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# Current Issues in Life Insurance Planning

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# CURRENT ISSUES IN LIFE INSURANCE PLANNING

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# CURRENT ISSUES IN LIFE INSURANCE PLANNING

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

A. Gifts of Insurance in General.

1. The economics favor gifts of some types of insurance.

a) The best candidates have the lowest lifetime value potential.

(1) And the largest ratio of death benefit to total investment.

(a) Such as group term, individual term, financed whole life, so-called "quick pay" whole life, or minimum premium universal life.

(i) Universal life policies may be especially attractive, since premium payments could be adjusted as needed, to fit the gift tax results desired.

(b) As discussed below, the use of a split-dollar arrangement will lower the gift tax consequences of the transfer of the insurance proceeds and therefore increase the transfer tax "spread".

(i) Although, as noted below, the possible taxation of any policy "equity" would produce negative gift tax leverage.

(2) Although the risk with such products is that they may not be kept in force for the long-run, wasting any transfer tax credits or exemptions allocated to the trust which owned them.

(a) Getting the insured to pay more into the policy than is required to maintain it may be worthwhile, to assure that it will remain in force throughout the insured's lifetime.

(i) Offset by the increased transfer tax costs of such increased premium payments.

(ii) Not an easy sale, unless the insured can be made to think about his or her insurance as something other than a commodity.

b) The worst candidates are heavily investment-oriented (and therefore non-death benefit-oriented) policies (with the ability to vary premiums to fit transfer tax needs).

(1) With the smallest ratio of death proceeds to cash values.

(a) Such as single premium or truly paid-up insurance.

(i) Again, loss of access to those values and the large gift associated with their use makes them unattractive gifting candidates.

c) The most difficult choices are policies with a mixture of death benefit and lifetime values.

(1) Such as non-financed traditional insurance, variable life policies, etc.

(a) In fact, variable life may be a policy type to be considered for gifting, if, over time, the equity-based investments inside the policy grow in value enough to "force up" the death benefit (to keep the policy qualified as life insurance), which would occur without transfer tax consequences.

(i) That cash value growth also might allow the insured-grantor to reduce or terminate gifts to the trust to continue to pay premiums due on the policy, since the trustee could access these values to pay premiums.

(b) And if the variable policy is built on a universal type frame, the ability to reduce or eliminate premium payments as cash values grow could, again, help fit gifts within available exclusions, exemptions, or credits.

d) Joint life policies may be ideal candidates.

(1) Because of the premium reduction available when compared to individual life policies(with the ability to vary premiums to fit transfer tax needs).

(a) Meaning smaller annual gifts will be required to keep the policy in force.

(2) Also, because they are available for rated or even otherwise uninsurable clients.

(3) And also, as noted below, because of the reduced gift (and therefore the increased transfer tax leverage) resulting from using a split-dollar arrangement with such policies.

(a) Although, as discussed below, the taxation of policy equity would decrease the potential transfer tax leverage.

(4) Especially if they are variable universal policies.

2. Tax aspects.

a) Gifts of appreciation are the only gifts that make sense after TRA 76.

(1) The unique spread between the lifetime and deathtime values of life insurance makes it a perfect candidate for gifting (to a trust or otherwise).

(2) Again, joint life policies may offer this spread in a unique form.

(a) For the reasons noted above.

b) Annual premium gifts could be arranged to fit the gift tax annual exclusion.

(1) Where that technique is planned for.

(a) Again, especially in universal type policies.

c) It is the transfer tax "leverage" available through the use of insurance inside a trust which makes the transaction attractive.

(1) Moving insurance proceeds outside of the transfer tax system, at as small a gift tax cost as is possible for as long as is possible (subject to possible generation-skipping tax implications).

(a) The insured is allocating transfer tax exclusions, exemptions and credits to policy premiums to exempt policy death proceeds from transfer taxes for as long as is possible.

(i) And again, using split-dollar to potentially further reduce the measure of the gift and the extent of the leverage.

(ii) And also considering the use of a variable policy to provide the opportunity to allow policy value growth and to force up the death benefit, without transfer tax consequences.

(iii) Again, using universal type policies may make sense.

B. 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 or split-dollar arrangements.

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

(i) Including, if TAM 9604001 is correct, the policy equity in split-dollar plans, on an annual basis.

2. Gift tax valuation of policies.

a) The replacement cost rule.

(1) Approximation by the interpolated terminal reserve formula.

(a) Reg. Sec. 25.2512-6(a).

(2) Note the effect of a terminally ill (or perhaps even a rated) insured on replacement cost (and therefore the gift tax value of the policy).

b) Again, gifts of cash to allow the trustee to acquire the policy will avoid this 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) Because of a policy transfer in which the policy loan exceeds the donor's cost basis.

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

b) The risks in this situation are:

(1) A taxable gain on the transfer.

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

(3) Both.

c) There is a safe harbor.

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

(2) A gift to an intentionally defective grantor trust (which most insurance trusts would be anyway, because of violating Section 677(a)(3)) may be an alternative solution.

(a) On the theory that there can't be income tax consequences in transactions between a grantor and his or her grantor trust and/or 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).

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

(b) Or, alternatively, that there is no transfer for value to such a trust, based on a broad (some would argue overly broad) reading of 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.

d) Because of the personal interest deduction limits of Section 163, policy loans won't often be used as often, but still may be if the gift tax value reduction is important enough.

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) Perhaps except where the gift is to a group of donees who must act together to exercise policy incidents of ownership.

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.

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) There was no notice to or knowledge by the donees.

(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:

(a) Notice.

(i) 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.

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

(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 intentionally defective grantor trusts, which goes back to 1981.

(a) Rev. Proc. 99-3, 1999-1 I.R.B. 5.

(i) Rulings are still being issued outside the so-called "super trust" area.

(4) Legislative or administration proposals which, if adopted, would effect the use of Crummey powers.

(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) A final one (in many ways) 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.

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.

e) (1) Ltr. Rul. 9045002 dealt with withdrawal powers held by direct 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 Cristofani Estate v. Commissioner, 97 T.C. 74 (1991), a unanimous Tax Court allowed exclusions for the decedent's children who were current income beneficiaries and for her grandchildren who were contingent remainder beneficiaries.

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

(b) Cristofani 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 Crummey powerholders; the AOD acquiesces in the result of Cristofani only — it also indicates that the next "worst" (i.e., 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 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.

(a) Ltr. Rul. 9628004 illustrates the "substance over form" approach being taken by the Service in this area.

(i) There, in apparent dicta, 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.

(ii) 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.

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

(5) Also note the Clinton Administration's proposal, as part of its 1998 Budget, to eliminate Crummey powers for gifts made after 1998 (even to prior trusts); no such proposal was made in the 1999 Budget.

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, 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.

(b) Also note the increase in this limit as the gift tax annual exclusion is adjusted for inflation by TRA 97; drafting for that possibility may be difficult.

(2) Accordingly (except for the amount unwithdrawn for the year of death), 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, the same guideline may apply to <u>all</u> powerholders in long-term Dynasty Trusts.

(3) 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.

(b) But, the powerholders have potentially lapsed/released a general power of appointment for both gift and estate tax purposes.

(i) Creating gift and/or estate tax problems for the powerholders.

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

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

(i) Special (testamentary) powers of appointment.

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

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

(ii) 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.

(a) 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.

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

(c) 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).

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

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

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

(a) 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.

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

(a) 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.

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

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

(a) 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.

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

(i) 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.

(a) 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 <u>entire</u> transfer, requiring allocation of his or her GST exemption to the entire gift, to give the trust a zero inclusive ratio for the trust.

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

(a) And the powerholder's GST exemptions will have to be allocated to that excess.

(b) Subject to the effectiveness of that allocation under the ETIP rules, noted above and described below.

(iii) As 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) is the most conservative planning technique in such trusts.

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

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

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

(iv) The only other practical alternative is to use full, hanging Crummey powers and risk inclusion of any hanging amount outstanding at a powerholder's death in his or her estate.

(a) Recognizing that three isn't any authority for the concept.

(v) 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.

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

(4) 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 such trusts, since they 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, because 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 grantor of his or her spouse, under Section 677(a)(3).

(a) Under Section 678(b), the insured - as the real grantor 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).

(3) Ltr. Ruls. 8142061, 8521060, 8701007 and 8805032.

(a) These articulate the Service's "deemed" withdrawal and recontribution theory.

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

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

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

(b) 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.

(4) Impact of TRA 86.

(a) Intentionally defective grantor trusts no longer make sense for passing through any interest deduction on policy loans to the grantor, because of the personal interest deduction limits of Section 163.

(b) But consideration should be given to continued use of the defective grantor trust concept, to have the insured be treated as the owner of the trust for income tax purposes, even after TRA 86, which, again, will likely continue to be true because of Section 677(a)(3).

(i) To allow the insured to pay the tax on any trust income (and thereby make an additional "gift" to the trust), arguably without transfer tax consequences (since he or she is only discharging a direct tax obligation).

(a) Note the Service's inconsistent positions on this issue in recent private letter rulings. See Ltr. Ruls. 9444033 and 9543049.

(b) Note also the economic impact of this result on the grantor.

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

(iii) And also, to consider this trust as the purchaser or seller of assets to or from the grantor, without tax consequences to either.

h) 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 (for split-dollar arrangements).

(b) Measure of the gift.

