

legal & tax trends

Spring 2010
Issue 2

Financial Solutions from

Advanced Markets

Crummey Powers

Inside this issue

- I. Introduction
- II. Historical Perspective
- III. The Crummey Notice
- IV. Who Can Hold a Crummey Power?
- V. Gift Implications of Crummey Powers
- VI. Income Tax Implications of Crummey Powers
- VII. Generation Skipping Tax implications of Crummey Powers
- VIII. Conclusion

Peter S. Rosengard, CLU, RHU
R⁴ Risk & Wealth Solutions™

- ◆ Multi-Generational Wealth Protection ◆
- ◆ Retirement Distribution Strategies ◆
 - ◆ Key Employee Retention Plans ◆
 - ◆ Business Succession Plans ◆
 - ◆ Group Employee Benefits ◆
 - ◆ Financial Assets ◆

302 Harper Drive, Suite 103
Moorestown, NJ 08057

856-866-0028 Phone
856-234-4975 Fax

PRosengard@R4RWS.com
www.R4RWS.com

I. Introduction

For more than forty years Crummey powers have allowed donors to claim the annual gift tax exclusion with respect to gifts to irrevocable trusts, in particular, irrevocable insurance trusts, and thereby avoid utilization of the unified credit or the payment of gift tax. Crummey powers were first recognized in the case of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), in which the Tax Court upheld the validity of the withdrawal powers granted to the adult and minor beneficiaries of an irrevocable trust. Yet despite the widespread use of Crummey trusts since the Tax Court rendered its decision over forty years ago, Crummey powers continue to be the focus of intense IRS scrutiny.

In fact, despite the practical acceptance of the Crummey trust as a legitimate estate planning tool, Crummey powers continue to come under attack. The Service continues to challenge what it views as abusive applications of the power, and has, for example, adopted the position that a transfer in trust will qualify for the annual gift tax exclusion only if the withdrawal power is held by a beneficiary who has a current right to income or a vested remainder interest in the trust. And in addition to the Service's hostility toward Crummey powers, there have been legislative proposals put forth that would curtail or eliminate their use.

The controversy which surrounds Crummey withdrawal powers and Crummey trusts poses certain challenges to the estate planner, and requires vigilance in the drafting of an irrevocable insurance trust and in handling the administration of the Crummey powers. In this issue of *Legal & Tax Trends* we examine some of these issues and their implications.

II. Historical Perspective

The annual gift tax exclusion allows every individual who is a U.S. citizen or resident to transfer up to \$13,000 per year to an unlimited number of donees free of federal gift tax.¹ Since 1998, the exclusion (at the time \$10,000) has been subject to a cost-of-living adjustment that allows for increases in the exclusion amount in increments of \$1,000. Husbands and wives are able to transfer \$26,000 per year per donee. They can do so by each making a \$13,000 gift of their own property, by making a joint transfer of \$26,000 of jointly-owned or community property, or by taking advantage of the gift-splitting provisions.² Under the gift-splitting provisions, a \$26,000 gift made by one spouse can fully qualify for the annual gift tax exclusion if the donor's spouse consents to have the gift treated as made one-half by him or her. If a gift-splitting election is made, it applies to all gifts made by both spouses during that year and the election is made by the filing of a gift tax return (Form 709) signed by both spouses.

The annual gift tax exclusion is available with respect to gifts of a "present interest" in property. A present interest in property is defined in the gift tax regulations as the unrestricted right to the immediate use, possession, or enjoyment of the property.³ The annual exclusion is not available with respect to gifts of a "future interest." A future interest is defined to include reversions, remainders, and other interests or estates, whether vested or contingent, which are scheduled to commence in use, possession or enjoyment at some future date or time.⁴

If a gift does not qualify for the annual gift tax exclusion, it will constitute a taxable gift that will reduce the donor's applicable exclusion or require the payment of gift tax. A gift to an irrevocable trust will generally be treated as a gift of a future interest unless the beneficiary has a current right to the income from the trust.⁵ If the irrevocable trust's only asset is a life insurance policy, there would be no current income to distribute. Since the beneficiary's enjoyment of the transferred property would be delayed until the death of the insured, the transfers would not qualify for the annual gift tax exclusion. Whether this result could be avoided if the trust required all income be distributed currently is uncertain. Thus, in the absence of some mechanism that would convert such future interest gifts to present interest

¹ IRC § 2503(b).

² IRC § 2513.

³ Treas. Reg. § 25.2503-3(b).

⁴ Treas. Reg. § 25.2503-3(a).

⁵ Treas. Reg. § 25.2503-3(c), Ex. (2).

gifts, a gift to an irrevocable insurance trust would generally not qualify for the annual gift tax exclusion.

