PART I

THE TRANSFER TAX CONSEQUENCES OF THE USE OF LIFE INSURANCE IN IRREVOCABLE INSURANCE TRUSTS

FLORIDA FELLOWS INSTITUTE
OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL
FORT LAUDERDALE, FLORIDA
OCTOBER 23, 2015
10:30 AM – 12:00 PM

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I. THE TRANSFER TAX CONSEQUENCES OF THE USE OF IRREVOCABLE LIFE INSURANCE TRUSTS.

A. Gift Tax.

1. In general.

a) Gifts of policies to the trust.

(1) As noted below, these gifts will always be subject to the Section 2035(a) three year rule.

b) Gifts of cash to the trust to allow the trustee to acquire the policy and to pay policy premiums.

(1) As discussed below, this is the transaction which is most likely going to be planned for, to attempt to avoid the three year rule.

c) Indirect gifts to the trust.

(1) Generated by employer-provided insurance, such as group term policies, non-contributory split-dollar arrangements, or interest-free loans.

(a) Measured by the income tax effect of the transaction on the insured.

2. Gift tax valuation of policies.

a) The usual gift tax valuation of a policy is set out in Reg. Sec 25. 2512-6(a), which requires use of the cost of a "comparable" policy, since there traditionally was no market for life insurance policies.

(1) For a single premium policy, that is its replacement cost.

(2) For a new policy, that would be the premium paid.

(3) For a more usual policy on which further premiums are due and which has been in force for some time (an undefined term), since replacement cost would be hard to determine, the regulations provide that it <u>may</u> be <u>approximated</u> by the interpolated terminal reserve ("ITR") plus any prepaid premiums.

(a) The type of policy and the insured's health are not relevant considerations in the ITR determination.

(b) Note that the ITR concept only applies directly to traditional whole life policies, but is used for universal and variable life policies as well.

(c) Note also the potential effect of a "shadow account" used in a no-lapse guarantee universal life policy to increase the policy's ITR (even when cash values are low or even non-existent).

(d) Finally, note that use of the ITR formula does not appear to be mandatory.

(4) See, eg, Rev. Ruls 81-198, 1981-2 C.B. 188 and 79-429, 1979-2 C.B. 321.

(5) See also Reg. Sec. 20.2031-8 (a) (2), the estate tax analog of Reg. Sec. 25.2512-6(a), for a policy on the life of another owned by the decedent.

(6) As noted above, Reg. Sec. 25.2512-6(a) also provides that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula doesn't reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead).

(a) Presumably, a standard policy issued by an insurer would not be subject to this exception.

b) These valuation rules were developed before the life settlement market, provided any measure of a policy's value in the market.

(1) Is the value of a policy for gift tax purposes its value in the life settlement market or the regulation formula?

(a) Could we ignore the regulation formula and use a higher life settlement value, even if we wanted to?

(b) Such as a gift of policy to a charity?

(2) Does it matter if a settlement offer has been received?

(3) What if the policy would qualify for a settlement, but no offers were solicited?

c) Note the instructions to Form 712

(1) They indicate that for single premium or paid-up policies, the amount shown on the Form may not be relied on where the surrender value of the policy exceeds its replacement cost, implying that for all other policies, the 712 value may be relied on for gift purposes.

(2) The practice of carriers in reporting values on Form 712 is apparently not consistent, with some only reporting the ITR and some others reporting the policy cash value or its statutory reserves.

(3) Should practitioners request all possible values for a policy before deciding what value to use for reporting the transaction?

(4) Some carriers have apparently begun providing a series of values, leaving the determination up to the adviser.

(5) The gift value (or values) reported on recent Forms 712 are substantially higher than cash values, perhaps indicating a new conservatism by carriers.

(a) These values should be known <u>before</u> the policy transfer.

d) Is the value of a policy sold for “full and adequate consideration” to avoid Section 2035 its gift tax value or the amount necessary to replace it in the insured’s estate for estate tax purposes - an amount equal to the policy proceeds?

(1) See <u>Pritchard v. CIR</u>, 4 T.C.204 (1944), holding that “normal” policy gift tax values don’t apply in a sale scenario to avoid Section 2035, if the insured is “near death” (an undefined term) -- at that point, fair market value approaches the full face value.

(a) See also PLR 9413045, holding the policy’s gift value controls for a gift of a survivorship policy, if the insureds weren’t “near death”.

(2) Compare TAM 8806004 (dealing with a single life policy owned by the insured), holding that full value was its face amount, with PLR 9413045 (dealing with a survivorship policy owned by one of the insureds), holding it was its gift value. See also, PLR 19905010, assuming that a sale of a

single life policy for the greater of its gift tax value or its cash value would be for full and adequate consideration.

(a) For a survivorship policy sold by one of the insureds, Section 2035 would not seem to apply, since Section 2042 would not apply if the owner were to die within three years of the sale, if the other insured were still alive (since there would be no policy proceeds to which Section 2042 could apply).

(3) Also, compare D'Ambrosio v. CIR, 101 F.3d 309 (3rd Cir. 1996), with Gradow v. US, 897 F.2d 516 (Fed. Cir. 1990), on a similar issue under Section 2036, involving a sale of a remainder interest.

(4) Finally, note the transfer for value issue raised by such a sale, under Section 101(a)(2) and the possible exceptions to its application in such sales.

e) Finally, what is the value of a gift of an undivided interest in a policy; would there be a discount applied, since all owners must act together to exercise any incidents of ownership?

(1) See Skouras v. CIR, 14. T.C. 523(1950).

f) Again, gifts of cash to allow the trustee to acquire the policy will avoid this policy valuation issue.

3. Where policy loans are made (for instance) to reduce the policy's gift tax value prior to transfer, there is a potential income tax trap.

a) Policy transfers in which the policy loan exceeds the donor's cost basis will be treated as a sale to the trust (to the extent of the excess).

(1) Rev. Rul. 69-187, 1969-1 C.B. 45.

b) The risks in this situation are both:

(1) A taxable gain on the transfer, and

(2) Loss of a portion of the Section 101 income tax-free receipt of proceeds, because of a non-exempt transfer for value.

c) There is a safe harbor.

(1) Keeping the policy loan balance less than both the policy's cost basis and gift tax value would avoid the issue.

d) In addition, if the gift is to an intentional grantor trust (which most insurance trusts would be anyway, because of violating Section 677(a)(3)), both of these issues could be avoided.

(1) On the theory that there can't be income tax consequences in transactions between a grantor and his or her grantor trust (so there would be no gain to report) and on the theory that the carryover basis exception to the transfer for value rule would apply, because of the non-recognition of gain or loss on the transfer to a grantor trust, (so no transfer for value).

(a) Rev. Rul. 85-13, 1985-1 C.B. 184.

(2) Alternatively, a transfer to a grantor trust is treated as an exempt transfer to the insured for transfer for value purposes.

(a) See Swanson v. Commissioner, 75-2 USTC ¶ 9528 (8th Cir.), holding that a grantor trust (in that case, a revocable trust) should be treated as the insured for this purpose.

(b) Ltr. Rul. 200120007 and Rev. Rul. 2007-13, 2007–1 C.B. 684, are to the same effect, and both dealt with an irrevocable trust.

e) In universal type policies, withdrawals could be used to reduce policy value for gift tax purposes, without creating the transfer with a loan in excess of basis issue.

4. The gift tax annual exclusion.

a) It is available only for present interest gifts.