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

(ii) Under Rev. Ruls. 78-420 and 81-198, above, the "economic benefit" or the income tax effect of the split-dollar arrangement on the insured employee.

(a) The lower of the PS 58 rate or the insurer's generally available, published term rates for single life policies and the PS 38 rate for survivorship policies (while both insured are alive).

(b) 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 TAM 9604001 taking that position.

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

(a) The PS 38 rates.

(i) What about alternative term survivorship rates?

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

(2) Drafting and planning issues in using Crummey withdrawal powers.

(a) There may be no contributions to the trust.

(i) Arranging for contributory split-dollar plans.

(ii) Special drafting of the withdrawal power.

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

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

(i) Again, arranging for contributory plans.

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

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

(i) Arguing for planning for lifetime rollouts.

(b) The taxation of policy equity under TAM 960001.

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

(i) In equity arrangements, if the equity isn't taxed each year under TAM 9604001.

(ii) In modified endowment contract arrangements.

(iii) Basis issues for rollouts relying on policy withdrawals.

(d) Avoiding both issues by early rollouts during the insured's lifetime, possibly using non-policy values.

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

6. a) Multiple donees.

(1) Pro rata withdrawal rights.

(2) An ordering rule.

b) Ascertainable withdrawal rights.

(1) Rev. Rul. 80-261, 1980-2 C.B. 279.

C. 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 intentionally defective trust (avoiding both the application of Section 2035 and the transfer for value rule, under its carryover basis exception).

(2) The issue of indirect transfers 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 or split-dollar 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.

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.

(a) Or even powers to remove and replace the trustee.

(i) 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.

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

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

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

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

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

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

(c) 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.

(d) 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 grantor status.

(a) Beneficiaries contributing to the trust.

(i) Including indirectly by lapsing Crummey powers in excess of the Section 2514(e) protected amounts.

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

(b) The reciprocal trust doctrine.

(i) An important planning issue.

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

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

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.

(a) 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.

(i) 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(2) to apply to the proceeds.

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

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 grantor-insured should not be the trustee, be able to become the trustee, or 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 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.

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 policy transfers within three years of 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) And, again, possibly for sales (rather than gifts) to intentionally defective trusts.

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) The agent of the insured or the conduit theory.

(a) Detroit Bank v. U.S., 467 F.2d 964 (6th Cir. 1972); the trustee was held to be acting as the insured's agent for the purchase of the policy.

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

(4) 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 is unclear; however, the Sixth Circuit in Headrick rejected the Service's alternative agency argument.

(5) 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.

(6) 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. See also Ltr. Rul. 8806004.

(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 a corporation which owned a policy.

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

(1) Ltr. Rul. 8724014.

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) Not using the insured's funds, if possible.

(b) 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.

5. Community property issues.

a) 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 or group term insurance 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.

D. Generation-Skipping Transfer Tax.

1. In general.

2. The $1,000,000 GST exemption, as indexed for inflation under TRA 97.

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

3. Exempt transfers.

a) The original Section 2642(c) exemption for "non-taxable" gift tax annual exclusion gifts.

(1) Limited by TAMRA 88 for 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 using 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 $1 million GST exemption, indexed for inflation beginning in 1999 (doubled if gifts are split with a spouse, if he or she makes an independent gift, or if 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 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 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), and 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.

(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 to 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 be needed to 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) For long-term (rule against perpetuities) trusts, this procedure will be required to exempt the trust, now that TAMRA 88 restricts the non-taxable gift exemption for gifts to trusts.

(ii) This will require filing a gift tax return and using up some of the insured's unified(s) 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 counter-productive, 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.

(a) See Rev. Rul. 81-198, above.

(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.

(a) Especially the reverse leverage implications of TAM 9601004.

e) 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.

f) 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 Crummey 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 automatically, because trust income can be used to pay premiums on a policy on the insured's (or the spouse's) life.

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 <u>unavailable</u> 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 <u>revocable</u> 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 <u>directly</u> to the insurer and nothing is contributed to the trust against which a holder of a <u>Crummey</u> 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 grantor and the trustee must <u>fully understand</u> 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 <u>Crummey</u> withdrawal powers, etc.

## III. DRAFTING SUGGESTIONS FOR USING IRREVOCABLE LIFE INSURANCE TRUSTS.

A. Some argue that the trust should avoid using the words Life Insurance in its title and should not <u>require</u> the trustee to obtain insurance on the grantor's life, on the theory that it helps avoid the indirect transfer/agency theories for including policies acquired by the trust within three years of the insured's death.

1. Query as to whether such a transparent mechanism would really help.

    a) Or whether it is necessary under the current state of the law, given the demise of the beamed or indirect transfer theory under the current version of Section 2035.

B. The trust must, by its terms, be expressly irrevocable and unamendable by the grantor.

1. Of course, however, others may be given powers to change the trust (either indirectly by exercising powers of appointment, or directly under a power to do so granted in the trust to a "trust protector").

C. The trust should specifically provide that ownership of all policies of insurance transferred to the trustee or purchased by the trustee is to be vested in the trustee and that the grantor relinquishes any and all rights in any policies transferred to or acquired by the trust.

D. 1. The trustee should be given broad powers to specifically deal with any insurance policies owned by the trust during the insured's lifetime (in addition to the usual trust powers granted to the trustee).

2. The trust should expressly provide how the trustee is to pay premiums due on the policies held by the trust during the grantor-insured's lifetime.

3. The trustee should be given the power to dispose of the policies, exercise any ownership rights (such as surrender of the policies, conversion into paid-up policies, etc.) or (so long as the trustee is not a beneficiary) terminate the trust and distribute the policies directly to the trust beneficiaries, in the event funds in the trustee's hands are insufficient to pay the premiums and the grantor or any other donor fails to supply additional funds necessary to make the premium payments.

    a) Alternatively, the trustee could be given directions as to how to proceed in such an event.

4. The trustee should be exonerated from any obligation to make any future premium payments if trust funds are inadequate, and should be indemnified against any liability for failing to do so.

E. The trustee (again, if not a beneficiary) could be given the absolute discretion to terminate the trust and distribute the trust assets (that is, the insurance policies) to the beneficiaries of the trust at any time during the insured's lifetime.

1. As an escape valve if the trust becomes uneconomical or otherwise undesirable, to insure that the future premium payments will thereafter

qualify for the gift tax annual exclusion if the Crummey withdrawal provision fails to achieve that result, etc.

a) A "special" trustee or a "trust protector" might be used to exercise this power.

F. 1. Consideration should be given to granting a trust beneficiary (traditionally, the grantor's spouse) a special power of appointment (i.e., one exercisable to other than the donee of the power, his or her estate, or the creditors of either) over the assets of the trust during the grantor's lifetime (the policies), as a way of building in additional flexibility to allow the insurance policy or policies owned by the trust to be withdrawn.

a) To be safe, the grantor probably should not be a permissible appointee.

b) Note the impact of potential marital disharmony on the wisdom of giving such a power to the grantor's spouse.

(1) If the donee of such a power is the spouse of the insured, consideration should be given to terminating that power in the event of the dissolution of the marriage of the grantor and the donee of the power.

(a) Such a special power could be limited to distribute the policies among the descendants of the grantor (which might reduce the grantor's concern about its exercise after or during a divorce).

c) In any event, having a back-up holder of that power would make sense, either because of divorce or the death of a spouse.

2. To avoid creating estate tax problems for the donee of the power, the power should not be exercisable with regard to any policies of insurance insuring the life of the donee held by the trust.

a) Again, including one insuring the life of the donee and the grantor jointly — i.e., a joint, second-to-die policy.

G. 1. a) Where Crummey withdrawal provisions are used for gift tax annual exclusion purposes, the trust should specifically provide that, during the life of the grantor, each direct (or indirect) transfer to the trust (including the initial transfer of an insurance policy or cash) up to a specified dollar limit each calendar year will be subject to withdrawal by the beneficiaries of the trust estate created under the irrevocable trust agreement.

b) The dollar limits could be tied to the lower of the amount of the annual exclusion (including gift-splitting) or the $5,000/5% lapse protection amount. Alternatively, the donor could determine the dollar limit of the withdrawal right each year, to react to increases in the lapse protection or annual exclusion amounts (although note the retained transfer tax power issue in using this technique).

c) Consideration should be given to granting the donees the power to withdraw more than the $5,000/5% protected amount in any year, in light of the higher gift tax annual exclusion amounts available to the grantor (and his or her spouse).

(1) Note the gift and estate tax issues this raises for the donees, since Crummey withdrawal powers are general powers of appointment.

(2) Giving them a special testamentary power over their interest in the trust or using a "hanging" power should solve the gift tax issue for them (although note the IRS position that what may have been a typically worded hanging power is ineffective to prevent an unprotected lapse); the estate tax issue generally is a major planning problem only if a donee dies after the insured but before the trust ends, and in any event is only a problem if the donee's interest in the trust would attract an estate tax if the donee were a grantor of the trust.

(a) If the hanging power technique is used, the estate issue for the powerholder should vanish at the death of the insured(s), since 5% of the death proceeds should be large enough to "use up" any portion of the powers still then hanging.

(3) Note that any such power held by the insured's spouse should in any event be limited to the lapse protection amount in any year, to avoid estate tax consequences to the spouse.