The mechanism to effect this conversion is found in *Crummey v. Commissioner*. In *Crummey*, a father created an irrevocable trust for the benefit of his children. Under the terms of the trust, each beneficiary was given the right to withdraw a portion of the contributions made to the trust each year. Two of the beneficiaries were minors. The Internal Revenue Service allowed the exclusion with respect to gifts for the benefit of the grantor's adult children, but it disallowed the exclusion with respect to the gifts to the minors. The Tax Court determined that each beneficiary was legally and technically capable of immediately enjoying the property transferred to the trust. Despite a minor's legal incapacity to exercise the power on his or her own behalf, the Court reasoned that since the power could be exercised by the minor's guardian, the gift should qualify for the annual gift tax exclusion.

III. The Crummey Notice

Reasonableness of Notice

The court in *Crummey* did not require that the beneficiaries be notified in any particular manner of their right of withdrawal. Nevertheless, a notice requirement did evolve after *Crummey* and it is now well-established that a Crummey beneficiary must receive actual notice of his or her withdrawal right.⁶ In fact, the manner and sufficiency of the notice continues to be the subject of IRS letter rulings. In general, these rulings have required that the beneficiaries be given prompt notice of their right of withdrawal and a reasonable opportunity to exercise the power before it lapses.

The Service has indicated that a 30-day withdrawal period constitutes a reasonable time period within which to exercise the power, but it remains unclear whether a shorter period of time would be deemed reasonable.⁷ It might be argued, for example, that an adult beneficiary does not need a full thirty days in which to decide whether or not to exercise a withdrawal power. The Service has ruled, however, that three days does not constitute a reasonable period of time.⁸

Timeliness of Notice

If notice is not sent in a timely manner, or if the contributed property's full value is not available for withdrawal throughout the withdrawal period, the gift may not fully qualify for the annual gift tax exclusion. If, for example, a contribution is made within the last few days of the calendar year and the power must be exercised by

⁶ Rev. Rul. 81-7, 1981-1 C.B. 474.

⁷ Priv. Ltr. Ruls. 9311021, 9232013, 8103074.

⁸ Priv. Ltr. Rul. 8022048.

December 31 of that year, the Service may determine that the beneficiaries did not have a reasonable time in which to exercise their withdrawal powers. To address this problem, the trust might require all contributions to be made no later than December 1 of each calendar year. As an alternative, the trust might provide that the right of withdrawal with respect to any gift made after December 1 would be exercisable for a full 30 days, and would therefore terminate in the following calendar year. Doing so would appear to allow the exclusion to be available for the year of the gift.⁹

The annual exclusion may only be partially available if the full value of the contributed property is not accessible to the trustee for the entire withdrawal period. This issue typically arises where a life insurance policy is acquired by a newly created irrevocable insurance trust. In a typical situation, an application for life insurance is submitted to an insurance company before the trust has been drafted because the proposed insured/grantor wants to first determine his or her insurability. The application is submitted without payment of any kind and the underwriting process begins. (So long as no payment accompanies the application, there should be no risk that the insured would be deemed to hold any incident of ownership in the policy.¹⁰) If the insurance company agrees to issue a policy, the trust must then be created and funds must be contributed to the trust so the policy premium can be paid. If the trust is not created in a timely manner, the trustee may be required to submit payment to the insurance company before the expiration of the Crummey withdrawal period. If this occurs, the annual exclusion may be disallowed, at least with respect to a portion of the gift.

The relevant question is what portion of the gift would the trustee be able to access if all of the beneficiaries opted to exercise their rights on the last day of the withdrawal period? If the trustee were forced to surrender the policy, policy charges and surrender fees imposed by the insurer could prevent the trustee from being able to recoup the entire original contribution. As a result, it is likely that the difference between the original contribution and the amount of the surrender proceeds would not qualify for the annual gift tax exclusion. There is no easy solution to this dilemma other than to suggest that contributions be made, and beneficiaries be notified, as soon after the trust has been executed as possible.

As an additional means of protection, however, the trust might specifically provide that in exercising their withdrawal rights, the beneficiaries may demand distribution of the policy or a fractional interest of the policy. Such a provision would be intended to allow the full exclusion to apply under the rationale the Service applied in several private letter rulings involving premiums paid on trust-owned group term life insurance contracts. In those rulings, the Service held that the premiums paid would qualify for the annual exclusion if the beneficiaries had the power to withdraw the policy from the trust.¹¹

⁹ Rev. Rul. 83-108, 1983-2 C.B. 167.

¹⁰ See e.g., Tech. Adv. Mem. 9323002.

¹¹ Priv. Ltr. Ruls. 8143045, 8138170.

Given that every state allows a policyholder to receive a full refund of all premium amounts within ten days after issuance, this “ten-day free look” in effect adds ten days to the withdrawal period. Thus, if the trustee were to hold the contribution for twenty days before paying the premium, the thirty-day requirement would appear to be satisfied.

Another possibility is having the beneficiaries waive the balance of the 30 day withdrawal period. This should enable the gift to qualify for the annual exclusion but could have gift tax ramifications for the beneficiaries. A Crummey withdrawal power is considered a general power of appointment and a lapse by the holder of this power is considered a transfer to the extent the lapsed power exceeds the greater of \$5,000 or 5% of the aggregate value of the trust assets.¹² However, the release of a power of appointment, like a lapse, is considered a transfer of property but the transfer appears to apply to the entire property over which the power could be exercised, and is not just the amount of property that exceeds the greater of \$5,000 or 5% of the trust corpus.

