rights.

The Tax Court rejected the IRS arguments and held that the gifts were gifts of a present interest. With respect to the issue of failure to give notice to minor beneficiaries, the Court held that such written notice was not required since the parent of the minor beneficiary was the trustee and did not need to give notice to himself. 73 T.C.M. at 3237-10. With respect to the failure to give written notice to the adult beneficiaries, the Court stated that such written notice was not required when there was evidence of actual notice. 73 T.C.M. at 3237-10. In dealing with the prearranged agreement issue, the Court held that the most important factor in determining whether a gift to a “Crummey-type” trust was a gift of a present interest is whether or not the beneficiary possessed a legal right to make a demand for payment; not whether it is likely that the minor beneficiary is to receive any enjoyment of that property. In this connection, the Court stated “The sufficiency of the notice given the beneficiaries is a factor in the likelihood that the right of withdrawal will be exercised; it is not a factor in the legal right to demand payment from the trustee.” 73 T.C.M. at 3237-10. The Court also found no evidence to support a prearrangement. 73 T.C.M. at 3237-10.

1. Estate of Turner v. Commissioner. Facts: On January 7, 1992, Clyde W. Turner, Sr. (“Clyde”) created an irrevocable life insurance trust with Son and Daughter as Co-Trustees. There were 12 beneficiaries of the trust (children and grandchildren). Clyde, Sr. arranged for the trust to purchase three life insurance policies on Clyde’s life. Clyde, Sr. never transferred money to the trust to pay the premiums. Instead, he remitted the premium directly to the insurance companies. *Further, the trustees never notified any of the beneficiaries of the indirect gifts via direct premium payments.* The trust contained all of the provisions normally found in a well drafted ILIT. The trust provided that after each direct or indirect gift to the ILIT, each beneficiary was given a right to withdraw the amount of the gift equal to the then available annual exclusion amount (after considering other annual exclusion gifts previously made during that calendar year). If a beneficiary wished to exercise his or her withdrawal right, he could do so by giving 30 days prior notice to the trustees of the beneficiary’s intention to exercise the right. Upon receipt of the notice, the trustees were required to distribute trust

assets in an amount sufficient to satisfy the withdrawal right. The trust further provided that in satisfying the withdrawal right, the trustees could distribute cash, or any other trust property, including cash obtained from policy loans. The IRS held that the beneficiaries' withdrawal rights were illusory because Clyde, Sr. did not deposit cash with the trustees but instead paid the premiums directly. The Tax Court rejected the IRS argument and found the gifts, via direct premium payments, to be gifts of a present interest. The Court held, *“the test is not whether the beneficiary was likely to receive the present enjoyment of the property, but whether he or she had a legal right to demand it.”*

- III. Salvaging the Annual Exclusion. Now that the history of Crummey and its aftermath has been briefly examined, it is now time to turn our attention to how poorly drafted and/or maintained Crummey powers can be addressed.
- A. Notice Formalities Ignored and/or Neglected. Client's potential gift tax problem described in Case No. 1 (i.e., "Neglected Crummey Formalities") should be familiar to the experienced estate planning practitioner. On several occasions, this author has thoroughly explained Crummey notice procedures to clients only to later discover those formalities were ignored. Does this mean that upon discovery of the neglect, gift tax returns should be filed reporting the transfers as gifts of a future interest? The answer to that question is "No," at least until the following annual exclusion salvaging techniques are first examined:
1. Was Written Notice Actually Given? First, determine if some type of written notice of the gifts and corresponding withdrawal right was actually given. This could include copies of the annual notice letters or any written correspondence that puts the donee or his natural or legal guardian on notice when the gifts will be made and the nature of the withdrawal right with respect to present and future gifts.
  2. Was Oral Notice Given? If no proof of written notice can be obtained, determine if the donee and/or the donee's natural or legal guardian had actual notice of the gift. Under both Kohlsaat and Holland, actual notice of the gift was held to be sufficient. See Kohlsaat, 73 T.C.M. at 2734 and Holland, 73 T.C.M. at 3237-10. In order to further document the oral notice, consider having the donee sign a written statement confirming the date of each gift, the withdrawal right associated with each gift, and the donee's action with respect to that withdrawal right.
  3. If Written or Oral Notice Was Not Given, Did the Donee (or the Donee's Natural or Legal Guardian) Know Enough About the Gift to Have it Qualify as a Gift of a Present Interest? Likewise, if neither written nor oral notice was actually given in connection with a particular gift, the practitioner must determine if the facts and circumstances exist that would put the donee(s) on

notice of the circumstances surrounding the gift and the attendant withdrawal rights. For example, did the creator of the trust discuss the ILIT with his children such that each child has sufficient information regarding the substance and timing of the gifts? Again, Kolhsaat and Holland support the position that actual notice is sufficient and in this context, actual notice could have occurred at the inception of the ILIT. See, e.g., Ltr. Ruls. 8006109; 8111123; 8134135; 8138170; 8138171; and 8143045.