(4) The GSTT implications of such powers also needs to be considered, especially in a long-term trust where estate tax avoidance at each generation is desired; in these trusts, limiting the withdrawal rights to the lapse protection amount may be the only safe course.

(a) Limiting the withdrawal powers to the lapse protection amount for all beneficiaries will avoid any transfer tax consequences to them of unprotected lapses of the powers.

(b) It will also avoid issues as to the identity of the GSTT transferor; the donor of the gift will be the GSTT transferor of the entire gift, and his or her GST exemption will need to be allocated to the entire gift (including that part subject to the 5 and 5 Crummey withdrawal rights) to produce a zero inclusion ratio for the trust.

(c) Finally, it will avoid any potential ETIP problems for the GSTT transferor for withdrawal rights granted to his or her spouse, under a specific exception to the spousal ETIP rules in the Final GSTT Regulations.

(5) In trusts relying on the non-taxable gift exception from the GSTT, Crummey powers can be used up to the full annual exclusions available.

2. This provision could allow the donor to prevent the withdrawal right from applying to any specific transfer to the trust (although again note the retained power issue of this technique), should provide that the withdrawal right is non-cumulative and lapses within some reasonable period of time (30 or 45 days), and should provide that if the beneficiary of the withdrawal right is under a legal disability of any kind, the withdrawal right is to be exercised by his or her legal guardian or natural guardian (probably other than the donor).

3. In addition, it should require the trustee to notify the beneficiary of any addition to the trust which triggers such withdrawal right (or should otherwise insure that the beneficiary has actual notice of each such addition), should require the trustee to retain sufficient liquid funds or transferable assets (including insurance policies) at all times to satisfy that demand right, and might provide that the bankruptcy of a beneficiary automatically forfeits his withdrawal right (although note the possible invalidity of this provision).

4. Finally, this provision needs to be coordinated with the trustee powers provisions and all termination or withdrawal provisions exercisable during the grantor's lifetime, to insure that the exercise of those powers will not defeat the beneficiaries' withdrawal rights while they are outstanding.

H. 1. Under pre-TRA 86 law, where a defective grantor trust was intended, so that the grantor could obtain the interest deduction personally for interest paid by the trustee on policy loans, the trust might have provided that the trustee had to (or could) use the income from the trust to pay premiums on the grantor-insured's life.

2. Alternatively, or in conjunction with that provision, an individual trustee who was neither independent nor adverse, such as the grantor's brother or sister (who was not a beneficiary of the trust), was used as the trustee of the trust during the grantor-insured's lifetime, and was given the power to distribute principal among trust beneficiaries.

3. Finally, the trust might have required that the trust income earned during the grantor's life be paid to his or her spouse (but not so as to discharge his or her obligation of support in any way).

4. Again, because of the impact of the personal interest disallowance rules, there is no necessity for such provisions in trusts being drafted currently for the interest deduction pass-through.

    a) However, there are other continuing reasons for use of these provisions, as indicated below.

I. The trust should either provide that any net income (and/or principal) of the trust estate during the lifetime of the grantor will be paid to the beneficiaries of the trust estate (or accumulated and either used and applied for their benefit if they are then under a legal disability or added to principal), or used to pay policy premiums, if the defective grantor trust concept makes sense for reasons other than the interest deduction.

1. If the policy chosen has the potential for increases in its cash surrender value during the insured's lifetime (a variable policy, for instance), making those values available for distribution to the trust beneficiaries during the insured's lifetime may make sense.

2. Under pre-TRA 86 law, many such trusts included a provision allowing the trustee to use the income from the trust assets to pay premiums on such policies, where the defective grantor trust provision was utilized in an attempt to obtain the deduction for interest on policy borrowings for the grantor.

    a) Because of the impact of the personal interest deduction disallowance rules of TRA 86, this type of provision doesn't make sense for the interest deduction pass-through in trusts being currently drafted.

(1) Accordingly, in many such trusts, any such income is directed to be accumulated or paid out to the trust beneficiaries.

3. However, this type of provision may still make sense for other reasons, notably preventing the Crummey powerholders from being treated as the owners of the trust for income tax purposes allowing the insured to pay the tax on trust-generated income (apparently without transfer tax consequences), and perhaps avoiding tax consequences on sales of assets to or from the grantor.

J. The trust should provide that, upon the death of the grantor, the trustee is to collect the proceeds of all policies of insurance made payable to the trustee and is to have all powers necessary to do so (including the power to institute litigation, if necessary).

K. 1. The trust should provide that any required distributions to trust beneficiaries after the grantor's death should be deferred for three years (as an example) after the death of the survivor of the grantor and his or her spouse, to be sure that the insurance proceeds can be made available to the estates of the grantor and his or her spouse to pay estate taxes and other costs, if needed.

2. a) Consideration should be given to adding flexibility to the irrevocable life insurance trusts definitionally, by describing beneficiaries rather than naming them — including any children or grandchildren of the grantor-insured living at the date of his or her death, even if not living at date of creation of the trust, and by describing the grantor-insured's spouse as any person who is his or her spouse at his death, whether or not that person is his or her spouse at the time of creation of the insurance trust agreement.

b) Although note the possible (but weak) argument that that type of definitional flexibility gives the grantor-insured a power to change the beneficial enjoyment of the trust property which might be argued to be a retained transfer tax power.

(1) And the possible embarrassment such a provision might cause — especially generically defining the grantor's spouse.

3. The trustee should be authorized (but not required) to purchase assets at fair market value from the probate estate of the grantor (or his or her spouse) or from his or her revocable trust (or that of his or her spouse), or to lend money to any such estate or trust (with adequate interest and

security), to make the liquidity of the insurance proceeds available to the estate or trust to pay estate taxes and other costs.

a) The trustee might, in an appropriate case, also be authorized to pay the taxes and costs directly, if the beneficiaries of the trust and the estate are <u>identical</u> (which should preclude gift tax problems arising from such payments).

(2) Although such a provision, to the extent used, might include a part of the proceeds in the insured's estate for estate tax purposes.

b) The trustee should <u>never</u> be required to pay the insured's debts or taxes.

4. The trust should provide for the possible merger of the trust estate or trust estates created under the trust agreement with other trust estates created by the grantor-insured, such as the residuary trust in the grantor-insured's Will or revocable trust agreement, if the beneficiaries' interests in those trusts are substantially identical.

a) And the merger won't cause adverse tax consequences (such as a mixed inclusion ratio for the merged trust for GSTT purposes).

L. 1. The grantor should never be a trustee or a co-trustee (nor ever be able to become one).

a) Because of the risk that the hoped-for estate tax advantages of the trust would be lost in the grantor-insured's estate.

(1) Note the on-going problem of the grantor even having the power to remove a corporate trustee and replace it with another corporate trustee, in a trust funded with insurance on his or her life (even after that power was approved by the IRS in non-insurance trusts without adverse tax consequences).

b) Anyone who is an insured or a co-insured under any policy owned by the trust should not be (nor become) a trustee.

2. Consideration should be given to a provision allowing the trust beneficiaries to remove and replace corporate trustees (but not to allow them to appoint themselves as trustees, unless they could have seen a trustee originally without transfer tax consequences).

a) So long as the trustee has only ascertainable standard encroachment powers, there should be no effect of such a provision on the beneficiary for estate tax purposes at his or her death, since he or she could have been the trustee in any event.

M. 1. Assuming that the irrevocable insurance trust is not to be the major estate planning document in the grantor-insured's estate plan (that is, his or her Will or revocable trust will not pour over to the irrevocable insurance trust), consideration should be given to the inclusion of a contingent marital deduction bequest or trust in the irrevocable life insurance trust agreement if the insurance proceeds or the trust assets (despite planning) are determined to be includible in the grantor-insured's gross estate.

a) If the trust continuing after the grantor's death would qualify as a QTIP trust, that status could be totally or partially elected by the trustee, if some or all of the policies were includible, as an alternative to a separate contingent marital disposition.

(1) But note that the QTIP election (whether partial or total) must be made within nine months of death, before it will be finally determined the policies will (or won't) be includible in the insured's estate for estate tax purposes.

b) For survivorship policies, the risk is a major one only where the grantor-insured dies within three years of a direct transfer to the trust, and the other insured has already died; if the other insured survives the grantor-insured, it would likely be preferable not to use such a contingent tax clause (to avoid needlessly including the proceeds of the policy in the survivor's estate for estate tax purposes).

c) Any unwithdrawn amounts due Crummey powerholders (whether current or "hanging") should be paid out to them prior to funding any contingent marital disposition.

2. In addition, the tax clause in the grantor-insured's Will or revocable trust agreement should be reviewed, to be sure that the contingency of the insurance proceeds or the trust assets being includible in the grantor-insured's gross estate for federal estate tax purposes has been dealt with.

a) If more than, for instance, one-quarter or one-third of the grantor-insured's taxes are attributable to any transfers made during lifetime, those taxes could be fully apportioned, rather than being paid out of the residue of the grantor's probate estate or revocable trust.

N. The trust should specifically provide for additions to the trust by the grantor (or perhaps by anyone else but only with the consent of the trustee), including other policies of insurance on the life of the grantor.

O. 1. The trust should contain a provision indicating the grantor's intention that the trusts created under the trust agreement are intended not to be included in the gross estate for federal estate tax purposes and that therefore all provisions of the trust agreement be construed and the trusts be administered so as to carry out that intention.