Frequency of Notice

Another issue that commonly arises with respect to contributions to irrevocable insurance trusts is whether a Crummey notice must be sent every time a premium payment is made on the policy. Such a requirement could be quite burdensome if, for example, premiums are paid on a monthly basis. While it is clear that a single Crummey notice for the life of the trust will not satisfy the notice requirement, if premiums will be paid on a regular basis, in accordance with a regular schedule, a single annual notice setting forth the schedule would appear to be adequate.¹³

Sending the Notice

The trustee of the trust is responsible for notifying each beneficiary of his or her withdrawal right. Notice should be sent by registered or certified mail in order to establish a record of its mailing and receipt. If a beneficiary is a minor, notice must be sent to the child’s legal guardian, if one has been appointed, or if one has not been appointed, notice would generally be sent to the beneficiary’s parent as natural guardian. In some cases the beneficiary (or guardian) may be asked to sign and date the notice and return it to the trustee to provide evidence of its receipt. The Service has ruled that notice does not need to be sent when the parent of a minor beneficiary has actual knowledge of the contribution because he or she is also acting as trustee of the trust.¹⁴

Who should receive the notice for the beneficiaries when the policy is a joint and survivor policy and the parents are the donors? This issue has not been addressed

¹² IRC §2514(e).

¹³ Tech. Adv. Mem. 9045002, also see Priv. Ltr. Rul. 8121069

¹⁴ Priv. Ltr. Ruls. 9030005, 8008040.

in any private letter rulings so care should be exercised to avoid having the insurance proceeds included in either of the donor's estates. One possible way may be to send the Crummey notice to a relative (other than one of the donors) who is designated to receive such notice under the terms of the trust.

IV. Who can Hold a Crummey Power?

The IRS View

An issue that has generated a significant amount of controversy is the question whether the annual exclusion should be available with respect to withdrawal powers granted to any trust beneficiary, regardless of the nature of that beneficiary's interest in the trust. Given that expanding the number of trust beneficiaries would increase the amount of tax free contributions that could be made to the trust, grantors have a powerful incentive to extend Crummey rights to as many individuals as possible. To this end, some trusts have granted Crummey rights to beneficiaries with only remote contingent interests in the trust, or in some cases, individuals with no interest at all.

In response to these efforts, the Service has taken the position that the holders of Crummey withdrawal powers must have a beneficial interest in the trust for the annual exclusion to apply and that the interest must be more than a nominal interest such as a contingent remainder interest.¹⁵ The Service first espoused this view in a private letter ruling issued in 1987 involving two trusts that the donors created for their two sons.¹⁶ The sons were the sole beneficiaries of their respective trusts and each had a testamentary general power of appointment over his trust. Despite the fact that they had no other interest in the trusts, members of each son's family were given the right to withdraw a portion of the contributions made to the trusts. The Service ruled that the donors did not intend to benefit the power holders other than the sons and that adding them as beneficiaries was simply a means of avoiding the federal gift tax through a proliferation of annual exclusions. It therefore denied the annual exclusion for the beneficiaries other than the sons except to the extent the others actually exercised those rights.

The Service took the position in this and later rulings that in order for a beneficiary's withdrawal power to qualify for the annual exclusion, the beneficiary would have to be a current income beneficiary or have a vested remainder interest in the trust. If a beneficiary holds only a discretionary income interest, a contingent remainder interest or no interest at all, the power should not be recognized for annual gift tax purposes. The Service rationalizes that the non-exercise of withdrawal rights held by such beneficiaries (or non-beneficiaries) indicates some sort of pre-arranged understanding that the rights were not meant to be exercised or that their exercise would result in undesirable consequences.¹⁷

¹⁵ Action on Decision 1996-010, 1996-29 I.R.B. 4.

¹⁶ Priv. Ltr. Rul. 8727003.

¹⁷ Action on Decision 1996-010, 1996-29 I.R.B. 4.

The Tax Court's View

Unfortunately for the Service, the courts have been unwilling to accept the Service's argument on the issue of who can hold a valid Crummey power. The Tax Court in *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 1, handed the taxpayer a significant victory in recognizing the withdrawal rights of the donor's five grandchildren, each of whom held only a contingent remainder interest in the trust. The Service argued that there was an agreement among the donor, the trustees and the beneficiaries that the grandchildren would not exercise their withdrawal rights, but the Court refused to find that there was any such agreement. Consequently, the Court allowed the annual exclusions with respect to the gifts for the benefit of the grandchildren even though none of them would receive any benefit from the trust unless his or her parents were to predecease the donor.