(1) Section 2503(b).

b) Outright gifts of a life insurance policy are present interest gifts.

(1) Except where the gift is to a group of donees, all of whom must act together to exercise policy incidents of ownership.

(a) See Skouras v. Commissioner, above, holding, that, because of that fact, the gifts were of future interests.

c) Gifts to an irrevocable insurance trust generally are not gifts of a present interest.

(1) The consequences of the failure to qualify gifts to a trust for the exclusion are:

(a) Gift tax return filing requirement;

(b) Use of the insured's unified credit;

(i) Or payment of gift tax, once the available credit has been used; and

(c) As discussed below, loss of the non-taxable gift exemption potential under Section 2642(c) for GSTT purposes.

(d) Note, however, the Administration's proposal to allow each donor up to $50,000 per year in annual exclusion gifts to irrevocable trusts.

(i) It would restrict other annual exclusion gifts to outright gifts, eliminating Crummey withdrawal powers to obtain annual exclusions for gifts to trusts.

5. Crummey withdrawal provisions.

a) They are used to qualify gifts to trusts for the gift tax annual exclusion.

(1) And coincidentally for the Section 2642(c) exemption for GSTT purposes.

b) They are based on the withdrawal power in Crummey, et al. v. Commissioner, 397 F.2d 81 (9th Cir. 1968).

(1) Interesting aspects of the case.

(a) Annual exclusions were allowed, despite the fact that there was no notice to or knowledge of their rights by the donees.

(i) See Turner v. CIR, T.C.M. 2011-209, reaffirming that aspect of the case.

(b) Their withdrawal rights only extended to additions to trust.

(c) The holding extended prior case law, by allowing the exclusion for withdrawal rights held by minors.

c) See Rev. Rul. 73-405, 1973-2 C.B. 321 and the later series of Private Letter Rulings issued before the Service's moratorium, described below.

(1) They expressed the Service's concern about the possible illusory nature of the right, in three areas of concern.

(a) Notice.

(i) See Rev. Rul. 83-108, 1983-2 C.B. 167.

(ii) See Ltr. Rul. 9532001, apparently for the first time, making qualification for the annual exclusion hinge on notice of their withdrawal rights having been given to the beneficiaries.

(b) Adequate time to withdraw.

(i) Usually easy, since at least 30 days is given but see Rev. Rul. 81-7, 1981-1 C.B. 427 (two days insufficient).

(c) Assets in the trust available for and subject to withdrawal.

(i) Not an issue in most situations.

(d) As noted above and below, Turner v. CIR, above, held that no notice to the powerholders nor knowledge of those rights was required, and that no gifts to the trust were required to trigger the withdrawal rights, where the trust allowed withdrawals equal to indirect gifts (made by paying premiums on a trust owned policy directly to the insurer).

(2) Making whatever sense can be made out of the 100+ letter rulings.

(a) Many were inconsistent.

(b) There are some vague guidelines.

(i) They relate to the three above-noted areas of concern.

(3) The Service's present no ruling posture for trusts funded with life insurance which are intentional grantor trusts, which goes back to 1981.

(a) See, e.g., Rev. Proc. 2014-3, 2014-1 I.R.B. 6.

(i) Rulings are still being issued on grantor trust issues outside what the IRS called the "super trust" area.

(4) Legislative or administration proposals which, if adopted, would effect the use of Crummey powers as a way of crating present interest gifts to trusts.

(a) One, for instance, which would require that the withdrawal power remain effective throughout the donee's life – a vested, non-lapsing power.

(b) Another would indirectly effect this technique, by capping the total number of annual exclusions available in any given year.

(c) Another would replace the concept for new trusts, by only allowing annual exclusions for gifts to "vested" trusts.

(d) Another would eliminate Crummey powers as a way of obtaining gift tax annual exclusions for gifts to trusts.

(i) The most recent proposal would have been retroactive, since it would have applied even to future gifts to old trusts.

(e) The latest proposal, noted above, would create a new annual exclusion for gifts to irrevocable trusts, eliminating the need for Crummey powers to create present interest gifts to trusts.

(5) Best practices.

d) There is always an issue of the existence of a direct or implicit understanding with the beneficiaries not to withdraw.

(1) Especially when they have so-called "naked" withdrawal rights – rights of withdrawal given to those having no other interest in the trust (and accordingly no economic reason not to exercise their withdrawal rights).

(a) See Ltr. Rul. 8727003, the "naked" withdrawal power ruling, which was based on extremely bad facts for the taxpayer, and should not have been an unexpected result.

(i) One wonders why a ruling was requested on these facts.

e) (1) Ltr. Rul. 9045002 dealt with withdrawal powers held by current income beneficiaries, contingent remainder beneficiaries and non-beneficiaries; it concluded only the powers held by the direct beneficiaries qualified, since there wasn't any "logical" reason for any of the others not to withdraw (other than an understanding with the grantor).

(a) Its conclusion regarding the contingent beneficiaries is questionable.

(i) On the other hand, Ltr. Rul. 9030005 allowed the exclusion for withdrawal powers held by contingent remaindermen.

(2) In <u>Cristofani Estate v. Commissioner</u>, 97 T.C. 74 (1991), a unanimous Tax Court allowed exclusions for the decedent's children who were current income beneficiaries <u>and</u> for her grandchildren who were contingent remainder beneficiaries.

(a) See however Ltr. Rul. 9141008, issued immediately prior to the opinion in <u>Cristofani</u>, repeating the Service's contrary position.

(b) <u>Cristofani</u> wasn't appealed, but the IRS has indicated it would wait for the next, more abusive, case.

(3) See AOD 1992-09, indicating the Service's view that only current income beneficiaries and vested remaindermen can be "counted" as <u>Crummey</u> powerholders; the AOD acquiesces <u>in the result of</u> <u>Cristofani</u> only – it also indicates that the next "worst" (<u>i.e.</u>, more aggressive) case will be challenged.

(a) The Service did so in Kohlsaat v. Commissioner, T.C. Memo 1997-212, a Tax Court Memo decision, which the Service lost, reaffirming Cristofani.

(4) See Mikel v. Commissioner, T.C.M. 2015-64, which upheld Crummey powers granted to 60 beneficiaries, all of whom had totally discretionary rights to distributions, despite both an in terrorem clause as well as a religious court arbitration provision in the trust.

(a) The court disregarded the contingent nature of the beneficiaries' interests in the trust.

(5) See also AOD 1996-10, expanding on the Service's rationale for acquiescing in the result of Cristofani, and indicating its willingness to litigate the issue where there was a pre-arranged understanding that the right wouldn't be exercised or that the exercise would have adverse consequences to the powerholder.

(6) TAM 9628004 best illustrates the "substance over form" approach being taken by the Service in this area.

(a) There, in apparent dicta, since the donor had done everything wrong to obtain the exclusions, the Service disallowed gift tax annual exclusions for powerholders who had interests in the trust more remote than current income or vested remainders, on the assumption that there must have been an understanding between those powerholders and the grantor not to exercise their withdrawal rights.

(b) The rationale for this position appears to be that there isn't any economic reason why such a powerholder wouldn't withdraw, so an understanding not to withdraw must have existed.

(i) Not an unreasonable way to frame the issue.

(7) But see Kohlsaat v. Commissioner, above, reaffirming the Tax Court's holding in Cristofani, above.

(8) Best practices.

f) There are potential gift and estate tax effects on the holders of the power.