2. The trust should negate the existence of any powers which would cause the grantor to be taxed on the income of the trust under Section 675 (relating to administrative powers), assuming grantor trust status is to be (and can be) avoided.

3. The trust should limit the powers and authorities granted to the trustee to those which will prevent the trust estate from being includible in the grantor's gross estate for federal estate tax purposes.

4. The trust should specifically prohibit the principal and income of any trust estate created thereunder from reverting to or being distributable to the grantor or his or her estate, from being applied or distributable for the support of a beneficiary whom the grantor is legally obligated to support, or otherwise used and applied for the benefit of the grantor.

P. Finally, of course, the trust ought to be executed, delivered and acknowledged in accordance with local law.

## IV. SOPHISTICATED LIFE INSURANCE PLANNING

All sophisticated life insurance planning involves not having the insured(s) own any incidents of ownership in the policies insuring his, her, or their lives at death (and to the extent possible, not ever having owned incidents of ownership in any such policy and transferred those incidents of ownership within three years of death). In general, the owners involved in sophisticated life insurance planning are an Irrevocable Insurance Trust, or the sometimes suggested alternative of key person coverage for a partnership in which the insured is a partner.

The most usual form of sophisticated life insurance planning involves using an Irrevocable Insurance Trust. In its simplest format, that trust may own a policy on the life of an insured, to be held for the benefit of his or her surviving spouse and descendants. In a more complex format, it may involve a trust funded with a survivorship policy, insuring a Donor and his or her spouse, for the benefit of their children and lower-generation beneficiaries. A split-dollar arrangement — usually between the insured(s), his or her employer or owned entity (or even an individual or a trust), and his or her insurance trust — is sometimes used with either type of policy to increase the potential transfer tax leverage of the transaction, as are other "financing" techniques, described below. Finally, the use of a variable, universal policy may also increase the potential for transfer tax leverage.

A. An Irrevocable Insurance Trust Funded with a Single Life Policy.

This type of life insurance planning begins with the creation of an irrevocable life insurance trust, to be both the owner and the beneficiary of a policy on the life of the Donor/insured; where possible, it is usually planned to have the trust be both the initial applicant and owner of the policy, to attempt to avoid the application of Section 2035(a) to the transaction, if the insured were to die within three years of the initial policy acquisition. [1/]

The use of an irrevocable insurance trust as the owner and beneficiary of a life insurance policy insuring the life of the Donor/insured for the benefit of his or her spouse and/or children or other descendants may have income, gift and estate tax consequences to the Donor/insured and in some cases to the trust beneficiaries (where Crummey powers are used to obtain the gift tax annual exclusion for gifts to the trust); the generation-skipping transfer tax consequences of such a trust which benefits "skip persons" are described below.

For gift tax purposes, both the transfer of a policy to the trust and contributions of cash to the trust to allow the trustee to pay policy premiums are gifts by the Donor/insured for gift tax purposes. Whether those gifts will qualify for the Donor/insured's gift tax annual exclusion and, where available and appropriate, of his or her spouse, provided under Section 2503(b), will depend on whether the interests of the trust beneficiaries are "present interests"; in an irrevocable insurance trust, the only effective way to provide present interest status for the interest of the trust beneficiaries is the use of so-called Crummey withdrawal powers —powers given trust beneficiaries to withdraw limited amounts from the trust for a limited

1/ Whether anything short of arranging the transaction that way would work isn't clear; for instance, would a full value sale to an intentionally defective trust avoid both the three year transfer rule and the transfer for value rule?

period of time (usually 30 or 45 days), each time a direct or an indirect gift to the trust is made.[2/]

While the use of Crummey withdrawal powers benefits the Donor/insured, by allowing use of his or her gift tax annual exclusion (and that of his or her spouse) to protect gifts to the trust (and therefore avoiding use of Applicable Credit Amount(s) or payment of gift tax), such powers are general powers of appointment for both gift and estate purposes in the hands of the Donees of the powers. As such, they may have gift and/or estate tax consequences to those Donees (to the extent not limited to the Sections 2514(e) and 2041(b) \$5,000/5% protected amount).[3]

In addition, they may well cause those Donees to be treated as owners of the trust for income tax purposes (regardless of the amount subject to withdrawal by them). If, however, the trust only owns a life insurance policy, there won't be income to report, even if the trust does have income to report; if the Donor is treated as the owner of the trust for income tax purposes, as he or she would be in most irrevocable insurance trusts — because trust income is available to pay policy premiums[4/] - that will control. That will treat the Donor, rather than the powerholders, as the owner of the trust for income tax purposes[5/] — which may make transfer tax sense, since if the Donor is taxed on trust income generated by any non-insurance assets he or she will effectively be adding to the value of the trust (by paying the tax on its income), arguably without transfer tax consequences.

Lapses of the withdrawal powers by the Donees are treated as releases by them (to the extent they exceed the \$5,000/5% lapse protection amount),[6/]

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2/ Note the Administration's budget proposal to eliminate the exclusion for any gift to a trust.

3/ Actually, the greater of \$5,000 or 5% of the trust principal; in the early years of most insurance trusts, the \$5,000 amount will be the limit.

4/ Either because it is required to be so used, or may be so used, in the discretion of a non-adverse party.

5/ If the trust income exceeds premiums paid, it isn't clear that the excess would be taxed to the grantor under the grantor trust rules. There is old authority which indicates it would be taxed to the trust - in those cases, the taxpayer wanted that result; today the grantor may be arguing for the opposite result.

6/ Note that only lapses of the powers, not releases, are protected by the \$5,000/5% lapse potentially resulting in a gift of a future interest by the Donee and causing the Donee to be treated as a potential partial grantor of the trust for estate tax purposes. The gift tax issue for the Donees may be solvable (through the use of special powers of appointment or so-called "hanging powers"),[7/] but the estate tax issue for them usually isn't.[8/]

In non-Dynasty trusts, the estate tax issue for the holder of the power may not be a major concern (unless the Donee dies before the insured and before distribution of the trust— and then only the policy's cash value, or a part of it, would be includible in the Donee's estate), since the trust property will eventually belong to the Donee. As discussed below, however, in Dynasty Trusts, this will be a major concern, since the trust is designed to avoid transfer taxation at each generation level — as also discussed below, not using Crummey powers in such trusts, or limiting them to the $5,000/5% lapse protection amounts of Section 2514(e), will solve this problem.[9/]

For estate tax purposes, so long as the Donor/insured holds no incidents of ownership over the trust-owned life insurance policies at death and did not relinquish any such incidents of ownership within three years of his or her death, no part of the policy proceeds should be includible in his or her estate for estate tax purposes; those proceeds will, however, be available <u>indirectly</u>

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protection amount; accordingly, Donees of the power should not actively release their withdrawal rights prior to their lapse.

7/ The special power of appointment technique makes any gift by the powerholder resulting from an unprotected lapse incomplete; the hanging power technique prevents any power from lapsing in excess of the protected amount (it "hangs" until it can be lapsed in a future year as a protected lapse — presumably either when no gifts are made to the trust or when the insured [or the survivor of the insureds] dies, since 5% of the death proceeds will be enough to work out any remaining hang). There is a third, less frequently used technique, of creating a separate trust for the sole benefit of the powerholder or his or her estate, avoiding a gift to anyone resulting from an unprotected lapse.

8/ With the hanging power technique, the amounts unwithdrawn at death would be includible; with the special power technique, a portion of the value of the trust at death would be includible; with the sole beneficiary trust technique, the value of the trust would be includible. For that reason, in every instance, any withdrawal power held by the Donor's spouse should be limited to the $5,000/5% lapse protection amount; including any part of the trust in an estate at the generation level of the insured would be counterproductive.

9/ As also discussed below, in some long-term trusts, using hanging powers may make sense.

to the insured's estate (by purchase of assets or loans) to pay debts, taxes and expenses — they can't be used to pay those taxes or expenses directly, however, without adverse estate tax consequences for the insured Donor.

In addition, so long as the insured's spouse holds no tax-sensitive powers or interests in the trust either during the insured's lifetime or after the insured's death, the policy proceeds (including both the income generated by the proceeds and some part- or all- of the proceeds themselves, if desired) can be made available to provide income and support to the surviving spouse, without causing inclusion of the trust's value in his or her estate for estate tax purposes.

In order to be safe, the insured should not be a trustee of the trust, should not have the power to remove and replace trustees (even corporate trustees),[10/] and cannot retain any other powers or interests in the trust or over the policy during his or her lifetime. The extent to which a beneficiary can be a trustee, have the power to remove and replace trustees, etc., depends on whether all distributions from the trust to that beneficiary are limited by ascertainable standards - if they are, beneficiaries can be trustees and/or have such removal powers.

## ADVANTAGES

1. The policy proceeds will be outside both the insured's estate and that of his or her spouse for estate tax purposes, subject to the possible application of the Section 2035(a) three-year transfer rule (which, as noted, can be avoided by having the trust be the initial applicant and owner of the policy).[11/]

2. The trust proceeds are available to provide income and support to the surviving spouse, even though the policy proceeds will not be includible in his or her estate for estate tax purposes (assuming he or she has no tax sensitive interests or powers in or over the trust).

10/ Given the risk of the Service's argument on fiduciary incidents of ownership, to be safe in this area, the insured shouldn't retain this right even after the Service's recent reversal of its position in this area in other, non-insurance trusts.