In acquiescing in the result only in *Cristofani*, the Service stated that it would continue to litigate cases "whose facts indicate a greater abuse of the Crummey power than those of *Cristofani*, preferably outside the Ninth Circuit."¹⁸ True to its word, the Service was back in the Tax Court six years later arguing *Kohlsaat Estate v. Commissioner*, T.C. Memo 1997- 212. In *Kohlsaat* the Service challenged the withdrawal powers granted to the donor's sixteen grandchildren, who held only contingent remainder interests in a trust created for the primary benefit of the donor's two children. The Service denied the annual exclusions claimed with respect to the gifts made for the benefit of the grandchildren based on an implied understanding between them and the donor that their powers would go unexercised. The Tax Court refused to infer that such an understanding existed merely because none of the beneficiaries chose to exercise a withdrawal right. It consequently allowed the exclusions with respect to all of the contingent remainder beneficiaries.

In light of the *Cristofani* and *Kohlsaat* decisions, it appears that extending withdrawal rights to contingent remainder beneficiaries is a suitable means of enabling a donor to fund an irrevocable trust without utilizing his or her unified credit or creating a taxable gift. Nonetheless, caution must be exercised given the Service's clear hostility toward such powers and its willingness to challenge arrangements that it perceives to be abusive. Granting withdrawal rights to individuals who hold no beneficial interest in the trust, for example, would be an aggressive approach that would not appear to be supported by these decisions.

V. Gift Implications of Crummey Powers

If an irrevocable trust is designed to allow contributions to fully qualify for the \$13,000 annual gift tax exclusion—or \$26,000 under the gift-splitting provisions—certain adverse tax consequences may result when the beneficiaries fail to exercise their Crummey withdrawal powers. A Crummey power is a general power of appointment for gift and estate tax purposes. When a general power of appointment

¹⁸ Action on Decision 1992-09, 1992-12 I.R.B. 4.

is not exercised and it lapses, the lapse is treated as a transfer for gift and estate tax purposes to the extent the lapsed amount exceeds the greater of \$5,000 or five percent of the aggregate value of the assets from which the power can be satisfied—the so-called “five and five” amount.¹⁹ Thus a \$13,000 withdrawal power, when not exercised, would give rise to a gift by the trust beneficiary of \$8,000, unless five percent of the value of the trust (including the value of the gift) happens to be greater than \$5,000.²⁰

If a gift occurs, it is deemed to be made by a trust beneficiary to the other trust beneficiaries; it is a future interest gift that does not qualify for the annual gift tax exclusion, and it therefore makes use of the beneficiary’s applicable exclusion. The deemed gift upon the lapse of a Crummey power can be avoided if the power itself is limited to the five and five amount. Although this approach is utilized by some practitioners, it undermines the donor’s ability to make maximum use of the annual exclusion and to efficiently fund the trust from a gift tax standpoint. There are, however, other methods by which the five and five limitation can be addressed.

Hanging Powers

A common means of preventing a taxable lapse of a Crummey power is for the trust to provide that upon the expiration of the Crummey withdrawal period, a beneficiary’s power of withdrawal terminates only with respect to that portion of the gift equal to the five and five amount, and that any excess “hangs,” that is, remains subject to a power of withdrawal by the beneficiary. Since the five and five amount can lapse without gift tax consequences, it is only the excess that creates the potential for a taxable gift. But if the beneficiary is given a continuing right to withdraw that excess, a gift of the excess should only occur when the power is exercised, and then only if it is exercised in favor of someone other than the beneficiary.

Although the hanging power may be a means of avoiding a taxable lapse of a Crummey power, it carries with it the risk that a beneficiary might decide to demand distribution of the hanging amount, or be compelled to exercise it, for example, by creditors. The risk would increase as each year’s contribution causes an addition to be made to the cumulative hanging amount. For example, a beneficiary who has the right to withdraw \$26,000 per year from a trust could have a hanging power equal to \$84,000 after four years (\$21,000 excess per year times four years). The exercise of that right could prove quite damaging to the trust and threaten its viability. The possibility of a voluntary or involuntary exercise of a hanging power must therefore be carefully considered before it is employed as a means of avoiding a taxable lapse of a Crummey power.

The foregoing assumes that \$5,000, rather than five percent of the value of the trust (including that year’s contribution), is the relevant measure of the lapse amount. If

¹⁹ IRC § 2514(e).

²⁰ Rev. Rul. 85-88, 1985-2 C.B. 201. Only one 5 and 5 exception for a beneficiary each year.

five percent of the trust value (including the contribution) is actually greater than \$5,000, then upon the non-exercise of a \$26,000 withdrawal power an amount less than \$21,000 would “hang”. As the value of the trust grows each year, the amount that would have to hang to avoid a taxable lapse would be progressively reduced. In the year in which the trust property and contribution equal a combined value of \$520,000, no amount would hang because five percent of the trust value, that is \$26,000, could lapse without creating any taxable gift.