(1) Amounts unwithdrawn by the holders in any year are lapses of the power, which are treated as releases of general powers of appointment for both gift and estate tax purposes, but only to the extent the lapse of the power exceeds the $5,000/5% lapse protection amount of Section 2514(e) – the greater of $5,000 or 5% of the value of the trust.

(a) Note that it is only lapses of powers which are protected by that floor; presumably waivers of the rights would be treated as releases, not lapses, and should therefore be avoided.

(2) Accordingly (except for the amount unwithdrawn for the year of death - which is includible in the powerholder's estate), there are no transfer tax effects to the powerholders of powers limited to the lapse protection amount in any year.

(a) If withdrawal powers are given to the insured's spouse, they should always be limited to the lapse protection amount.

(i) To prevent any potential estate tax consequences to the spouse resulting from a lapse of the power.

(b) As discussed below, to be conservative, the same guideline may apply to all powerholders in long-term Dynasty Trusts.

(3) But, there are transfer tax effects on the powerholders of powers which are not so limited.

(a) This technique allows the insured to increase gifts to the trust protected by the insured's (and, where gifts are split, the spouse's) annual exclusion.

(4) The powerholders of such powers have potentially lapsed/released a general power of appointment for both gift and estate tax purposes.

(a) Without planning, creating gift and/or estate tax problems for the powerholders.

(i) Treating them as if they had made a gift of a future interest to the trust and as if they were partial grantors of the trust for estate tax purposes.

(ii) One way to think about this power is to treat the powerholder as if he or she had actually withdrawn the amount in excess of the protected amount and then re-contributed it to the trust.

(a) Making a gift of a (presumably) future interest for gift tax purposes.

(b) And becoming a partial grantor of the trust for income and estate tax purposes.

(b) And in long-term trusts, a change in the identity of the GSTT transferor.

(5) There are some gift tax (but, as discussed below, in most cases not estate tax) solutions for powerholders.

(a) An on-going special (testamentary) power of appointment.

(i) Over a separate share or trust for the powerholder.

(ii) Note the special (and difficult) drafting issues raised by this alternative.

(b) So-called “hanging” powers; powers that allow the full amount transferred to the trust for the powerholder to be withdrawn, but not lapsed in any year in excess of the protected amount - those excess amounts “hang” in abeyance until they can lapse within the protected amount.

(i) But see Ltr. Rul. 8901004, disregarding the “hang” of the power for gift tax purposes, based on the language of the power in the Ruling.

(ii) Presumably, a power drafted to avoid the problem in the Ruling would be accepted by the IRS.

(iii) Note that this technique presumes the "hang" will be able to work itself out at some point – either because gifts to the trust stop during the insured's lifetime or they will be worked out at the insured's death (because 5% of the death proceeds will be large enough to do so).

(iv) Note the accounting issue for the trustee created by this technique (which is widely overlooked in practice).

(v) Also note the difficult drafting and explanatory issues involved in using this technique.

(c) A trust only for the powerholder (and his or her estate).

(i) For estate tax purposes, without any special gift tax planning, the powerholder will be treated as the grantor of the trust for estate tax purposes -requiring an analysis of his or her interests in the trust and the tax sensitive nature of those interests.

(d) Even with special planning for the gift tax issue, there is still an estate tax issue for the powerholders.

(i) Both the special power technique and the sole beneficiary technique include the whole value of the trust.

(ii) The hanging power technique would include only the dollar amount left hanging at death.

(6) In some trusts, the estate tax issue for the beneficiary may be manageable.

(a) In a short-term trust, depending upon whether the powerholder dies before or after the insured.

(i) If he or she dies before the insured or after his or her interest is paid out, this is a minor (or even a non-existent) issue.

(b) In some cases, depending on the powerholder's interest in the trust, the estate tax issue may not be a problem for the powerholder.

(i) For example, where the powerholder has only a totally discretionary interest in the trust (without any enforceable, ascertainable right to any trust distributions), the powerholder doesn't have any type of power of appointment over the trust, and, under state law, his or her creditors can't reach his or her interest in the trust.

(7) In long-term, Dynasty Trusts, this issue will be critical.

(a) Since the trust is designed not to be subject to the estate tax to any extent at any beneficiary's death.

(i) Again, unless the risk of a powerholder with a hanging power dying before the insured and inclusion in his or her estate of the amount "hanging" is an acceptable risk, given the added gift tax annual exclusion which use of the hanging power technique provides the grantor.

(8) The generation-skipping transfer tax results to the powerholders resulting from the lapse of such unprotected powers were clarified by the Final GSTT Regulations.

(a) As noted above and discussed below, the powerholders will become partial transferors of the trust for GSTT purposes, but only as to a lapse of that portion of the power which exceeds the Section 2514(e) lapse protection amount.

(i) Regardless of the amount withdrawable by the powerholders, the donor of the gift will be treated, under those Regulations as the GSTT transferor of the entire transfer, requiring allocation of his or her GST exemption to the entire gift, to give the trust a zero inclusive ratio for the trust.

(b) In situations where the powers aren't limited to the protected amount, the generation assignment of the transferor will go down.

(i) And the powerholder's GST exemptions will have to be allocated to that excess (if the trust benefits skip persons from the powerholder's point of view).

(ii) Subject to the effectiveness of that allocation under the ETIP rules, described below.

(c) As also noted above and discussed below, not using Crummey powers in GSTT trusts (or at least limiting them to the lapse protection amount for each donee each year) will make the most sense in such trusts.

(i) Giving up (or limiting) the gift tax annual exclusion for GSTT planning certainty.

(ii) And avoiding transfer tax consequences to the powerholders.

(iii) Again, subject to taking the risk of transfer tax consequences to the holders of hanging powers.

(d) In any event, to prevent ETIP problems for the GSTT transferor under the Final Regulations, his or her spouse's Crummey power must always be limited to the lapse protection amount.

(i) Which, as indicated above, makes sense for estate tax purposes anyway.

(9) Balancing the interests of the insured and the powerholders is difficult.

(a) Who is our client?

(b) Does the attorney have a duty to counsel the powerholders on these tax consequences?

(i) Especially the generation-skipping transfer tax consequences?

g) The income tax effect on the holder of the power.

(1) Note that this issue isn't a problem for most insurance trusts, since they will only hold life insurance policies and therefore (absent a surrender a withdrawal in excess of

basis, or a distribution from a MEC) won't have any income during the insured's life (unless there is a "side fund", earning taxable income).

(2) In any event, almost all irrevocable insurance trusts will be treated as grantor trusts from the point of view of the insured, <u>even where the trust wasn't drafted as an intentional grantor trust,</u> under Section 677(a)(3), at least as to ordinary income.

   (a) Since, in most such trusts, trust income must, or in the discretion of a non-adverse party may, be used to pay premiums on insurance on the life of the settlor of his or her spouse.

(3) Under Section 678(b), where the trust is, intentionally or otherwise, treated as a grantor trust, the insured - as the settlor of the trust - will be treated as the owner of the trust for income tax purposes, even if the powerholders could be so treated under Section 678(a).

(4) Ltr. Ruls. 8142061, 8521060, 8701007 and 8805032, articulate the Service's "deemed" withdrawal and recontribution theory.

   (a) This theory would treat the powerholders as the owners of an increasing portion of the trust for income tax purposes.

   (b) Note that there is no "protected amount" for income tax purposes as there is for transfer tax purposes.

      (i) The $5,000/5% floor doesn't apply for income tax purposes.