11/ Again, whether anything short of that will work to avoid the three year rule isn't clear.

3. As noted, the policy proceeds will be indirectly available to the insured's personal representative or other statutory executor to pay estate taxes, debts and expenses, through the use of a loan to the personal representative or the purchase of estate assets for the benefit of the irrevocable insurance trust.

   Note that in the purchase scenario, the trust may then become the focal point of the insured's plan, since it will likely acquire and hold his or her "unique" or "best" assets for the long-term — making its planning and drafting critical (and arguing against rushing the planning and drafting of this trust).

4. To the extent gifts to the trust qualify for the gift tax annual exclusion of the Donor/insured and his or her spouse, there will be no gift tax consequences to either as a result of contributions to the trust; this provides transfer tax leverage, since there won't be any gift tax consequences resulting from this arrangement and the policy proceeds won't be includible in the estate of either spouse for estate tax purposes. In any event, the transaction is leveraged, since gift tax exclusions or credits are being applied to policy premiums to exclude the proceeds from the transfer tax system for the trust term; that leverage obviously decreases the longer premiums are paid with gifts from outside the trust.

5. Although the trust must be irrevocable, definitional flexibility can be built into the terms of the trust, and through the use of special powers of appointment held by beneficiaries of the trust (and even broader powers held by independent trustees or "trust protectors"), the otherwise irrevocable document can be made responsive to future changes in tax law and family circumstances.

   In addition, although not an incident of ownership in the insurance funding the trust, the Donor/insured can always "pull the plug" on the trust by declining to make future contributions to the trust (unless the policy is paid up, premiums are no longer due in cash, the trust has sufficient funding to allow it to pay premiums due without contributions from the insured, or premiums are being paid by the insured's employer under a continuing split-dollar or group term life insurance arrangement).

6. The trust assets — the policy(ies) — may be protected from the insured's creditors during his or her life (depending on state law) and

the proceeds can be protected from the spendthrift tendencies of the beneficiary(ies), as well as the claims of their creditors and spouses, by keeping them in a spendthrift trust for their benefit.

7. The use of an irrevocable insurance trust funded with a single life policy on the life of the insured-grantor for the benefit of his or her non-U.S. citizen spouse could add flexibility to the plan for such a spouse; since the trust won't be included in the insured's estate for estate tax purposes, the restrictive QDT provisions, otherwise needed to qualify gifts in trust for the benefit of a non-U.S. citizen spouse , won't need to be imposed.

## DISADVANTAGES

1. This is a complex arrangement. The insured cannot retain any interest in the policy nor in the trust, and the policy's lifetime values are unavailable to the insured (although they could be made available to family member-beneficiaries - including the insured's spouse, if he or she weren't also an insured under the policy - during the insured's lifetime, under the terms of the trust). [12/]

2. As indicated, despite any flexibility built into the trust, it is essentially an irrevocable arrangement; the insured cannot change the beneficiary of the policy proceeds nor the terms of the trust.[13/]

3. As also indicated, there may be gift tax consequences to the Donor/insured and his or her spouse generated by contributions to the trust; in any event, those contributions will "use up" their gift tax annual exclusions for other gifts to the trust beneficiaries.

4. The use of Crummey withdrawal powers to obtain the gift tax annual exclusion requires special planning and drafting and coordination among the Donor/insured, the trustee and the trust beneficiaries, on an ongoing basis.[14/]

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12/ Whether the insured can have access to policy values through loans or other techniques with estate tax safety isn't clear.

13/ As noted below, this is one of the major arguments made for using a partnership in lieu of an irrevocable insurance trust to own the insurance.

14/ The IRS has recently signaled its renewed interest in the ongoing mechanics of giving Crummey powerholders notice of their withdrawal rights, as a condition (in its view) of

5. As also noted above, Crummey powers may have transfer and income tax consequences to the powerholders.

6. As noted above, the Donor's ability to pull the plug by withholding future premium contributions may not work as planned, if other trust assets are available to pay the premiums (or if the insured's employer is paying them).

B. An Irrevocable Trust Funded with a Survivorship Life Insurance Policy.

This planning is similar to that described above, but involves a joint life, survivorship policy, normally insuring husband and wife, which pays its proceeds only at the survivor's death.[15/] By stretching out the time for payment of the policy death proceeds to the death of the surviving insured (when estate taxes are normally planned to be due for married couples), the annual premium cost per dollar of death benefit can be reduced.

**ADVANTAGES**

1. As with any irrevocable insurance trust, the policy proceeds will be outside both insureds' estates for estate tax purposes, subject to the possible application of the Section 2035(a) three year rule (if the grantor of the trust dies within three years of a direct gift of a policy to the trust, and the other insured is not then living).[16/]

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qualifying gifts to the trust for the gift tax annual exclusion. In addition, it has also indicated its concern that the withdrawal powers be intended to provide the powerholders with immediate access to the amounts withdrawable, in order to qualify gifts to the trust for the gift tax annual exclusion. That concern is reflected in the other interests of the powerholders in the trust and evidence of the existence of any implicit agreement or understanding between the Donor and the powerholders about their ability to make withdrawals; to the extent a powerholder has no other interest in the trust (or, in the Service's view only a remote interest in the trust), such an understanding will likely be presumed — since there isn't any rational economic reason for such a powerholder not to withdraw (other than such an understanding).

15/ A similar (but not identical) result can be obtained by using a survivorship rider on a single life policy, giving the policy owner the choice between the policy death proceeds or a new policy on the surviving spouse's life (for some multiple of the original face amount); there, premiums will not be lower and split-dollar will not be an added benefit, both of which would be true in a survivorship arrangement.

16/ If the other insured is living then, it appears that no part of the policy proceeds would be

2. Again, this provides "leverage" of the allocation of exclusions, Applicable Credit Amounts and/or GST exemptions to policy premiums, to exempt policy death proceeds from transfer tax.

3. As indicated, the use of joint life policies increases the leverage potential in the transaction, by reducing the premium cost per dollar of death proceeds; as discussed below, because of special rules applicable to the valuation of the benefit provided in a survivorship policy, a split-dollar arrangement with a survivorship policy provides further leverage by reducing the gift tax cost of the transfer while both insureds are alive, (in many cases, dramatically).[17/]

4. The joint life policy proceeds can be indirectly available to provide the liquidity needed at the survivor's death to pay estate taxes (when most married couples' plans provide that they will be due).

5. A joint life policy may allow a rated (or even an uninsurable) client to obtain insurance at something approaching standard rates.

6. Most such policies are "splittable" in the event of divorce or a change in the estate tax unlimited marital deduction provision.[18/]

7. Some survivorship policies provide an increase in cash surrender values at the first death, reducing (or eliminating) the need to continue to pay premiums thereafter.

## DISADVANTAGES

1. This is a complex arrangement, with all of the general disadvantages of any irrevocable insurance trust arrangement, as described above.

   Here, neither insured can retain any interest in the policy or in the trust; the policy's cash values are unavailable to the insureds (although they could, under the terms of the trust, be made available

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includible in the deceased grantor's estate, because there are no death proceeds to which Section 2042 could apply, through the application of Section 2035(a).

17/ As described below, use of a split-dollar arrangement with any type of policy reduces the gift tax consequences of providing the death benefit to the trust from the full premium to the "economic benefit" of the arrangement to the insured-employee.

18/ Note that planning for that possibility in drafting the trust should be considered.

to children or other family members during the insureds' lifetimes), and they cannot change the beneficiary of the death proceeds or the terms of the trust.

2. Contributions to the trust are gifts for gift tax purposes and will use up gift tax exclusions and/or Applicable Credit Amount(s) and/or will require payment of gift tax.

3. The death proceeds are unavailable to provide support for the surviving spouse or to the estate of the first insured to die (to pay any debts or taxes then due).

4. Paying policy premiums after the death of the wealthier spouse/bread-winner may be an economic issue (unless the trust has sufficient other assets and/or policy cash values are then large enough to be used to continue premium payments, without further contributions from the survivor).[19/]

C. More Complex Irrevocable Insurance Trust Planning.

The next step in sophisticated irrevocable insurance trust planning involves the use of a split-dollar arrangement between the insured's corporate employer, a corporation in which he or she is a shareholder, or partnership in which he or she is a partner,[20/] and the insured's irrevocable insurance trust to further leverage the gift, estate and generation-skipping tax advantages of the irrevocable insurance trust which owns the survivorship policy.[21/] That arrangement requires the employer (or other premium

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19/ Or, unless as noted below, a split-dollar arrangement with respect to the policy continues after the death of the insured employee.

20/ The Service has ruled that a private, contributory, non-equity split-dollar arrangement created no income or gift tax consequences to the insured or his spouse (the premium provider), since she was entitled to get back her advances or the policy cash values, apparently without reaching the gift tax issue of the interest-free nature of the advances. It has also similarly ruled on the use of a private split-dollar arrangement between both insureds in a survivorship policy and their trust, where the insureds provided the premiums, under a "restricted" collateral assignment arrangement. Both rulings involved contributory, non-equity arrangements; whether equity arrangements would be treated the same isn't clear.