Moreover, the cumulative hanging amount that the beneficiary could withdraw would actually be reduced in any year in which contributions to the trust were less than the five and five amount. This is because the hanging power language would simply provide that the beneficiary’s ongoing power to withdraw would lapse to the extent of the five and five amount. Thus, in any year in which there is no contribution, or a contribution of less than the five and five amount, the hanging power would be reduced to the extent of the excess of the five and five amount over the amount of the contribution.

It should be noted that the Internal Revenue Service has issued one private letter ruling on the subject of hanging powers, and the result was adverse to the taxpayer.²¹ In that ruling, the trust document in question provided that the beneficiary’s right of withdrawal would lapse only to the extent that the lapse would not constitute a taxable gift. The Service found the power to be a condition subsequent that would discourage enforcement of the gift tax laws given that it attempted an after-the-fact nullification of the gift that would have resulted from the lapse. Thus, the power holder was treated as having allowed the entire power to lapse in the year it was granted.

Many commentators have suggested that the outcome in that ruling was due to inadequate drafting of the provision, rather than a fundamental shortcoming of the concept itself. Specifically, if the provision had been worded in a manner that allowed for the power to lapse only to the extent of the five and five amount each year, and a continuing right to withdraw the excess, the condition subsequent problem might have been avoided. From an estate tax perspective, if the power holder dies while the power remains outstanding, the dollar amount that the power holder could have withdrawn would be included in his or her estate.

Testamentary Limited Powers of Appointment

Another means by which a taxable lapse might be avoided upon the non-exercise of a withdrawal power is by giving the beneficiary a limited power to appoint his or her interest in the trust under the terms of his or her last will and testament. Under these circumstances the lapse of the Crummey power should not constitute a gift given that the beneficiary would have a retained power to control the disposition of the lapsed amount by virtue of the limited power.²² In order for this approach to be

²¹ Tech. Adv. Mem. 8901004.

²² Treas. Reg. § 25.2511-2(b).

viable, however, the trust would have to have only one beneficiary or, if it had more than one beneficiary, a separate share would have to be created for each beneficiary. In this way, the beneficiary (or beneficiaries) would have an identifiable interest in the trust over which the limited power might be exercised.

From an estate tax perspective, using the limited power of appointment approach will result in inclusion of some or all of the trust property in the beneficiary's estate should he or she die before the trust terminates. This might be a manageable risk if the beneficiary were to die while the insured is alive, since under these circumstances, the amount includible would be based on the policy's cash value. However, if the beneficiary were to die after the death of the insured and prior to termination of the trust, the amount includible in the beneficiary's estate would be based on the value of the trust as augmented by the death proceeds of the policy.

Another potential drawback to this approach is that the division of the trust into separate shares precludes the addition of other beneficiaries. It would therefore be inappropriate in any situation where the class of beneficiaries might include those yet to be born. Since a separate share must be created for each beneficiary at the trust's inception, a new trust would have to be created for any later born member of the class.

Funded Trust

When the value of the property from which a withdrawal power can be exercised exceeds \$100,000, the amount that can be allowed to lapse without constituting a taxable gift is five percent of the value of that property rather than \$5,000. Therefore, if the trust were funded initially with a gift of \$520,000 of cash or property, the amount that could lapse without gift tax consequences would be \$26,000 (five percent of \$520,000). By using this approach, the five and five limitation issue could be avoided completely.

The funded trust approach would generally require that the grantor make use of his or her applicable exclusion or pay a gift tax, but it would be a simple means of circumventing the five and five limitation. In fact, not only would it allow gifts equal to the maximum annual exclusion amount to be made to the trust each year without creating a taxable lapse, the funding assets could serve as a source of premium payments for the policies held within the trust. In addition, if the trust were designed as a grantor trust, the grantor, rather than the trust, would be taxed on trust income, thereby making the full pre-tax amount of the income available to the trustee.²³

Split-Dollar Insurance

Another means of addressing the five and five limitation issue might be to lower the value of the gift made to the trust each year by having the trustee enter into a split

²³ IRC Secs. 671-678.

dollar arrangement with the grantor, the grantor's spouse, or with a corporation, partnership or other entity in which the grantor might have an interest. Under such an arrangement, the policy would be owned by the irrevocable trust and the trustee would enter into a split dollar agreement with the grantor or other third party.

Split Dollar Arrangements Entered Into Before 1/28/02 and Not Materially Modified Thereafter

The term insurance value for a policy insuring one life would be based on the rates set forth in Revenue Ruling 55-747, 1955-2 C.B. 228, i.e., the P.S. 58 rates²⁴, or if lower, the insurer's published one-year term insurance rates available to all standard risks.²⁵ Note that the P.S. 58 rates are only used if the split dollar agreement requires the use of these rates, otherwise the Table 2001 rates are used.²⁶ For policies that insure two lives and pay a death benefit upon the death of the survivor, the rates generally used are those from U.S. Life Table 38, which are derived from the Table 2001 rates.²⁷

If a policy owned by a trust is made subject to a split-dollar agreement, the measure of the gift made to the trust each year is not the premium paid on the policy, but instead the value of the economic benefit.²⁸ Under the terms of the agreement, the trustee would typically be required to pay that portion of the premium equal to the "economic benefit" amount, that is, the term insurance value of the life insurance death benefit the trustee would be entitled to receive, and the grantor or other third party would agree to pay the remainder. Thus, only an amount equal to the economic benefit need qualify for the annual exclusion rather than the full premium. By lowering the value of the gift in this manner, the amount that would lapse when the beneficiaries fail to exercise their withdrawal rights may be well within the five and five amount and consequently avoid any issue with respect to its lapse.