   (c) See also Ltr. Rul. 9034004, citing Rev. Rul. 67-241, 1967-2 C.B. 225, for the proposition that the powerholder is treated as having released the power for purposes of Section 678(a)(2), when the power lapses (despite what appears to be a difference in involvement by the powerholder between a lapse and a release).

      (i) Also treating the powerholder as owning an increasing portion of the trust for income tax purposes each year the power lapses.

(5) Consideration should be given to creating the trust as an intentional grantor trust, to have the insured be treated as the owner of the entire trust for income tax purposes, by intentionally violating another non-estate tax sensitive grantor trust power.

(a) To allow the insured to pay the tax on any trust income (and thereby make an additional "gift" to the trust), without transfer tax consequences (since he or she is only discharging a direct tax obligation), and reducing his or her remaining estate by that payment – the so-called "tax burn" effect.

(i) Note the Service's inconsistent positions on the gift issue in several early private letter rulings, and its favorable published conclusion.

(a) See Ltr. Ruls. 9444033 and 9543049, finally put to rest by Rev. Rul. 2004-64, 2004-2 C.B. 6, holding that there is no gift in this situation.

(ii) Note also the economic impact of this result on the grantor – having to pay tax without any cash.

(a) Consider drafting flexibility into the trust to respond to this issue – providing for the retained grantor trust power(s) to be given up by the grantor or terminated by a non-fiduciary trust protector.

(b) Note, however, that the grantor cannot give up the trustee power to use income to pay premiums (since it hadn't been retained by the grantor) and that the trustee cannot terminate any grantor trust powers (since that would hurt – not help – the trust beneficiaries); that power would have to be negated by requiring the consent of an adverse party to the use of income to pay premiums to avoid continuing grantor trust status for the trust.

(c) The powers to borrow without security and/or to substitute trust assets for assets of equivalent value (even for a policy on the insured's life, under Rev. Rul. 2011-28, below) should be considered, as alternatives, since they are not estate tax sensitive and can be given up and/or terminated.

(b) And, as noted above, to prevent the powerholders from being treated as the owners of the trust for income tax purposes under Section 678(b).

(c) Also, to consider this trust as the purchaser or seller of assets to or from the grantor, or the lender or borrower to or from the grantor, in either event, without tax consequences to either under Rev. Rul. 85-13, above.

(i) Including a sale of a policy on the grantor's life to the trust, avoiding transfer for value issues, under Rev. Rul. 2007-13, as described above.

h) All of these complex legal and administrative issues would be eliminated by the Administration proposal noted above.

i) Use of group term or split-dollar insurance.

(1) Indirect or deemed gifts.

(a) Rev. Rul. 84-147, 1984-2 C.B. 201 (for group term insurance) and Rev. Ruls. 78-420, 1978-2 C.B. 67 and 81-198, 1981-2 C.B. 188, Notice 2002-8, and the Reg. Secs. 1.61-22 and 1.7872-15 (for split-dollar arrangements).

(b) Measure of the gift.

(i) The (updated) Table I cost (or actual cost if the plan discriminates) for group term policies.

(ii) The "economic benefit," measured by the income tax effect of the split-dollar arrangement on the insured employee.

(a) Under Rev. Rul. 66-110, 1966-1, C.B. 13, the lower of the PS 58 rate or the insurer's generally available, published one year term rates.

(b) Under Notice 2002-8, the lower of the Table 2001 rates (based on the Table I rates) or the carrier's alternative term rates; after 2003, alternative term rates are further restricted for post-January 28, 2002 arrangements (to assure that they reflect term policies actually sold).

(c) This provides the transfer tax "leverage" element in split-dollar arrangements.

(iii) What about any "equity" in the split-dollar arrangement – policy values exceeding the amounts owed the corporation which belong to the policy owner – would those amounts be gifts when and to the extent taxed to the insured?

(a) See Notice 2002-8, implying that result, for pre-final regulation arrangements – those entered into before 9/18/03 and not materially modified thereafter.

(i) Since it taxes the equity for income tax purposes on a lifetime rollout and states that its principles will be applied to gift transactions, and because it applies to donor-donee arrangements (in which the only tax effect would be a gift tax).

(ii) But note the "no inference" provision of the Notice, which may provide a reporting position that equity on termination isn't treated as transferred for tax purposes.

(b) The final regulations contain similar provisions in economic benefit regime arrangements taxed under Section 61, taxing the equity currently, based on "access," (as broadly defined); the explanation applies these rules for gift tax purposes.

(c) For post-final regulation loan regime arrangements taxable under Section 7872, the equity isn't taxable, but the measure of the gift is determined by the interest imputed under Section 7872, not the economic benefit.

(iv) Note the special (and favorable) rule for determining the economic benefit for joint life policies subject to a split-dollar arrangement.

(a) At least while both insureds are alive; after the first death, the measure of the gift reverts to the traditional single insured economic benefit.

(b) Traditionally, the U.S. 38 rates, under a series of Information Letters.

(c) Notice 2002-8 suggests deriving such rates from Table 2001.

(i) They will be lower than the old U.S. 38 rates.

(v) As noted above, for post-final regulation arrangements treated under the loan regime, the benefit is measured by the foregone interest, under Section 7872, which is treated as a gift by the insured.

(a) In lieu of loan regime arrangements, private premium financing, described below, would likely make more sense.

(2) Drafting and planning issues in using <u>Crummey</u> withdrawal powers.

(a) In non-contributory arrangements, there would be no contributions <u>to</u> the trust.

(i) Arranging contributory split-dollar plans, where the grantor gifts the economic benefit <u>to</u> the trust, to be used as part of the premium.

(ii) Special drafting of the withdrawal power.

(a) To allow withdrawals from the trust equal to the deemed or indirect gift.

(i) See <u>Turner v. CIR</u>, above, approving such a provision as qualifying the grantor's direct payments of premiums to the insurer for the annual exclusion.

(b) Policy values may be inadequate to support the withdrawal rights.

(i) Again, arguing for contributory plans.

(3) The practical problems of using split-dollar.

(a) The on-going (and ever-increasing) economic benefit (based on term costs) for income, gift, and generation-skipping tax purposes.

(i) Arguing for planning for lifetime rollouts.

(a) Using external policy assets – where the trust had other assets to begin with or was side-funded with other assets as a part of the life insurance transaction.

(b) The on-going series of loans and imputed interest in loan regime split-dollar.

(i) And the problems of complying with the Section 7872 rules for gift loans.

(c) Taxation of policy equity for pre-final regulation arrangements, on termination, under Notice 2002-8 and currently (based on access), under the final regulations.

(i) Also arguing for early, pre-equity lifetime rollouts.

(d) The economic and tax issues inherent in policy rollouts at termination of the arrangement.

(i) In equity arrangements, taxed under Notice 2002-8.

(ii) In modified endowment contract arrangements.

(iii) Generally.

(e) The indirect retained incident of ownership issue for controlling shareholders, discussed below.

(f) The value of the receivable in the insured's estate for private split-dollar.

j) Premium financing techniques.

(1) Loans to the trust from the grantor, interest at the AFR payable annually, principal payable at death (private premium financing).

(a) Changing the gift from the full premium to the interest gifted to the trust (which is to be repaid to the grantor).

(b) Note the incident of ownership issue in any security interest retained.

(c) Also note the provision in the split-dollar regulations (which are broad enough to apply to such loans), treating this as a Section 7872 arrangement if the grantor is "to pay" the interest to the trust (through a gifting arrangement).

(d) Finally, note the effect of the trust being a grantor trust from the point of view of the lender.