21/ It might also involve an interest-bearing or an interest-free loan by the Donor/insured to the trust to allow it to acquire the policy and pay premiums, or even a guarantee by the Donor/insured of the trust's own loan to do so.

provider) to advance all (or most) of the policy premiums each year, which it will get back (usually without interest) at the insured's death (or earlier termination of the arrangement); that repayment is normally secured by a collateral assignment of the policy by the trust to the employer (or other premium provider).[22/]

In entity-related or employment-related split-dollar arrangements, unless the insured contributes the "economic benefit" of the arrangement, measured by the lower of the PS 58 cost or the insurer's generally available, published term rate, he or she will be taxed on that amount; because the employer's premium advances are returned, it gets no deduction for any part of the premiums paid. For gift (and presumably GSTT purposes), the economic benefit amount is treated as a direct or an indirect gift to the trust by the insured (depending upon whether it is contributed to the trust or the insured is taxed on it), except to the extent the trust contributes its own funds to the arrangement equal to the economic benefit amount.[23/]

Use of a split-dollar arrangement for the insurance increases the leverage potential of the transaction by lowering the value of the gift of the insurance provided to the trust each year for gift tax purposes from the full policy premium to the "economic benefit" of the arrangement to the insured for income tax purposes (again, for single life policies the lower of the PS 58 cost or the insurer's generally available, published one year term premium). Use of a joint life policy insuring the Donor and his or her spouse (or the Donor's child and his or her spouse) (or the Donor and his or her child) (etc.) can reduce the cost of the insurance and therefore the gift which needs to be made to pay the premium; use of a split-dollar arrangement with a joint life policy can further reduce the gift tax consequences, because of the drastically lower "economic benefit" of the arrangement (while both insureds are alive),[24/] determined under the PS 38 tables.[25/]

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22/ Alternatively, the arrangement could be documented on an endorsement basis, in which the corporation owns the policy, or under the unsecured method, in which the policy is not used to secure the corporate repayment.

23/ Apparently, in at least contributory, non-equity family or private split-dollar, there is no gift being made from the premium provider to the trust, and the arrangement has no income tax consequences to either party. The premiums returned will, of course, be a part of the premium provider's estate for estate tax purposes.

24/ After the first death, the measure of the economic benefit reverts to the usual single life measure.

These techniques are known as "trust packing", because, either alone or in combination, they allow more insurance to be "packed" into the trust within the Donor's available transfer tax exclusion(s) and/or credit(s).[26]

In either case, these techniques may also involve the use of a variable life insurance product (one in which the policy values are "invested" in "mutual funds" inside the policy), which also has universal life insurance product characteristics (including the ability — within broad ranges — to vary policy premiums and to choose, for an additional premium, to have the death benefit be paid in addition to the policy's values).

Split-funding the trust should be considered as a way of reducing the need for future gifts to pay premiums. Early funding with appreciating or income producing assets and/or with a discounted entity, the cash flow or the sale proceeds from which can be used to pay future premiums or to roll-out split-dollar arrangements earlier than could otherwise take place if only policy values were available to do the rollout, can make sense.[27] In fact, making the insurance trust the residuary beneficiary of a GRAT or QPRT (if the insurance trust is not generation-skipping) or of a lead trust or the buyer in an installment sale may allow an early rollout with a leveraged gift.

Finally, choosing to fund the trust with a variable/universal policy allows the trustee (as the policy owner) to attempt to maximize policy values, by selecting to invest those values in one or more mutual fund-type accounts offered and managed by the insurance company, within the "tax umbrella" of the policy. Income and gains in the funds (or in switches between the funds) are income tax deferred (or income tax free, if the policy is held until death).[28] If the policy is not a modified endowment contract and the forced-out gain provisions of Section 7702(f)(7)[29] don't apply, and any

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25/ The use of the PS 38 tables here is based solely on several IRS Information Letters.

26/ But note the potential for "negative" leverage in equity split-dollar arrangements, based on the equity TAM.

27/ Income generated by this funding will be taxed to the grantor, increasing its value to the trust.

28/ Note the Administration's budget proposal to tax such switches.

29/ This provision applies to policy distributions during the first 15 policy years, if the death lifetime withdrawals are limited to basis (policy loans can be used to access cash values in excess of basis), access by the trust to policy values during the insured(s)' lifetime(s) will also be income tax-free. Increases in policy values, which can support the death benefit, are ignored for transfer tax purposes — allowing a reduction in gifts to the trust to pay premiums to support the death benefit.

On the assumption that, in the long run (whatever that is) equities will outperform fixed income securities, investing policy values in the equity funds available in the policy will allow those values to grow faster over time, tax-free. In addition to having those policy values available, under the terms of the trust, to be distributed to the trust beneficiaries,[30/] because of the requirements imposed on such policies to remain classified as life insurance policies for federal tax purposes, the policy death benefit will be forced to increase with the increase in policy cash values, under the so-called "corridor test" — increasing the value of the trust (sometimes dramatically), without transfer tax cost.

With the ability to vary policy premiums (as in any universal policy), gifts to the trust can be reduced to the amount needed to keep the death benefit in effect (allowing the policy to mimic a fixed premium term policy), or increased up to the modified endowment contract - or perhaps up to the higher life insurance definition limit(s) - to increase the efficiency of the transaction, by allowing policy values to grow tax-free in as large an amount and for as long as is possible.

It might make sense to re-think the terms of a variable life policy irrevocable insurance trust during the insured(s)' lifetimes(s), to allow the trustee to distribute those policy values to children or lower generation beneficiaries (if the trustee is not a beneficiary or distributions are limited to ascertainable standards); in these cases, non-modified endowment status for the policy and avoiding the forced-out gain provisions will be critical (whereas, if loans or withdrawals aren't contemplated during the insured(s)' lifetime(s), those issues won't matter).

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benefit is reduced as a result of the distribution.

30/ As discussed above, potentially on an income tax-free basis.

## ADVANTAGES

1. As noted above, the split-dollar arrangement allows further transfer tax leverage by reducing the measure of the gift to the trust to the "economic benefit" of the arrangement to the insured (whether that amount is contributed to the trust or is treated as an indirect gift, because the insured is taxed on the benefit). Again, in survivorship policy arrangements, the economic benefit measure is particularly low while both insureds are alive, increasing the leverage potential.

2. As also noted above, the use of a variable-universal single life policy can allow policy values to grow to support the death benefit (assuming equities will — over time — out-perform fixed income securities) and reduce the need for additional gifts to support that benefit. In addition, in a split-dollar context, faster policy value growth can accelerate the timing of a roll-out during the insured(s)' lifetime(s), eliminating continuing gifts of the economic benefit. Finally, as noted above, the growth of policy values will at some point force the death benefit of the variable policy to increase, in order to continue its status as life insurance for tax purposes — without transfer tax consequences.

3. Again, a survivorship policy could be in the form of a universal-variable policy, with the potential advantages noted above — here, allowing tax-free growth of policy values and therefore death benefits over an actuarially longer time frame.

4. Loans to the trust by the Donor/insured as an alternative to gifts may make sense to avoid gifts of the full premium, if the interest payments or the Section 7872 implications of the loan make economic and tax sense; presumably, the Donor would gift the interest amounts to the trust, to be repaid to him or her. [31/] If the trust can borrow from a third-party, again subject to economic considerations, that would avoid gifts of full premium amounts to the trust by the Donor; again, presumably the Donor would make gifts to the trust of the interest amounts. These transactions are like split-dollar arrangements, but the measure of the gift is driven by the interest element, not economic benefit amounts.

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31/ There shouldn't be income tax consequences to the Donor or the trust from the interest payments or accruals, since the trust would presumably be a grantor trust for income tax purposes.

## DISADVANTAGES

1. Split-dollar arrangements are complex. The income tax (and transfer tax) implications of equity arrangements (where policy values in excess of corporate premiums belong to the trust)[32/] and arrangements with trusts created by controlling shareholders (owners, without most attribution, of more than 50% of the vote) pose special planning and drafting problems. There are as yet no clear-cut solutions to either issue (although the use of an unsecured or a restricted split-dollar arrangement should avoid the attribution of corporate incidents of ownership to a controlling shareholder).[33/]

   In any event, split-dollar can be viewed as a temporary financing technique; the longer it goes on, the higher the economic benefit cost, the more will be owed to the premium provider, and the possible equity issue will get worse.[34/] Finally, the spectre of the IRS reversing its position on the income and gift tax consequences of split-dollar arrangements, and subjecting them to the Section 7872 below market interest rules, is ever-present. [35/]

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32/ The Service issued a TAM — which for the first time — stated its view that, even in collateral assignment arrangements, those policy excess values (the equity) were taxed each year to the insured <u>and</u> were an indirect gift by the insured to the trust-owner. If that position is correct, split-dollar will still be helpful in reducing the gift value of the transaction during the early years, and the arrangement can always be unwound at the point of equity. Loans to the trust - either by the insured or by a third party - will avoid the equity issue.

33/ The Service had been routinely ruling that a "restricted" collateral assignment arrangement did not create corporate incidents of ownership in the split-dollar policy which would be attributed to the controlling shareholder. As noted, it has also ruled that such a restricted assignment would avoid even direct incidents of ownership, in a private split-dollar arrangement.

34/ For those reasons, policy roll-outs are normally planned for during the insured's lifetime; that exit strategy might include planning for an "external" rollout - using non-policy values to repay the premium provider - that may allow an earlier rollout than an internal rollout and could be done before policy equity developed.