4. No Notice Required. As a last resort, the practitioner could take the position that if under the trust, the donee is given the right to make the withdrawal, then the donee's possession of such a legal right is sufficient to confer present interest status on each gift even if the donee is unaware of the withdrawal right. This position can be taken for two reasons:
  - a. Crummey Did Not Require Notice. Under Crummey, the mere possession of the demand right rather than knowledge of its existence is all that is necessary to confer present interest status on the gift. In fact, in holding the gifts to the minor grandchildren were gifts of a present interest, the Ninth Circuit acknowledged that it was unlikely the grandchildren would ever know of the gift. Similarly, in Holland, the Tax Court distinguished between possession of the withdrawal right and actual knowledge of the right. The Court arguably held that possession of the withdrawal right was all that was necessary to confer present interest status on the gift and that the knowledge of the gift merely dealt with the likelihood of the gift ever being exercised. This holding was further supported by Turner where the Tax Court held that possession of a legal right to make the withdrawal was sufficient to confer present interest status.
  - b. Analogy to IRC § 2041. Further support that mere possession of the withdrawal power (rather than actual knowledge of its existence) will confer present interest status on the gift can be found in those cases holding that the mere possession of a general power of appointment is sufficient to cause property subject to the power to be included in the power holder's gross estate even if the power holder was never competent to exercise the power.
    - i. IRC § 2041(a) provides that the value of a decedent's gross estate includes the value of all property with respect to which the decedent possesses a general power of appointment created after October 21, 1942. IRS Section 2041(a)(2). IRC Section 2041(b)(1) provides that 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.
    - ii. Courts have consistently held that the mere possession of the power of appointment is sufficient to cause inclusion in the

power holder's estate, even if the deceased power holder was incapacitated at the time the power was conferred and remained incapacitated until the power holder's death. See, e.g., Rosenblatt v. Commissioner, 633 F.2d 176 (10th Cir. 1980) (Grandfather established a trust for Granddaughter under which Granddaughter possessed a general power of appointment. Granddaughter died at age sixteen (16) before she was able to make an effective will. Further, under the laws of Granddaughter's domicile at the time of her death, a guardian had no power to make a will in Granddaughter's behalf. The Tenth Circuit held that the mere possession of the power is sufficient to cause inclusion in Granddaughter's estate for Federal estate tax purposes.); see also Fish v. United States, 432 F.2d 1278 (9th Cir. 1970) (Ninth Circuit adopted the position that the opportunity to control the disposition of property by a power of appointment should be determined solely by the existence of the power and its terms, and not by the decedent donee's legal capacity to exercise the power.); and Boeving v. United States, 650 F.2d 493 (8th Cir. 1981) (Wife held to have general power over trust created by deceased Husband even though Wife never had capacity to exercise the power.).

- iii. By analogy, it would not strain logic to conclude that if mere possession of a power to consume property in favor of a power holder who always lacked legal capacity is sufficient to cause inclusion in the power holder's estate, the mere possession of a withdrawal right should be sufficient to confer present interest status on the gifts subject to the withdrawal right.

B. Trust Has Defective and/or Inadequate Crummey Power or Has No Crummey Power at All. What if the experienced practitioner discovers his client has created an ILIT that has a defective Crummey power? Or what if the attorney determines that because of changing tax laws (namely the increased annual exclusion and the adoption of various cutting edge planning techniques designed to expand withdrawal rights) that an existing trust drafted by that attorney many years ago now provides for an inadequate withdrawal right? This is the scenario at Example No. 6 above ("Case of the Skimpy Withdrawal Right"). Or what if the client has created a perfectly useful irrevocable trust that has no withdrawal right whatsoever? What can be done to improve upon the existing Crummey power or even add a power where none exists? Here are some approaches to consider:

1. Modify the Trust to Expand the Withdrawal Right. The trust could be judicially modified via a "friendly" modification suit to expand the Crummey withdrawal right to accommodate the larger gifts. All states recognize the common law authority of a court to modify an otherwise irrevocable or unamendable trust under the authority of the so-called