(2) Loans to the trust from the grantor, interest accrued at the AFR and due with the principal at death.

(a) Requiring no gifts, since no interest needs to be paid.

(b) But reducing the death benefit remaining in the trust.

(i) Also arguing for an early rollout.

(c) Also note the effect of the trust being a grantor trust from the point of view of the lender to avoid OID income.

(3) Loans from a third party lender to the grantor/insured, at variable market rates, re-loaned to the trust at the fixed AFR.

(a) Giving the trust the benefit of the spread in interest rates and imposing that risk on the grantor/insured.

(4) Loans from a third party lender to the trust, likely guaranteed and collateralized by the grantor, interest payable annually, principal at the end of the term – generally not more than 5 or 10 years (subject to renewal, based on the lender's then requirements).

(a) Same gift result.

(b) The guarantee may raise gift issues.

(i) See Ltr. Ruls. 9409018, withdrawing 9113009, which had held the guarantee was a gift, when made.

(ii) Paying a "fair market value" guarantee fee should avoid the issue.

(c) Inclusion of the note from the trust in the insured/grantor's estate would be offset by a Section 2053 deduction for the amount owed to the lender.

(5) The economic issues of these techniques.

(a) The possible disintermediation between the loan interest rate and policy value growth.

(b) Having enough death benefit to pay off the loan and adequately fund the trust, perhaps using an increasing death benefit policy design.

(i) Especially where the interest accrues until death.

(c) Inclusion of the value of the note in the insured's estate for private premium financing.

B. Estate Tax.

1. In general, the issues for the insured are:

a) Retained powers under the trust.

(1) Solvable by drafting.

b) Incidents of ownership in the insurance policy, directly or under the terms of the trust.

(1) Again, solvable by drafting.

c) Transfer of the policy to the trust by the insured within three years of death.

(1) Direct transfers.

(a) An insoluble problem.

(i) Except perhaps with respect to survivorship policies, if the other insured is alive at the transferor's death.

(a) Since there aren't death proceeds available to which Section 2035 could apply Section 2042.

(ii) Or except perhaps for sales for adequate consideration to an intentional grantor trust (avoiding both the application of Section 2035 and the transfer for value rule, under its carryover basis exception or under the theories of Rev. Rul. 2007-13, above).

(a) Noting again the issue of what full value is in such a sale.

(2) The issue of indirect transfers, based on the insured's payment of premiums, raised by some early cases, appears to have been solved, as discussed below.

d) Community property issues.

(1) Making sure the insurance policy and all gifts to the trust (including indirect gifts resulting from group term, split-dollar or premium financing arrangements) are the separate property of the grantor-insured, if the spouse has an interest in the trust after the insured's death.

(a) Assuming that can be done under state law.

e) Survivorship policy issues.

(1) Based on the fact that there are two insureds, both of whom must avoid estate tax sensitive powers or interests in the policy and in the trust.

2. Retained powers.

a) Retention of the right to income of the trust for life.

(1) General.

(2) Use of trust income to discharge the grantor's legal obligation of support.

b) Possession of a power to affect beneficial enjoyment of trust income or principal.

(1) General.

(2) The power to have or adopt children or to divorce a spouse.

(a) Ltr. Rul. 8819001 should put this issue to rest.

(3) Powers as held as a trustee or a successor trustee, even powers to remove and replace the trustee.

(a) Rev. Rul. 79-353, 1979-2 C.B. 325, and Ltr. Rul. 8922003, both dealt with a power held by the grantor to remove the corporate trustee and replace it with another corporate trustee, and found that that power gave the grantor all of the powers of the trustee.

(i) Rev. Rul. 79-353 had been widely criticized.

(b) See also Ltr. Rul. 8916032, relating to such a power held by a trust beneficiary.

(i) Limiting all encroachment rights by ascertainable standards should solve the problem for the beneficiaries.

(c) What about the power only to replace a trustee if there is a vacancy?

(i) Or a power to remove and a power to appoint, each held by different people?

(d) However, Wall v. Commissioner, 101 T.C. 300 (1993), held that Rev. Rul. 79-353 was incorrect.

(e) Finally, in Rev. Rul. 95-58, 1995-2 C.B. 191, the Service revoked Rev. Rul. 79-353.

(i) However, it apparently limited that revocation to a situation where the grantor could only appoint a corporate trustee or an individual who was not related or subordinate to the grantor (as defined in the grantor trust rules).

(a) That latter portion of the ruling is a troubling cross-over from the grantor trust rules for income tax purposes into the transfer tax area.

(ii) In addition, it isn't clear that in an insurance trust context, the insured can retain that power without Section 2042 fiduciary incident of ownership issues.

(f) Despite Rev. Rul. 95-58, because of the fiduciary incidents of ownership issue, these are powers that probably shouldn't be retained by grantor-insureds in irrevocable insurance trusts.

(4) Inadvertent status as the trust creator.

(a) Beneficiaries contributing to the trust.

(i) Stavroudis v. Commissioner, 27 T.C. 583 (1956).

(a) Including indirectly contributing to the trust by lapsing Crummey powers in excess of the Section 2514(e) protected amounts.

(b) The reciprocal trust doctrine.

(i) An important planning issue.

(a) Especially for spouses creating trusts for each other, which are identical.

(b) See Estate of Levy v. CIR, TCM 1983-453, holding similar, but not identical trusts not reciprocal.

(ii) See, e. g., U.S. v. Grace, 395 U.S. 316 (1969).

(a) See also Sather v. CIR, 2001 USTC ¶60, 409 (8th Cir.), applying the doctrine, even where the grantors didn't retain an interest in the transfers, so long as they were interrelated.

c) Most of these issues can be drafted (or planned) around.

3. Payment to the insured's estate and incidents of ownership.

a) Proceeds receivable directly or indirectly by the insured's estate.

(1) Generally, this should not be a problem, so long as the trust doesn't require use of the insurance proceeds to pay estate taxes or other obligations of the insured's estate.

(a) Authorizing a purchase of assets or a loan of the proceeds to the insured's estate or revocable trust can make the proceeds indirectly available to pay taxes and expenses, without causing Section 2042(1) to apply to the proceeds.

(i) Cf. Rev. Rul. 77-157, 1977-1 C.B. 279; surprisingly, this is all the authority there appears to be for this proposition.

(b) See PLR 2001407039, holding that the authority (but not the requirement) to pay debts and taxes didn't cause Section 2042(1) issues.

b) Retention of incidents of ownership.

(1) Definition.

(2) Retention as a fiduciary.

(a) Reg. Sec. 20.2042-1(c)(4).

(i) Rev. Rul. 84-179, 1984-2 C.B. 195, carved out an exception where the insured inherited ownership and couldn't exercise the incidents of ownership for his own benefit.

(a) This is a very limited concession by the Service.

(b) As noted above, despite the revocation of Rev. Rul. 79-353 by Rev. Rul. 95-58, the most conservative approach would suggest that the grantor-insured should not be the trustee, nor be able to become the trustee, or probably even have the power to remove and replace the trustee.

(3) Indirect retention of incidents of ownership for majority shareholder split-dollar arrangements, as defined in Reg. Sec. 20.2042-1(c)(6).

(a) Rev. Rul. 82-145, 1982-2 C.B. 213, modifying Rev. Rul. 76-274, 1976-2 C.B. 278.

(i) See also Ltr. Ruls. 9037012 and 9348007.