The split dollar agreement will generally require the trustee to make an annual premium payment equal to the amount of the economic benefit. The grantor can provide the trustee with the funds necessary to make the payment by transferring a like amount to the trust each year. The trustee would make the transferred amount available to the beneficiaries for the exercise of their withdrawal rights. After the withdrawal period has expired, the trustee can remit the premium amount to the insurer.

²⁴ Notice 2002-8 prohibits the use of P.S. 58 rates unless the split dollar agreement specifically requires its use.

²⁵ Rev. Rul. 66-110, 1966-1 C.B. 12.

²⁶ IRS Notice 2001-10; IRS Notice 2002-8.

²⁷ Support for the use of the Table 38 rates is found in a General Information Letter dated August 10, 1983 from Mr. Norman Greenberg, Chief, General Actuarial Branch of the Internal Revenue Service to Mr. Morton P. Greenberg, Advanced Underwriting Director and Counsel, The Manufacturers Life Insurance Company. This letter indicates that the economic benefit should be the probability that both lives die during a one-year period, which is best measured by use of Table 38.

²⁸ Rev. Rul. 78-420, 1978-2 C.B. 67.

In the absence of an actual contribution by the grantor, the trustee would have nothing in hand to make available to the beneficiaries and the gift would likely be characterized as a future interest gift that does not qualify for the annual gift tax exclusion. To avoid this result, and any unnecessary utilization of the grantor's unified credit, the grantor should provide the trustee with the trust's portion of the premium.

Split Dollar Arrangements Entered Into or Materially Modified After 1/28/02

It is still possible to utilize split dollar to reduce the amount of the annual gift and fall within the five and five limitation by use of either the loan regime or the economic benefit regime. Under the loan regime, the gift to the trust may be reduced to the amount of the annual loan interest. This affords the trustee with the option of paying the loan interest annually to avoid having the interest amount added to any outstanding loan obligation. Assuming proper use of Crummey withdrawal powers, a contribution to the trust of an amount equal to the amount of the loan interest will qualify as a present interest gift.

The economic benefit regime will result in the grantor making a gift to the trust equal to the economic benefit as measured by either the Table 2001 or the insurer's alternate term rates (subject to the requirements outlined in Notice 2002-8). It is unlikely that the trust or employee would actually contribute an amount equal to the economic benefit since this would create taxable income for the owner unless the trust was an intentionally defective grantor trust. Even though the trust or employee does not actually pay an amount equal to the economic benefit, this amount will still be considered a gift of a future interest and will not qualify for the annual exclusion unless an amount equal to the economic benefit is actually contributed to the trust and Crummey withdrawal notice is given. For a more detailed discussion of split dollar, see the Summer 2009, Issue 1 of *Legal & Tax Trends* entitled 'Split Dollar Life Insurance'.

Grantor's Spouse as a Crummey Power Holder

When an irrevocable trust is created by a grantor for the benefit of his or her spouse and children, the children are frequently granted a withdrawal power equal to the maximum annual exclusion amount of \$26,000. The power granted to the spouse, however, is typically limited to the five and five amount. This limitation is imposed in order to avoid inclusion of any portion of the trust in the spouse's estate. As noted above, both a hanging power and a limited power of appointment will generally have estate tax consequences to the power holder. If such a power were held by the spouse, some part of the trust would be included in his or her estate.

On the other hand, if the holder of such a power is a child of the grantor, unless the trust is designed to be a generation-skipping trust, the trust will likely have terminated, and all assets therefore distributed by the time of the child's death. Thus, the adverse consequences of granting a hanging power or a limited power of

appointment to a child beneficiary may be significantly less than granting such rights to a spousal beneficiary.

If the grantor's spouse is named as a beneficiary of the trust, it is imperative that he or she not make any contribution to the trust. If the spouse makes a contribution, he or she would be treated as a grantor of the trust to the extent of the contribution and some portion of the trust property would be included in the spouse's estate.²⁹ Gifts to the trust should be made with the grantor's separate funds and not from a joint account held with the spouse. Extra caution is required in community property states where it may be necessary to segregate certain community assets for the purpose of making separate property transfers to the trust.