Doctrine of Deviation. See RESTATEMENT (SECOND) OF TRUSTS SECTION 167 (1957). Some states have codified an interested party's right to modify an otherwise irrevocable and unamendable trust. For example, Section 112.054 of the Texas Trust Code provides that a Court, upon petition by a trustee or a beneficiary of an otherwise irrevocable or unamendable trust, can modify the trust, in whole or in part, if (1) the purposes of the trust have become impossible to fulfill or (2) because of circumstances not known to or anticipated by the settlor, compliance with the trust terms would defeat or substantially impair the accomplishment of the purposes of the trust. Given the unanticipated tax law changes and the unforeseeable need for additional life insurance, it would appear that such a modification should be easily obtained. However, the practitioner needs to be aware of two issues as follows:

- a. Cost. Even though the "lawsuit" is in large part uncontested, there will be a monetary cost associated with the modification which will include costs associated with bringing and prosecuting the lawsuit and the cost for a guardian ad litem to represent the interests of minor, unknown, and unascertained beneficiaries. If a minor beneficiary is not represented and, upon obtaining majority, seeks to nullify the reformation for whatever reasons, he would likely be able to do so.
- b. Beware of Loss in GST Grandfathering. In structuring the modification, care should also be taken to insure that a grandfathered GST trust or a GST trust with a zero inclusion ratio does not lose its exempt status. In relevant part Treas. Reg. §26.2601-1(b)(4)(D)(1) provides that a judicial modification of an otherwise exempt GST trust will not cause the trust to lose its exempt status if the judicial modification does not shift beneficial enjoyment of the trust assets to any beneficiary who occupies a lower generation than the person or persons who held beneficial interests before the modification. Further, a shift in beneficial interest to a lower generation will be deemed to have occurred if the modification can result in . . . an increase in the amount of a GST transfer . . . Treas. Reg. §26.2601-1(b)(4)(D)(2).

Question. Since the reformation will allow for more property to be transferred to the ILIT gift tax free, will this necessarily be considered an increase in the amount of a GST transfer to younger generation beneficiaries? Obtaining a favorable letter ruling may be the most prudent course of action.

2. "Letter Trust" to The Rescue. Another technique involves the following two-step procedure: Client in Example No. 6 would make a gift to the trust in an amount equal to the maximum withdrawal rights available under the instrument. In Example 6 above, this gift, assuming no other gifts during the

calendar year, would equal \$10,000.00 since each of the two (2) beneficiaries is given an annual withdrawal right equal to \$5,000.00. Sometime after these gifts are made, Client delivers a cashier's check to the Trustee in the amount of \$30,000.00 along with a letter instructing the Trustee to notify each of the children that a gift has been made to them via the letter and that each child has 30 days to withdraw this additional gift and upon failure to do so, the amount that is not withdrawn would be transferred to the trust. See Ltr. Rul. 8445004 where this technique was used to increase a withdrawal right from \$3,000.00 to \$10,000.00. The advantages and disadvantages of this technique are as follows:

- a. Advantages. The two main advantages of this technique are its simplicity and attendant low cost. The expansion of the withdrawal rights can be handled with a single letter.
  - b. Disadvantages. There are, however, several disadvantages associated with this technique:
    - i. Under the scenario described, to the extent each child allows his or her withdrawal right over the "letter gift" to lapse, he or she will be deemed to have made a gift to the ILIT. This could be mitigated by structuring the letter gift as a hanging power of withdrawal.
    - ii. The practitioner must also be aware of the generation-skipping transfer tax consequences of these gifts and, accordingly, will likely be required to allocate GST exemption to these gifts or determine whether or not the automatic GST allocation rules apply.
  - c. Why a Cashier's Check? The above two-step procedure recommends that a cashier's check be delivered to the Trustee rather than a regular check drawn on a bank account. This is because the delivery of a standard check to a donee will not be considered a completed gift until the donee deposits the check. Metzger v. U.S., 38 F.3rd 1181 (4th Cir. 1994). Furthermore, if the donor is terminally ill, the gift would not be considered complete if the donor dies before the check clears the donor's bank. See, e.g., Estate of Dillingham v. Commissioner, 88 T.C. 15669 (1987). Accordingly, delivery of a cashier's check to the Trustee of the "letter trust" should avoid the scope of both of the above-described cases.
3. "Purchase Policy From Old Trust and Contribute It To New Trust. Another alternative would be for Client in Example No. 6 to create a new ILIT with "state of the art" Crummey withdrawal right provisions. Thereafter, Client would purchase the insurance policy from the existing ILIT and contribute it to the new ILIT.