(b) See Ltr. Rul. 9511046, further modifying Rev. Rul. 76-274, and approving an appropriately restricted collateral assignment arrangement as avoiding corporate incidents of ownership in the policy.

(i) Also note the possible use of the so-called unsecured documentation method (where the policy isn't pledged as collateral) to attempt to avoid this issue.

(4) In joint life policies.

(a) Neither insured may have an incident of ownership in the policy or under the trust.

(i) Including for instance, any power of appointment over the trust or even a power exercisable as a trustee.

(5) Retention of the power to acquire the policy under a power to substitute assets of an equivalent value, held in a non-fiduciary capacity, designed to make the trust a grantor trust under Section 675(4).

(a) See <u>Estate of Jordahl v. CIR</u>, 65 T.C. 92 (1975), holding such a power was not a retained incident of ownership in the policy, but involving a power held in a fiduciary capacity.

(b) See also, Ltr Ruls. 9413045, 200606006, and 200604028.

(c) See Rev. Rul. 2008-22, 2008-16 I.R.B. 749, holding such a power was not a Section 2036 or 2038 power, so long as the fiduciary had a duty to confirm the assets were in fact equivalent in value and that the substitution did not alter beneficial interests – but not dealing with the Section 2042 issue.

(i) Because of that omission, most practitioners had limited the substitution power to non-insurance assets.

(d) Finally, see Rev. Rul. 2011-28, 2011-49 I.R.B. 830, holding that the grantor's retained power to acquire ("re-acquire") a policy on his or her life, by substituting assets of an equivalent value was not a Section 2042 power, on the same conditions.

(i) Note again the issue of determining the value of a policy, as discussed above.

c) Again, most of these are drafting and planning issues.

4. Transfers within three years of death.

a) Section 2035, as amended by the Tax Reform Act of 1976.

b) Amendments to Section 2035 by the Revenue Act of 1978 and the Economic Recovery Tax Act of 1981.

c) The absolute rule for gratuitous policy transfers by the insured within three years of his or her death of Section 2035(a).

(1) Again, with a possible exception for survivorship policies where no death proceeds are payable at the transferor's death.

(2) Note again the "full value" sale technique to avoid Section 2035, as discussed above.

d) Indirect policy transfers.

(1) The "beamed" transfer theory.

(a) Bel v. U.S., 452 F.2d 683 (5th Cir. 1971); Rev. Rul. 71-497, 1971-2 C.B. 329, etc.

(2) A purchase by the third party owner, at the insured's direction and with the insured's funds.

(a) First National Bank of Oregon v. U.S., 488 F.2d 575 (9th Cir. 1973).

(b) Relationship to annual gifts of group term or split-dollar insurance premiums.

(i) Ltr. Rul. 8509005.

(3) However, Estate of Leder v. Commissioner, 89 T.C. 235 (1987), affd., 893 F.2d 237 (10th Cir. 1989), and its later Tax Court and Circuit Court progeny, hold the source of premiums irrelevant, so long as the insured never possessed incidents of ownership; see also Headrick v. Commissioner, 93 T.C. 171 (1989), affd., 90-2 U.S.T.C. ¶60,049 (6th Cir. 1990) and Estate of Perry v. Commissioner, 91-1 USTC ¶60,064 (5th Cir.).

(a) These cases underscore the added importance of a pre-arranged transaction, in which the trustee acquires the policy initially.

(b) Leder was the first post-ERTA Section 2035 case, and as such is an especially important taxpayer victory.

(i) The relevance of these cases on the "agency" theory, discussed below, is unclear; however, the Sixth Circuit in Headrick rejected the Service's alternative agency argument, discussed above.

(4) AOD 1991-12 indicates that the Service will no longer litigate the beamed transfer doctrine, based on the Leder-Headrick-Perry line of cases.

(a) Although note again the possible continued vitality of the agency argument.

(i) And note also the rejection of that theory in Headrick.

(5) The controlled corporation transfer theory.

(a) In Rev. Rul. 82-141, 1982-2 C.B. 209, the Service held that a transfer by a more than 50% owned corporation of a policy on the insured-controlling shareholder within three years of his or her death would be treated as a Section 2035 transfer by the insured.

(i) Similarly, Rev. Rul. 90-21, 1990-1, C.B. 172, applied the concept of Rev. Rul. 82-141 to a policy transfer by a controlled corporation, notwithstanding the insured's later gift of the controlled corporate interest to a third party.

(ii) See also Ltr. Rul. 8806004, discussed above in connection with the value of a policy for the full and adequate exception of Section 2035.

(b) Rev. Rul. 90-21 went further and applied Section 2035 to a transfer of the controlled corporate interest by the insured within three years of death, where the corporation owned a policy on his or her life.

(i) Note that here the interest transferred within three years of death was not of a policy, but of an interest in a corporation which owned a policy.

(6) The agent of the insured or the conduit theory.

(a) Detroit Bank v. U.S., 467 F.2d 964 (6th Cir. 1972) held the trustee was acting as the insured's agent for the purchase of the policy, so its acquisition within three years of the insured's death was subject to Section 2035.

(i) Would the type of indemnification provisions being required by some corporate trustees make the trustee the insured's agent for acquiring the policy?

(ii) Or would it be true in every insurance trust policy acquisition – as a practical matter, it is the insured, not the trustee, who arranges for the trustee to acquire the policy.

(b) See also Hope v. U.S., 82-2 U.S.T.C. ¶13,504 (5th Cir.) and Kurihara v. Commissioner, 82 T.C. 51 (1984).

(c) But see Headrick, above, rejecting that argument.

e) Payment of policy premiums within three years of death.

(1) Ltr. Rul. 8724014 should put that issue to rest.

f) These issues can only partially be solved by planning and drafting.

(1) Inclusion of contingent marital deduction provisions in the trust, to at least defer the issue until the surviving spouse's death.

(a) But not in a survivorship policy situation.

(i) On the theory that at worst only the policy cash value – not the policy proceeds – would be includible in the grantor's gross estate if he or she died within three years of a "transfer", assuming the non-grantor insured were still alive.

(ii) Again, there is an argument that nothing would be included in the grantor's estate for estate tax purposes in these circumstances, because Section 2035(a) requires policy death proceeds to invoke Section 2042.

(2) Initial acquisition by the trustee.

(a) Note the importance of Estate of Leder v. Commissioner, Headrick v. Commissioner, and Perry Estate v. Commissioner, above, on planning in this area, especially given AOD 1991-12.

(b) Also note the possible on-going relevance of the Detroit Bank agency argument, as discussed above.

5. Community property issues.

a) As noted above, the policy and/or the funds used to pay premiums must be the separate (i.e., non-community) property of the insured-grantor, if (but only if) the insured's spouse is to have an interest in the trust which would be a tax-sensitive interest if he or she were a trust grantor.

(1) The insured's ability under local law to declare property to be his or her separate property, or to otherwise sever the community as to such property, should be considered if it is necessary to "find" separate property to fund the trust.

(a) The effect of funds provided by the insured's employer under split-dollar, group term insurance or premium financing arrangements is unclear; may such compensation-related income be treated as separate property of the employed spouse by agreement?

b) Again, with joint life policies, this shouldn't be an issue, since neither spouse will have an interest in the trust in any event.

C. Generation-Skipping Transfer Tax.

1. In general.

2. The GST exemption.

a) For lifetime gifts, doubled if the spouse consents to split the gift.

3. Exempt transfers.

a) The Section 2642(c) exemption for "non-taxable" gift tax annual exclusion gifts in trust to "vested" trusts.

b) The now-expired Gallo exemption.