In a situation such as the foregoing, a natural question is whether the spouse's consent to split the \$26,000 gifts for the benefit of the children causes the spouse to become a grantor of the trust. The answer appears to be no. Merely consenting to *treat* the gifts as if they were made one-half by each spouse does not cause the non-grantor spouse to become the owner, and transferor, of one-half of the property.³⁰ However, the consenting spouse will become a transferor of one-half of the property transferred to the trust for generation-skipping transfer tax purposes. Thus, through gift-splitting, the grantor could contribute a maximum of \$26,000 (as indexed for inflation) to a trust each year for each child, and an additional \$5,000 (or, if greater, five percent of the value of the trust plus the value of the contribution) for his or her spouse under the annual exclusion.

VI. Income Tax Implications of Crummey Powers

In addition to having potential gift tax consequences, the Internal Revenue Service takes the view that the lapse of a Crummey withdrawal power can also have income tax consequences. It is well-established that the holder of a general power of appointment (of which a Crummey power is one) is treated as the owner of that portion of the trust with respect to which the power relates and is taxable on the income there from.³¹ A Crummey power holder is therefore taxable on trust income attributable to the property with respect to which he or she can exercise the power—at least while the power is outstanding.

However, if the sole asset of a Crummey trust is a life insurance policy, the trust would have no income and this rule would have no impact. Even if the trust did have income, only the income earned during the withdrawal period would be taxable. But in any event, no amount would appear to be taxable to the power holder if the grantor of the trust is treated as the owner of the trust under the grantor trust rules.³²

²⁹ IRC § 2036.

³⁰ See e.g., Rev. Rul. 74-556, 1974-2 C.B. 300, Priv. Ltr. Rul. 2001130030

³¹ IRC § 678(a)(1); Rev. Rul. 67-241, 1967-2 C.B. 225.

³² IRC § 678(b).

The Service has by private letter ruling taken the position that the holder of a Crummey withdrawal power that releases the power should be treated as the owner of that portion of the trust over which he or she has a withdrawal power, not only during the withdrawal period itself, but even after it has expired.³³ Thus the power holder would continue to be treated as the owner of that portion of the trust that he or she has released the power of appointment — apparently until trust termination. Once again this rule would be of no consequence while the grantor is alive if the only trust asset were a life insurance policy on his or her life or the trust was considered a grantor trust. Some commentators believe the literal reading of Code §678(a) requires the Crummey beneficiaries to be taxed on at least a portion of the trust income even if the trust is a grantor trust.³⁴

However, upon death, if the trust should continue in existence, the income would be taxed to the beneficiaries whose Crummey powers had lapsed rather than being taxed to the trust or perhaps to the beneficiary to whom the income is distributed. For example, if the trustee were authorized to make unequal distributions of income among the beneficiaries, the impact of this rule might be that a beneficiary would pay income tax on a distribution made to another beneficiary. The Service's position on this issue is questionable and several commentators have disagreed with it. But unfortunately, although the gift and estate tax consequences of lapsed powers of appointment are clearly set forth in the Code and regulations, the same is not true of the income tax consequences. For example, whereas the gift tax provisions carve out an exception for lapses within the five and five limitation, no such safe harbor is provided under the income tax provisions.

To add to the confusion, despite having consistently taken this position in rulings issued from 1981 onward, in a 1993 ruling the Service took the opposite position in a reversal of a previously issued ruling. In the earlier ruling, the Service took its standard position and ruled that the beneficiary would be treated as the owner of the trust for income tax purposes. With no explanation, the Service then issued the reversal and ruled that the beneficiary would not be treated as the owner.³⁵ In subsequent rulings, however, the Service reverted to its standard position on the matter.³⁶ In the end, the only thing that is clear is that the income tax treatment of Crummey powers for income tax purposes remains quite uncertain.

VII. Generation Skipping Transfer Tax Implications of Crummey Powers

In addition to the gift, estate and income tax consequences of Crummey powers, the generation-skipping transfer tax (GSTT) implications must also be taken into

³³ Priv. Ltr. Ruls. 8517052, 8701007, 9034004.

³⁴ See “Beneficiary Withdrawal Powers in Grantor Trusts – A Crumm(e) Idea?”, Estate Planning, October 2007, Vol.34, No. 10.

³⁵ Priv. Ltr. Rul. 9321050.

³⁶ Priv. Ltr. Rul. 200949012.

consideration. In fact, the generation-skipping transfer tax can have a significant impact on an irrevocable trust, in particular, an irrevocable insurance trust.³⁷

The generation-skipping transfer tax applies to all gifts to or for the benefit of a skip person. If a skip person is a primary or contingent beneficiary of an irrevocable trust, gifts to the trust will have GSTT implications. In funding the trust it will be necessary to determine whether to permit a deemed allocation of a portion of the grantor's GSTT exemption to the gifts made to the trust in order to insulate the trust and its distributions from generation skipping transfer tax.

In general, a gift to a skip person that qualifies for the annual gift tax exclusion will also be excluded from generation-skipping transfer tax. However, this rule does not apply with respect to gifts made in trust. Instead, a gift in trust which qualifies for the annual gift tax exclusion by reason of a Crummey withdrawal power will only qualify for exclusion from GST tax if (1) during the life of the skip person no portion of the corpus or income may be distributed to any individual other than the skip person, and (2) if the skip person dies before the trust is terminated, the gift in trust must be included in the gross estate of the skip person.³⁸ In effect, the provision requires that the trust be established for the benefit of the skip person only, or that a separate and distinct share of the trust be set aside for the benefit of the skip person.