- a. Advantages. This approach has the following advantages:
- i. The new ILIT can reflect Client's new objectives.
  - ii. This approach would be less expensive than a judicial modification and should achieve the same result.
  - iii. This approach is easy to understand ("Client buys existing policy from old trust and gives that policy to new trust.").
  - iv. Because the policy is being purchased by the insured, the proceeds when paid will still be exempt from Federal income tax because a purchase of a policy by the insured avoids the "transfer-for-value" trap. IRC § 101(a)(2)(B).
- b. Disadvantages. This approach has the following disadvantages:
- i. Under this approach, a new "three year inclusion" period would begin to run. Thus, if Client/insured dies within three years after having contributed the policy to the new ILIT, the insurance proceeds would be included in Client/insured's estate under IRC §2035 (a). One technique to mitigate exposure would be to have the new ILIT also purchase additional term insurance in an amount equal to the projected estate tax liability if the old policy is included in Client/insured's estate.
  - ii. This approach can be quite expensive, especially if the existing policy in the old ILIT has considerable cash value. In effect, Client/insured would be purchasing the policy twice, once through the initial gifts to the trust for the ongoing premium payments and again when Client/insured purchases the policy from the old ILIT for contribution to the new ILIT. This double cost could be mitigated somewhat if Client/insured borrows money from the policy after the purchase in order to recoup all or part of the purchase price.
  - iii. If Client/insured is currently uninsurable, the fair market value of the existing policy could both be prohibitive and be much greater than the unearned premium plus interpolated terminal reserve.
- c. Is Termination and/or Distribution of the Policy an Option? If the old ILIT is a Spousal ILIT and if Client/insured's spouse is a current beneficiary, it may be possible (depending upon the provisions of the trust instrument) to distribute the policy to Client's spouse or to terminate the trust (through a judicial termination) in favor of

Client's spouse who, in turn, could contribute the policy on Client/insured's life to a new "state of the art" ILIT. By doing so, the "three year inclusion" rule should not be applicable. IRC § 2035(a). This is because the "three year inclusion" rule would only apply with respect to the transfer by Client's spouse if the insurance policy would have been includable in spouse's estate under IRC § 2042. Since spouse is not the insured, that provision would not appear to be applicable. In using the alternative, however, the practitioner must realize that spouse cannot be a beneficiary of the new ILIT.

4. New Trust Becomes Partner with Insured and Purchases Policy from Old Trust. If Client/insured is currently a partner in a family limited partnership or other partnership, an effective technique which should avoid the pitfalls and the approach described immediately above would be as follows: Client/insured would create a new ILIT with "state of the art" withdrawal right provisions and other provisions that meet Client's current objectives. Client/insured would then transfer part of his or her partnership interest to the new ILIT in a manner that results in the Trustee of the new ILIT becoming a partner with Client/insured. After the Trustee of the new ILIT becomes a partner in the partnership, the new ILIT would then purchase the policy on Client/insured's life from the old ILIT for fair market value.
  - a. Advantages. This approach has the following distinct advantages:
    - i. The "three year inclusion" rule is not reactivated.
    - ii. Because the trust is a "partner of the insured," purchase by the new ILIT should not trigger the transfer for value rules.
    - iii. This is relatively easy to explain and not particularly costly.
    - iv. The new ILIT could purchase policies from old ILIT on an installment sale or balloon note basis after a fair down payment via gifts from client/insured.
  - b. Disadvantages. However, this approach has the following disadvantages:
    - i. This approach can be expensive if the existing policies in the old ILIT have considerable cash value.
    - ii. If Client/insured is currently uninsurable, fair market value of the existing policy could be both prohibitive and much greater than the unearned premium plus the interpolated terminal reserve.
  - c. Avoid Using Partnership That Only Owns Life Insurance. It is

strongly recommended that the partnership used in connection with the purchase transaction be a partnership that was created for bona fide business or investment purposes and not merely as a vehicle to meet this partnership exception.

5. Purchase by Grantor Trust From Another Grantor Trust. If Client/insured is deemed to be the grantor of the old ILIT, the Grantor/insured could create a new ILIT with “state of the art” withdrawal right and other provisions and could further draft the new ILIT so that Client/insured is also considered to be the grantor of that trust. The new ILIT could then purchase the policy from the old ILIT and avoid the transfer-for-value rules. See, e.g., Rev Rul. 85-13, 1985-1 C.B. 184 and Ltr. Rul. 200228019.