(1) Direct skip gifts to or for the benefit of grandchildren, if made before 1/1/90.

(2) Up to $2,000,000 per grandchild could have been given by each grandparent.

(3) Limited by TAMRA 88 for gifts in trust to even more restrictive "vested" trusts.

4. GSTT planning with irrevocable insurance trusts.

a) Relying on the Section 2642(c) exemption.

(1) Under the statute as originally enacted, qualifying gifts to a trust for the gift tax annual exclusion (presumably by using Crummey withdrawal powers) meant that the trust's inclusion ratio would always be zero.

(a) Keeping the trust out of the GST tax system for the trust's duration, without requiring the use of the transferor's GST exemption.

(2) The impact of the TAMRA 88 amendments to Section 2642(c).

(a) With a narrow exception for certain "vested" trusts for grandchildren (or other skip persons) – which, among other things, must be for the exclusive benefit of the skip person and must be includible in his or her estate – Section 2642(c) eliminated gifts to trusts as non-taxable gifts for GSTT purposes.

(i) Allowing these trusts to benefit only one generation.

(ii) Effectively eliminating the availability of this exemption for long-term, Dynasty Trusts.

(b) In these trusts, qualifying gifts for the gift tax annual exclusion (presumably relying on Crummey withdrawal rights or qualification under Section 2503(c)) provides automatic protection for this one generation skip for GSTT purposes.

(i) Assuming the trust is appropriately restricted.

(3) Full use of these trusts increases the potential GSTT planning for the grantor, by saving his or her GST exemption to be used elsewhere.

b) Relying on allocation of the transferor's GST exemption (doubled if gifts are split with a spouse, if he or she makes an independent gift, or community property is gifted).

(1) As noted above, prior to the issuance of the Final GSTT Regulations, on December 27, 1995, the identity of the transferor of the gift for GSTT purposes was unclear where Crummey powers were used to obtain the gift tax annual exclusion for gifts to a trust which wasn't designed to qualify under Section 2642(c).

(2) Was the GSTT transferor the donor of the gift, or, under an offshoot of the Service's deemed withdrawal and recontribution Crummey power theory, was it the donee of the withdrawal power?

(a) If it was the donee, the generation assignment of the transferor moves down, with a resultant move down of the imposition of the GSTT.

(i) See Ltr. Rul. 8904001, apparently reaching this conclusion; the IRS had, however, informally indicated this result was incorrect.

(ii) Reg. Sec. 26.2612-1(f), Ex. 3, makes clear that the gift to a trust with Crummey powers is a gift to the trust, not to the holder(s) of the power.

(b) However, until the transferor is identified, no one's GST exemption could have been allocated to gifts to the trust.

(c) And any allocation of the donee's GST exemption would appear to be nullified at his or her death, under the TAMRA 88 amendments to Section 2642(f) (the ETIP period concept), if (because of the nature of the donee's interest in the trust) the trust would be includible in the donee's estate - because, for example, of unprotected lapses of Crummey powers.

(3) However, as Reg. Sec. 26.2652-1(a)(6), Ex. 5, makes clear, the donor of the transfer is the GSTT transferor of the entire gift, requiring allocation of his or her GST exemption to the full value of the transfer to produce a zero inclusion ratio for the trust.

(a) However, a lapse of the power in excess of the protected amount will cause a switch in transferors, with respect to that excess (with a resultant move down of the imposition of the GSTT, but possible problems relating to administering a single trust with two transferors with an inclusion ratio of something other than zero).

(i) There will, however be Section 2642(f) ETIP problems for any attempted allocation of the donee's GST exemption to that part of the gift in excess of the lapse protection amount, since allocation of the exemption has to wait until it is clear no part of the trust will be includible in the transferor's estate.

(b) Use of the special power or hanging power techniques, described above, should avoid a taxable lapse and therefore such a switch of transferors and the other issues.

(i) However, each of those techniques can have adverse transfer tax consequences to the powerholder; for that reason, they may not make sense in long-term trusts.

(a) Since these trusts are planned to avoid transfer tax implications for each generation which benefits from the trust.

(b) Again, subject to taking the risk of transfer tax consequences to holders of hanging powers.

(ii) The only alternative would be to limit the withdrawal rights to the lapse protection amount (or not use them here at all) – a transfer tax cost to the donor for GST exemption certainty for the trust and avoidance of transfer tax issues for the powerholders.

(4) Under the spousal ETIP rules of the Final GSTT Regulations, any general power of appointment (including a Crummey power held by the GSTT transferor's spouse) would create an ETIP for the transferor, preventing allocation of his or her GST exemption to the trust.

(a) However, under Reg. Sec. 26.2632-1(c)(2)(ii)(B), a typical Crummey power (which lapses not more than 60 days after it is granted, and which is limited to the lapse protection amounts), is excepted from the spousal ETIP rules.

(i) As noted above, these powers should always be so limited for estate tax purposes, anyway.

c) (1) Accordingly, in long-term trusts, not relying on Crummey withdrawal powers to qualify gifts for the non-taxable gift exemption for GSTT purposes (or using them only up to the lapse protection amount per year) and allocating the grantor's GST exemption to the entire gift to the trust will produce a zero inclusion ratio for the trust and thereby protect the trust from the GSTT.

(a) This will keep the trust out of the transfer tax system for its term, so long as the GST exemption allocated covers all gifts to the trust.

(i) This will require filing a gift tax return and using up some of the insured's unified credit (or payment of gift tax).

(b) As noted above, this still provides leverage of allocating the insured's GST exemption to policy premiums and exempting policy proceeds.

(c) Split gifts for gift tax purposes allows use of each spouse's lifetime GST exemption.

(2) The alternative of using "full" Crummey powers (to lessen the need to use the donor's unified credit(s)) would appear to be a more difficult choice, since it would seem in all cases to cause some inclusion in the estates of the powerholders (even if one of the gift tax avoidance techniques, described above, is used), contrary to the

desired goal of protecting the dynasty trust from transfer tax exposure during its extended term.

(a) Except for assuming the risk that holders of hanging powers will outlive the insured(s), allowing the hanging part of their power to lapse (based on 5% of the death proceeds), eliminating any transfer tax issues for them.

(i) At worst, only the amount of the unlapsed powers remaining at death would be includible in the power holder's estate, not the full value of the trust.

d) Use of split-dollar arrangements.

(1) Allows leveraging the proceeds that can be placed outside reach of the GST tax, by reducing the gift tax value of the transfer to the trust.

(2) This is called "trust packing" – using split-dollar to reduce the gift values and therefore maximize use of the donor's gift tax annual exclusion/unified credit/GST exemption.

(3) But note the planning and drafting issues and the practical problems associated with split-dollar arrangements, discussed above.

e) Use of other premium financing techniques.

(1) Using the gift tax leverage of such arrangements, as described above, for GST purposes.

f) Use of survivorship policies to reduce the premium required to move the proceeds down to the beneficiaries.

(1) Perhaps combined with a split-dollar arrangement to further reduce the value of the gift.

(a) "Super trust packing".

(2) This is a popular use of survivorship insurance.

(a) Including "creative pairing" of the insureds.

(i) For example, a grandparent and a child, for the benefit of a grandchild.

g) Consideration should be given to using GSTT grandfathered trusts (or even Gallo exemption trusts) to purchase insurance, as a way of increasing the leverage possibilities available from such pre-existing trusts.