35/ In a recent Field Service Advisory, the Service reiterated its position that Section 7872 doesn't apply to split-dollar arrangements, and indicated that if it changed that position, the change would be prospective.

2. Policy values in variable policies are not guaranteed — they may, in fact, decrease or even disappear; the investment risks have been passed through by the insurance carrier to the trust, as the policy owner. Because of this risk, the insured should consider a policy with a fixed minimum death benefit, not dependent on policy investment performance.[36/]

3. In a survivorship split-dollar arrangement the corporation may not want to continue to advance premiums if the employee-spouse dies first; in any event, the tax consequences of continuing a non-contributory arrangement after the death of the employee-spouse are unclear - for that reason, most are or at least become contributory after the first death. Perhaps single life policies or riders on each insured (or at least on the employee-insured) would make sense, to provide funds to the policy owner to continue to pay premiums (or to repay the employer and unwind the split-dollar arrangement).

4. As noted, loans from the Donor require payment of arm's-length interest (or Section 7872 implications), and most trusts won't likely be able to borrow from a third party without the Donor's guarantee (which may have gift tax implications).[37/]

D. Key Person Life Insurance Owned by a Family Partnership.

This technique, which is sometimes suggested as an alternative to using an irrevocable insurance trust, involves creating a family partnership, in which the insured is the managing general partner (but probably without the power to exercise partnership incidents of ownership in his or her own policy), which partnership owns a policy on the insured's life, payable to the partnership. At the insured's death, the policy proceeds are collected and distributed among the partners, according to their respective interests in the partnership; in most cases, the insured's interest in the partnership is nominal, based on capital accounts and profit sharing, but he or she may be

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36/ Which will increase the premium cost, because of the extra term charge imposed for that guaranteed coverage.

37/ The Service first held such a guarantee was a gift for gift tax purposes, then revoked that portion of the letter ruling; even if the guarantee itself were held to be a gift by the guarantor, how to measure the amount of the gift - the value of the guarantee - isn't clear. In addition, it must be clear that the insured-guarantor has no security interest in the policy under the guarantee, to avoid incidents of ownership issues.

the only managing partner. In theory, only the insured's partnership interest, increased by a proportionate part of the insurance death proceeds, would be includible in his or her estate for estate tax purposes.

## ADVANTAGES

1. A partnership is a true pass-through entity for income tax purposes, without the hazards and hypertechnical rules of S Corporations or the unknowns of the grantor trust rules.

2. The arrangement is a contractual arrangement, potentially offering much more flexibility than the irrevocable insurance trust; the partnership agreement can be amended with the consent of all of the partners.

3. Insurance is an inherently risk-free investment, so that the use of a general partnership might make sense here.

4. Income-generating assets or activities of the partnership can provide the source of policy premiums, without additional transfers from the insured; to the extent partnership assets and their cash flow can be used to provide the source of policy premiums, gifts from the insured to allow the partnership to pay premiums would be avoided.

5. Annual exclusions for gifts to the other partners should be readily available, with none of the risks associated with Crummey withdrawal powers, assuming the partners can withdraw their capital accounts.[38/]

6. This arrangement provides the insured indirect access to policy values during his or her lifetime, arguably without adverse tax consequences; the safest course of action would be to prevent the insured from exercising any powers over the policy, even as a partner.

7. Interests in the partnership are transferable (subject to the terms of the partnership agreement), and the use of minority interests or other available discounts in valuing the interests gifted to the younger generation family members should be available.

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38/ Which obviously isn't true in typical FLPs.

8. The bases of the partners' interests in the partnership will be increased pro rata by its receipt of the tax-free insurance proceeds (including the interest of the insured, which would have received a stepped-up basis at death in any event).

9. There appears to be limited, but favorable authority, on the estate tax issue for the insured where the policy is both owned by and payable to the partnership (even where the insured as a partner could exercise incidents of ownership over the insurance), the partnership is engaged in a business, and the interest of the insured in the partnership is "substantial"; under this authority, the pro rata interest of the insured partner (including his or her share of the insurance proceeds) will be includible in his or her estate for estate tax purposes, but the insurance arguably won't be includible as insurance, by analogy to the corporate setting.[39/]

## DISADVANTAGES

1. Most states require a business purpose to form a valid partnership; ownership of a policy or other passive investments may not qualify. Note again the partnership "anti-abuse" regulations (issued under the income tax provisions), which, despite having been amended to delete the family limited partnership examples, may pose a special problem for a partnership holding only a policy (or other passive investments), given their business purpose focus.

2. The general advantages of a trust for the beneficiaries (such as spendthrift protection, professional management) are unavailable, unless the younger generation family members' interests in the partnership are in fact held by trusts.

3. Policy proceeds insuring the life of a partner owned by, but not payable to the partnership (or for its benefit under a binding obligation to be used to purchase the decedent's partnership), will be includible in the insured's estate for estate tax purposes.

4. Any incidents of ownership in the insurance policy which are exercisable by the insured in his or her individual capacity will cause

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[39/] The Service recently issued a private letter ruling apparently re-confirming the prior authorities.

the policy proceeds to be includible in his or her estate for estate tax purposes.

5. The authority to date has excluded the partnership key person insurance proceeds from the insured's estate for estate tax purposes as life insurance even where he or she could deal with the policy as a partner, on the theory that to include them as insurance and to include an increased value for the decedent's "substantial" partnership interest would be a "doubling-up", at least in a business partnership setting. It isn't clear how large the decedent's partnership interest would have to be to invoke this rule (that is, what is substantial in this context), nor whether the same rule would apply where the partnership was formed just to own the policy or for other passive investment purposes.

6. The IRS has recently indicated that it will no longer rule on the status of a partnership, the sole asset of which is insurance on the partners' lives owned by the partnership. Although, note again that it has just ruled favorably on this key person approach in a partnership.

E. Use of Irrevocable Insurance Trusts in Generation-Skipping Planning.

1. Use of the Non-Taxable Gift Exemption to Fund the Trust.

Any outright (non-trust) gift which is otherwise a non-taxable gift because it qualifies for the $10,000 annual exclusion[40/] for gift tax purposes (doubled to $20,000 if the Donor's spouse makes an independent gift, consents to split the gifts, or if community property is contributed) is also a non-taxable gift for GST tax purposes. If such a gift is made directly to a grandchild or more remote descendant, it will automatically be exempt from the GST tax.

For gifts to trusts which qualify for the gift tax annual exclusion, because the trust beneficiaries are given so-called "Crummey" withdrawal powers,[41/] the non-taxable gift exemption is only available for "vested" trusts — the trust (or independent share) must only benefit only one skip-person beneficiary and the trust assets

40/ Which will be indexed for inflation, beginning in 1999.

41/ Or because the trust qualifies as a minor's trust, under Section 2503(c).

must be includible in his or her estate for estate tax purposes (if he or she dies before termination of the trust).

Such a "vested" Irrevocable Insurance Trust funded entirely with annual exclusion gifts (so long as all of such gifts are covered by "Crummey" withdrawal powers held by the trust beneficiaries) would also be exempt from the generation-skipping transfer tax. If this technique is used to fund insurance premiums on the life of the Donor or any other person, the insurance proceeds received on the death of the insured will also be exempt. This permits a "leveraging" of these $10,000 (or $20,000) annual exclusion gifts, so that a significant amount of property could be transferred to grandchildren (or other similar generation level beneficiaries), free from the GST tax, and without any use of the Donor's GST exemption(s).

As noted above, a split-dollar arrangement, in an appropriate case, could reduce the gift tax/GSTT value of the transfer of the death benefit to amounts within the available exclusion(s). As also noted above, using a survivorship policy (and where appropriate a split-dollar arrangement with such a policy) could help increase the potential leverage of such gifts (if the beneficiary(ies) could wait for trust benefits until the death of the surviving insured). Finally, using a universal-variable policy may allow both insurance cash values and death benefits to be made available to the trust beneficiaries, and (as described above) could increase the potential leverage of the gifts.

## ADVANTAGES

1. As indicated, this technique allows a leveraging of gift tax annual exclusion gifts for GST tax purposes, without use of the Donor's GST exemption(s).

2. By making sure all of the gifts of premiums to the trust qualify for the gift tax annual exclusion, the trust itself (and therefore the insurance proceeds) are totally exempt from the GSTT. As noted above, the use of a split-dollar arrangement could reduce the gift value of the transfer and help "squeeze" the gift into the available exclusion(s).

3. The trust could provide income and support to grandchildren and would either be distributable to them or to their estates at their death (or to their descendants, subject to their general

power of appointment). As noted above, if the policy were variable, the policy growth during the insured(s)' lifetime(s) could be distributed under the terms of the trust to the beneficiary, on a tax-free basis (assuming the policy weren't a MEC, and the forced-out gain provisions didn't apply).

4. The insurance proceeds could be indirectly used — by loan to or purchase of assets from the Donor's probate estate or revocable trust — to provide liquidity in the Donor's estate for any estate or GST tax liability.

5. By insuring the "skipped" generation (perhaps on a survivorship basis), the proceeds per dollar of premium can be maximized — again, if the beneficiary(ies) can afford to wait longer for the proceeds.

6. While the policy is in force, increases in policy values or dividends received do not generate taxable income, avoiding the punitive trust income taxation rules; with a variable policy, this would be especially important, if policy values in fact increase more quickly than those in a traditional insurance product.