Since dividing a typical irrevocable insurance trust into separate shares will in many instances severely restrict the efficacy of the trust, it is unlikely that designing a trust in this manner will be viable. Consequently, in most instances, it will be necessary for the donor to permit a deemed allocation of his or her GSTT exemption to gifts made to any trust which names skip persons as primary beneficiaries. If skip persons merely hold contingent remainder interests in the trust, it will be necessary for the donor to decide if a deemed allocation should be permitted in order to protect the trust from GST tax in the event a child predeceases the grantor and his or her child succeeds to the decedent's interest in the trust. Keeping in mind that the predeceased child exception would not apply in such a circumstance, the result would otherwise be the imposition of GST tax on distributions made to the decedent's issue or upon a taxable termination in their favor.

In making a transfer to a GST trust, the transferor must be identified and his or her GSTT exemption will automatically be allocated to the gift in trust. According to the GSTT regulations, the grantor of the trust is the transferor with respect to the gift in trust, but when the beneficiary fails to exercise his or her withdrawal power, the beneficiary becomes the transferor of any amount in excess of the five and five

³⁷ GST exemption may be deemed allocated by a deemed allocation to an indirect skip within the meaning of Section 2632(c). An "indirect skip" is defined as a transfer that is subject to gift tax and is made to a GST trust (a defined term). If an indirect skip occurs, the transferor's unused GST exemption is automatically allocated to the transfer to the extent necessary to make the inclusion ratio of the property zero. An election to prevent deemed allocation of GST exemption to an indirect skip that has already occurred must be made on a timely gift tax return with respect to the transfer. See Section 2632 (c)(5).

³⁸ IRC § 2642(c)(2).

amount.³⁹ Since the beneficiary now becomes a transferor for GSTT purposes, the beneficiary must decide whether to permit a deemed allocation of his or her GSTT exemption in order to completely shield the trust from GST tax.

Whether to permit a deemed allocation or whether to elect out of such deemed allocation would depend on the generation to which the power holder is assigned for GSTT purposes and the anticipated term of the trust. If the trust is intended to remain in existence for several generations, such a deemed allocation should be permitted. If, on the other hand, the trust is not expected to make any distributions to a beneficiary more than one generation below that of the power holder, the transferor should elect out of the deemed allocation rule. If, for example, the trust is created to provide lifetime income to the grantor's children, with the remainder over to the grandchildren, the children could elect out of such deemed allocation and choose not to make any allocation of their GSTT exemption because the trust is not designed to make any distributions to the children's grandchildren.

VIII. Conclusion

Although Crummey powers have been with us for more than forty years, there is no guarantee that they will be available forever. For the moment they remain a viable and valuable means of funding an irrevocable trust. But in light of the Internal Revenue Service's barely disguised hostility toward Crummey powers, and the uncertainty that continues to surround some aspects of their tax treatment, it is vitally important that practitioners draft the powers properly and that trustees administer them properly, in order to insure that they achieve their intended purpose.

³⁹ Treas. Reg. § 26.2652-1(a), Ex. 5.

Legal & Tax Trends is provided to you by a coordinated effort among the MetLife advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich. All comments or suggestions should be directed to tbarrett@metlife.com or jdonlon@metlife.com, Co-Editors.

Pursuant to IRS Circular 230, MetLife is providing you with the following notification: The information contained in this document is not intended to (and cannot) be used by anyone to avoid IRS penalties. This document supports the promotion and marketing of insurance products. You should seek advice based on your particular circumstances from an independent tax advisor.

MetLife, its agents, and representatives may not give legal or tax advice. Any discussion of taxes herein or related to this document is for general information purposes only and does not purport to be complete or cover every situation. Tax law is subject to interpretation and legislative change. Tax results and the appropriateness of any product for any specific taxpayer may vary depending on the facts and circumstances. You should consult with and rely on your own independent legal and tax advisers regarding your particular set of facts and circumstances.

Peter Rosengard is an investment advisor representative and a registered representative of MetLife Securities, Inc. (MSI), which is a registered investment advisor and a member of FINRA/SIPC. Insurance offered through the Enterprise General Agency, Inc. (EGA), Somerset, NJ 08873, and the Metropolitan Life Insurance Company (MLIC), New York, NY 10166. Products and services offered through R⁴ Employee Benefit Solutions™ and R⁴ Enterprises™ are not guaranteed, endorsed or recommended by MLIC, MSI or the EGA. R⁴ Risk & Wealth Solutions™ is a marketing name for Peter Rosengard.

Metropolitan Life Insurance Company
200 Park Avenue
New York, NY 10166

New England Life Insurance Company
501 Boylston Street
Boston, MA 02116

L0310097588(exp0412)(all states)