II. PLANNING SUGGESTIONS FOR USING IRREVOCABLE LIFE INSURANCE TRUSTS.

A. The client should be fully advised of the irrevocability of the plan and, despite any attempts to inject flexibility into the plan by drafting techniques, its inherently inflexible nature.

B. The client should be fully advised of the risks associated with attempting to make the plan flexible:

1. The trust may be terminated by the trustee under a power granted in the trust and the policies distributed to the beneficiaries.

   a) Or a trust protector may change trustees or even the terms of the trust without consulting the insured.

2. A beneficiary may exercise a special power (granted to him or her to add flexibility to the plan) to appoint the policies out of the trust.

3. A Crummey powerholder may use the power!!!

   a) And the powerholder may be treated as having lapsed/released a general power of appointment for gift and estate tax purposes.

      (1) Unless the powers are limited to the $5,000/5% lapse protection amount.

   b) And the power may have income tax consequences to the powerholder.

4. The grantor's power to "pull the plug" by stopping premium payments may not work.

   a) The trustee may borrow to pay premiums or take a paid-up policy, someone else may advance premium dollars, or the third party premium payer (an employer, under a group term policy, for instance) may continue payments.

5. Definitional flexibility (i.e., generic definitions of "spouse") may be embarrassing to the grantor and may be argued to be a retention of a power over the trust (although that argument seems weak).

6. The grantor's ongoing power to determine if amounts are withdrawable under a Crummey power or the limit on amounts withdrawable thereunder may be argued to be retained powers for estate tax purposes.

   a) Although it is argued that these are just conditions on new gifts to the trust, not changes to the terms of prior gifts or the trust.

7. A contingent marital provision may over-fund the surviving spouse's estate.

   a) And, in any event, will only postpone the estate tax otherwise due at the insured's death (but for the marital provision).

C. In addition, the client should be aware of the complexity of the entire plan, the potential legal expense involved in implementing and maintaining it, and the ongoing administrative requirements.

1. It has been suggested that unless you have the grantor's "knowledgeable enthusiasm" for the concept, you shouldn't attempt it.

D. The client should be fully aware of all of the tax risks:

1. The possible inclusion of the trust or the insurance proceeds in the client's gross estate if he or she dies within three years of a direct transfer of a policy to the trust, or if the client retains any powers (directly or indirectly) over the trust or the policy (even as a fiduciary).

2. The risks involved in relying on the Crummey withdrawal power as a means of securing the gift tax annual exclusion.

   a) And that assuming the annual exclusion is obtained, the fact that gifts made under the Crummey withdrawal provision would "use up" the grantor's annual exclusion to the donee of the power for that year.

   b) And the potential transfer tax implications (both gift and estate) of the power for the powerholder.

3. The unresolved income tax issues relating to the treatment of the Crummey powerholders as owners of the trust for income tax purposes.

   a) Both during the insured's life and possibly thereafter.

4. The potential generation-skipping transfer tax implications of the trust, if it benefits "skip persons".

   a) And the effect of those implications on long-term trusts using Crummey powers, perhaps requiring limiting their use (to the "5 and 5” protected amount) and therefore requiring use of the insured’s unified credit.

b) Or the limited nature of the trust if it is to qualify for the non-taxable gift exception.

E. 1. The dispositive provisions of the trust agreement, both during the grantor’s life and after his or her death, should be determined and coordinated with the grantor’s other estate planning instruments.

a) Depending on the policy used to fund the trust, the terms of the trust during the insured’s lifetime may provide for distributions to trust beneficiaries.

2. The choice of a trustee (and one or more co-trustees and/or successor trustees) should be made in light of the powers given the trustee and the potential income and estate tax consequences to both the grantor and the trustee of the trust holding those powers.

a) Including the power to remove and replace the trustee.

F. The issue of funding the trust should be discussed.

1. Usually, an irrevocable life insurance trust is unfunded.

a) Except for a deposit where a <u>Crummey</u> withdrawal provision is used to obtain the gift tax annual exclusion for transfers to the trust, and such a deposit is deemed desirable for that purpose.

(1) Although most trusts rely on the policy values themselves (not a separate deposit fund) to support the donees’ power of withdrawal.

2. Although some such trusts are side-fund with other investments.

a) Which makes the issue of whether the trust is a grantor trust during the insured’s lifetime for income tax purposes critical.

b) Most will be grantor trusts (at least as to ordinary income) automatically, because trust income can be used to pay premiums on a policy on the insured’s (or the spouse’s) life, without the consent of an adverse party.

c) If grantor trust status is important, use of another, alternative income tax sensitive/estate tax insensitive power, which can be given up if needed to end grantor trust status for the trust should be used, and the use of trust income to pay premiums should be negated as a trustee power.

G. The issue of which policy or policies should be used to fund the trust must be resolved.

1. The ideal policy would be one with no (or low) lifetime values, since those will be unavailable to the insured during his or her lifetime (although they could be made available under the trust terms to other family members).

a) In some ways, individual term, group term, financed traditional whole life insurance, and split-dollar death proceeds would be preferable to paid-up, variable life policies, or single premium policies (which are intended to accumulate lifetime values), or traditional whole life policies which aren't intended to be financed (unless the "vanishing premium" or quick pay concept is used to reduce premium contributions to the policy).

b) Although, in a different sense, the "perfect" policy would need to be one which will have enough value in it to keep the policy in force until the insured's death.

(1) Arguing against any form of term insurance, financed whole life insurance, or minimum premium universal life.

c) Balancing the two seemingly contradictory analyses is often difficult for the insured and his or her advisers.

H. Any life insurance policies to be owned by and payable to the trust should be acquired by or assigned to the trust, using the required insurance company form which will vest all incidents of ownership in the policies in the trustee.

1. To the extent it is possible to arrange it, the policy should be applied for by the trustee as applicant and owner, to reduce (or perhaps eliminate) the risk of inclusion of the policy proceeds if the insured dies within three years of the policy's issuance.

a) Although still an issue, the three year risk with respect to transferred survivorship policies seems small (if either insured is alive at the end of the three year period).

I. Physical custody of the policies should be delivered to the trustee, and, after purchase or assignment of the ownership rights in the policies to the trustee, the trustee should be named as the revocable beneficiary of the policies.

1. If the trustee were named the irrevocable beneficiary of the policies, subsequent problems might arise if the trust was terminated prior to the grantor-insured's death.

J. 1. Special planning (and drafting) are needed for trusts funded in whole or in part with group term or split-dollar insurance policies, since the premiums are paid on those policies by the employer directly to the insurer and nothing is contributed to the trust against which a holder of a Crummey withdrawal power can exercise that power.

a) Unless in the case of split-dollar, the arrangement requires the insured to contribute the economic benefit amount (which would go into the trust).

b) Or unless the withdrawal power is drafted broadly enough to accommodate this situation.

2. Similarly, special drafting is needed to deal with joint-life (second-to-die) policies.

a) Neither insured may have any interests in nor powers over the trust or the policy (even as a trustee) without risking inclusion of the policy proceeds in his or her estate because of retained incidents of ownership.

K. The issue of leveraging the gift of getting cash into the trust to pay premiums must be considered and the risks of each of the techniques must be understood.

L. The grantor and the trustee must fully understand their respective roles in the on-going operation of the trust, including who is to get premium notices, how and when contributions to the trust by the grantor to allow the trustee to pay premiums are to be made, who will prepare and file the fiduciary tax returns for the trust, who will give the beneficiaries notice of their Crummey withdrawal powers, etc.