7. As noted above, while each trust can only benefit one skip-person, there is no limited on how many such trusts for different beneficiaries a Donor can create and fund; these trusts can be layered to benefit beneficiaries in multiple lower generations.

**DISADVANTAGES**

1. This is a complex arrangement; there are the expenses of creation and maintenance of the trust to be considered.

2. As noted above, split-dollar arrangements are complex and some aspects of those arrangements have uncertain tax consequences; there are special problems if the insured is a controlling shareholder of the corporate party.

3. TAMRA 88 limited the exemption for annual exclusion gifts to trusts to cover only gifts made solely to a trust for a grandchild (or other skip person), who was the sole beneficiary of that trust (or that share of a trust) until it

terminated — again the "skipped" generation may not have an interest in the trust. The trust would have to be structured to be includible in the grandchild's estate if he or she died before complete distribution,[42/] and children could not have an interest in it. In addition, as also noted above, the trust would otherwise have to qualify gifts to it for the gift tax annual exclusion.

2. Using the Donor's $1 Million GST Exemption to Fund the Irrevocable Insurance Trust — the "Dynasty Insurance Trust".

Gifts which don't qualify for gift tax annual exclusion (because they are to trusts which don't contain "Crummey" powers) or which are in excess of $10,000 per Donee ($20,000 if gifts are treated as split with the spouse, if the spouse makes an independent gift, or if community property is contributed) can be protected from the GSTT by allocation of some part of the Donor's $1,000,000 GST exemption[43/] (and that of his or her spouse), on a gift tax return.

In Dynasty Insurance Trusts, which last for the time period of the rule against perpetuities, Crummey powers generally aren't used at all (or if they are used, they are limited to the lapse protection amount for each Donee per year), to avoid having any part of the trust assets included in the powerholder's estate (as discussed above) and to avoid issues as to the identity of the GSTT transferor. In some cases, the hanging power technique is used to allow full annual exclusion gifts to the trust by the Donor, but avoid gifts by the powerholder; as discussed above, the tradeoff is risking including any unwithdrawn amounts at the powerholder's death. In many cases, split-dollar and/or the joint life policy techniques (perhaps insuring the lives of members of multiple generations) are also used to further leverage the transaction.

**ADVANTAGES**

42/ That could be accomplished either by paying the trust assets to his or her probate estate or by giving him or her a general power of appointment over those assets.

43/ Also indexed for inflation, after 1998.

1. This technique provides the same basic advantages as the gifts described above; in addition, the trust is outside the transfer tax system for its extended term. It can be used as a "family bank" to provide support for all lower generation beneficiaries and the liquidity needed in their estates. With a variable life policy, this function could start during the lifetime of the insured(s), using withdrawals from or loans against the policy values (income tax-free, as long as the policy weren't a MEC and the forced-out gain provisions didn't apply).

2. Gifts of the premiums protected by allocation of the GST exemption will exempt the trust (and therefore the insurance proceeds) from the GSTT — the GST exemption is being allocated to insurance premiums to exempt insurance death proceeds.

3. This technique combines the advantages of early use of estate and GSTT exemptions and credits with the leverage of an irrevocable insurance trust that could last for 100+ years (depending on the applicable state rule against perpetuities) with no transfer tax consequences to anyone during its term.[44/] It allows a Donor to create an "instant" Dynasty Trust.

4. There are no restrictions on who can benefit from this type of trust (again, so long as transfer tax sensitive interests in the trust held by beneficiaries are avoided).

5. Even limited use of Crummey powers reduces the required use of the Donor's Applicable Credit Amount(s) or payment of gift tax.

6. Again, the use of a survivorship policy and/or a split-dollar arrangement could reduce the gift tax cost of the arrangement, allowing more insurance to be "packed" into the Donor(s)' GST exemption(s).

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[44/] In an increasing number of states, such trusts can literally be perpetual. Those state laws can be "borrowed" by residents of other states, by establishing trusts in a chosen state with a local trustee and trust situs there.

7. While the insurance is in force, policy value growth and the receipt of dividends are protected from the income tax otherwise payable by a trust. Again, this is especially valuable if the policy is variable (and equities out-perform bonds over the long term).

8. Once the insurance proceeds are collected at the death of the insured(s), they could be reinvested in new policies on the lives of other beneficiaries (or anyone else in whom the trust would have an insurable interest), to continue the leverage of life insurance.

9. Many of these trusts are "split-funded", owning both life insurance and other investment assets, the income from which could be used to pay premiums and avoid future gifts to do so.

10. For non-resident aliens who create trusts for their U.S. person beneficiaries, investing trust assets in an insurance policy will avoid the adverse income tax consequences to the beneficiaries under the 1996 foreign inbound trust provisions.

**DISADVANTAGES**

1. This technique requires filing a gift tax return and irrevocably allocating some part of the Donor's GST exemption (and that of his or her spouse) to the gift.[45/]

2. Prior to adoption of the Final GSTT Regulations, it was uncertain as to who the transferor of gifts to the trust was for GSTT purposes, where the trust contained Crummey withdrawal powers — the Donor or the powerholders (or both). Under the GSTT Regulations, for gifts of up to the $5,000/5% protected amount per year per Donee, the Donor is the transferor; for any excess, the Donee is the transferor.[46/]

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45/ If done on a timely filed return, the allocation is to the amount transferred; if done on a late-filed return, it is to the then value of the trust assets — while a risky technique, note the possibility of intentionally filing the return late here, to allocate the GST exemption to the value of the insurance policy at the time of filing — in the early policy years, the then value of the policy (the cash value) will likely be less than the gift made (based on the premiums paid).

46/ The Service recently ruled that this interpretation of the same rule under the Proposed Regulations was correct.

However, under those Regulations, the Donor will have to allocate his or her GST exemption (and that of his or her spouse) to the full gift to give the trust an inclusion ratio of zero.

In addition, under the TAMRA amendment to Section 2642(f), any attempted allocation of the Donee's GST exemption will be nullified if the trust would be includible in the Donee's estate for estate tax purposes (as would normally be the case, if the trust were still in existence at his or her death).

Accordingly, limiting the withdrawal rights of Donees to the $5,000/5% protected amount per year (if they are used at all) in these trusts appears to be the only "perfect" solution, both to avoid issues as to the identity of the GSTT transferor, waste of any GST exemption allocated by the powerholders to the excess power, and to avoid any transfer tax implications at the deaths of the powerholders.[47/]

3. This technique also uses up some part of the Donor's Applicable Credit Amount (and that of a spouse) and/or requires payment of a gift tax, especially since Crummey powers will be limited to the lapse protection amount (if they are used at all).[48/]

4. As also noted above, split-dollar arrangements are complex; they require a split-dollar agreement with the Donor's employer, there are income tax consequences to the insured, and the issue of the taxation of policy equity has now been raised by the IRS. Special problems are created if the Donor is a controlling shareholder of the corporate party.

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47/ If full <u>Crummey</u> powers are used to reduce the transfer tax consequences of the arrangement to the Donor, using hanging powers (as discussed above) may make sense. The risk is that the powerholder dies before the insured(s) — if that happens, the "hanging" amount will be includible in the powerholder's estate; if the powerholder survives the insured(s), the "hang" will "work itself out", based on 5% of the death proceeds.

48/ Again, unless the risks of using the hanging power technique are acceptable.

5. As noted above, with any joint life policy, receipt of the proceeds is delayed until the survivor's death; they are unavailable to provide liquidity or support to the surviving spouse after the first death.

3. Using existing Gallo or other GSTT grandfathered trust to acquire insurance.

As discussed above, finding such a GSTT grandfathered trust and using it to acquire insurance on a life or lives in which the trust has an insurable interest can leverage the grandfathered status of such a trust, without GSTT consequences (so long as no current contributions are made or are deemed made to the trust).

F. Use of Insurance in Connection with Other Planning Techniques.

1. Its Use with Outright Gifts.

Insurance can hedge against the risk of the Donor's death before the gifting program is complete and during the three year look-back rule for excluding gift tax paid in connection with such gifts from the Donor's transfer tax base.

2. Its Use with Charitable Gifts.

It can be used to "reinherit" descendants where outright gifts or split-interest gifts to charity reduce their interest in the Donor's estate. It is especially useful as an adjunct to a charitable remainder trust or the use of charity as the death time beneficiary of retirement plans and IRAs.

3. Its Use with Marital Deduction Planning.

In planning for non-U.S. citizen spouses, life insurance allows for the flexibility of making principal available to the survivor without the negative tax consequences of distributions from QDTs.

4. Its Use with Estate Freezing Techniques.

In any freeze transaction, by definition, the Donor's estate for estate tax purposes isn't diminished; the need for liquidity for that estate likewise isn't diminished. In some freeze techniques, like installment sales or GRATs in which the annuity is paid in kind, the

Donor's estate is as illiquid as it was before the transaction.[49/] In addition, in GRAT planning, since children will be the remainder beneficiaries, they will own the GRAT asset at the end of the term, increasing the need for liquidating in their estates. Finally, as noted above, in GRATs and QPRTs, non-survival of the term can be insured against.

49/ Even in a SCIN transaction, although nothing from the sale will be includible in the seller's estate for estate tax purposes, the unpaid balance of the note will generate a capital gain for the estate.