IV. Salvaging the Flawed or Tainted ILIT (Even if The Crummey Power is Fine). Consider the following example:

Example No. 7—Case of the Spousal ILIT Gone Astray. Husband (age 56 and in excellent health) and Wife are domiciled in a community property state. Husband establishes an ILIT and arranges for the ILIT to purchase a \$5 million, 15 year level term policy on Husband’s life having an annual premium of \$12,000.00. The ILIT provides that after Husband’s death, the Trustee of the trust shall distribute all trust income to Wife and as much principal as Wife needs for her health, support and maintenance. At Wife’s death, the assets of the ILIT are to be distributed to Husband’s two adult children, outright. The Trustee of the ILIT is Husband’s brother. Wife does not have a special power of appointment over the ILIT.

Six years after the ILIT was established, you determine all of the “Crummey” formalities have been followed but you also discover that all of Husband’s gifts to the trust were made with community property (i.e., Wife is deemed to have made one-half (½) of all gifts). You explain to Husband and Wife that if they continue to make gifts of community property to the trust, then one half (½) of the trust will be included in Wife’s estate at her subsequent death. You explain that you will outline several alternatives to mitigate and perhaps even eliminate the problem.

Husband and Wife also ask you to come up with a way to prevent the assets of the trust from being distributed to their son, Jason, who is a member of a cult and has vowed to divest himself of all his earthly possessions. In fact, they want you to figure out a way for the assets of the trust to remain in trust until both of their children have died.

A. What Fix-It Options Are Available?

1. New Policy, New Trust. If Husband is insurable at standard rates, an obvious solution would be for Husband to establish a new trust to which he would transfer his separate property. The trust would then acquire a new policy that meets his and Wife’s objectives. As soon as the new \$5 million

policy is acquired by the trust, the insurance in the existing ILIT can be allowed to lapse. This solution, however, is not viable if Husband is uninsurable or only insurable at high sub-standard rates.

2. Same Trust But All Future Gifts Made With Husband's Separate Property. Husband could mitigate the estate tax inclusion problem by making all future gifts to the trust with his sole and separate property. Thus, if Husband dies after having made twenty premium payments, half of which were made with Husband's separate property, then only one-half of the ILIT is tainted and at Wife's subsequent death, only one-fourth of the ILIT would be deemed to be included in Wife's estate for Federal estate tax purposes. However, this alternative does not deal with Jason, the problematic son.
3. Husband Reacquires the Policy and Contributes It to a New Trust. Husband could reacquire the policy from the trust with his sole and separate property and contribute it to a new ILIT which meets his objectives. As indicated earlier, the primary disadvantage of this technique would be that a new "three year inclusion" period would begin such that if Husband died within three years after having made the transfer to a new ILIT, the insurance proceeds would be included in Husband's estate for Federal estate tax purposes. However, the new trust could be drafted to minimize the damage resulting from inclusion by including a contingent marital deduction trust in the ILIT which would receive the insurance proceeds if Husband died within three years of the transfer. In addition, the Trustee of the new ILIT could purchase term insurance, with Husband's separate property, in an amount equal to the projected tax liability if the insurance proceeds on the original policy would be included in Husband's estate for Federal estate purposes.
4. New Trust Becomes Partner with Insured and Purchases Policy. If Husband is a partner in a limited partnership, Husband could create a new ILIT containing terms consistent with Husband's objectives. He would then contribute a separate property partnership interest and separate property cash to the new ILIT. The Trustee of the new ILIT would then purchase the existing policy from the old ILIT. This purchase could be for a promissory note bearing the appropriate applicable federal rate or for cash.

- B. But What if Husband is Uninsurable? If Husband is uninsurable when any of the above solutions are considered, it is likely that any solution involving an acquisition of the policy would be impracticable because of the fair market value of the policy. Accordingly, under those circumstances, the "stop the bleeding" alternative at A2 above would appear to be most appropriate.

V. Conclusions. Practitioners who regularly use ILITs as an important tool in the estate planning process should continue to educate their clients on the need to properly implement and maintain such trusts. However, it is likely most clients will, from time to time, overlook the appropriate procedures that must be followed to properly maintain the ILIT. When that happens, it is incumbent upon the practitioner to consider, explain and implement solutions that would prevent neglected demand rights from becoming a disaster.

Similarly, from time to time, the practitioner may discover a trust that no longer meets the client's objectives or is improperly drafted or both. It is incumbent upon the practitioner to determine if remedies can be applied that will repair or change the trust to meet the client's objectives.

Hopefully, the above ideas will be of use to the practitioner.