POINT TO REMEMBER

Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique (Part 2)

By Adam Abrahams*

This two-part article addresses irrevocable life insurance trusts as a method for reducing the estate tax. Part 1, which appeared in the Summer 2013 issue, covered estate and income tax issues. Part 2 covers gift and generation skipping transfer tax issues.

Gift Tax Issues

An advantage of gifting a life insurance policy to an ILIT is leverage. The value of the policy at the date of the gift and subsequent premium gifts are often within the annual gift tax exclusion. At the insured's death, the value is much larger due to built-in appreciation. The built-in appreciation at death is shielded from estate tax.

Valuing the Gift

Life insurance policy gifts are generally valued at the replacement value of the policy on the date of the gift. The type of policy affects the replacement value. The replacement value of a new cash value policy is the initial premium payment. The replacement value of an existing single premium or paid up policy is the amount an insurer would charge for the same policy on the life of a person of the age of the insured as of the date of the gift.

If the cash value is substantially higher than the replacement premium, the cash value is used as the value of the gift. For existing cash value policies, the replacement value is derived from a formula incorporating an interpolated terminal reserve as of the date of the gift plus a proportionate part of the gross premium paid before the date of the gift that covers the period extending beyond that date. The replacement value of an existing term policy includes the portion of the last premium that covers the period beyond the date of the gift. The replacement value for group term insurance includes the unused premium paid for the period. *See* Treas. Reg. § 25.2512-6(a) and Examples 1, 3, and 4.

The Present Interest Requirement

To qualify for the annual gift tax exclusion, the transfer must be of a present interest. Transfers to ILITs typically include the initial transfer of the life insurance policy itself (or other liquid assets used to buy a new policy), the annual transfer of cash to fund required premium payments, and indirect gifts from the insured in the form of group term life insurance premiums paid by the grantor-insured's employer (after the grantor-insured irrevocably assigns a policy to the trust).

Because the policy benefits are not realized until the insured dies, the transfer might not qualify as transfer of a present interest. Fortunately, there is an exception to the rule. An ILIT may provide what is known as *Crummey* withdrawal rights. *Crummey v. Commissioner*, T.C. Memo. 1966-144, *aff'd in part and rev'd in part*, 397 F. 2d 82 (9th Cir. 1968). *Crummey* withdrawal rights give trust beneficiaries the right to withdraw, for a limited period of time, any amounts transferred to the trust. This invasion right is triggered only if the insured makes a contribution to the ILIT in a particular year, and the grantor-insured can specify at the time of the gift that the individual beneficiaries receive the power of withdrawal and the amount. The withdrawal power can qualify the transfers as transfers of a present interest.

Although not required by case law, it is recommended that the trustee provide prompt written notice to the trust beneficiaries of such withdrawal rights. *See* PLR 8008040 ("actual knowledge" is sufficient without written notification). It is typical to provide the beneficiaries with a 30–60 day window in which to exercise their right of withdrawal. It is recommended that beneficiaries receive a minimum of 30 days in which to exercise the withdrawal right. However, the Tax Court held for a taxpayer who provided a 15-day notice period of the exercise of the right of withdrawal in *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991). In that case, the court allowed the exclusion for rights of withdrawal held by the taxpayer's children, who were current beneficiaries, and for rights of withdrawal held by her grandchildren, whose interests did not vest unless their parents either predeceased the grantor or failed to survive her by at least 120 days.

The Tax Court stated that one determines the existence of a present interest in the context of gift tax by determining the beneficiary's ability to exercise the right to a withdrawal from the trust corpus and the trustee's ability to legally resist the beneficiary's demand for payment. The court noted that, even though the decedent's children were in good health when the decedent executed the trust, this did not "remove the possibility that the decedent's children could have predeceased" her. In addition, the grandchildren possessed the power to withdraw up to an amount equal to the amount allowable for the gift tax annual exclusion.

The "5 and 5" Exception and "Hanging Powers"

The "5 and 5 exception" exempts lapses from any gift or estate tax consequences to the donee-beneficiary if the lapse is limited to the greater of $5,000 or 5% of the fair market value of the trust's assets. If the

* The Abrahams Law Firm, Silver Spring, MD.

non-exercise of the withdrawal right is not exempted by the "5 and 5" amounts, the non-exercise is considered a release of a general power of appointment and thus a gift that potentially triggers adverse estate tax consequences. *See* PLR 9541029 (lapse of *Crummey* power in ILIT not a taxable gift under section 2514(e) because the amount was within the "5 and 5" exception).

The $5,000 component of the "5 and 5" power is a cumulative annual limit for each beneficiary who lets the *Crummey* withdrawal power lapse. Rev. Rul. 85-88, 1985-2 C.B. 201. Thus, if a person is a beneficiary for separate trusts, the lapses for that beneficiary with respect to all trusts need to be coordinated. This is best done by setting a separate date for each lapse in a trust and saying that the lapse occurs to the extent that the lapse would not constitute a taxable gift under section 2514.

A grantor might consider providing a "hanging power"—a tool used to avoid gift tax on trust beneficiaries who do not exercise their withdrawal rights. Hanging powers are an option where the ILIT has multiple *Crummey* beneficiaries and the value of the ILIT exceeds the greater of $5,000 or 5% of the trust value. A gift of the entire amount subject to withdrawal, even if greater than this limitation, is still considered a gift of a present interest. At some point, such as upon collection of the death benefit, the value of the ILIT will be large enough to wipe out any beneficiary hanging powers.

The amount of only the "5 and 5" ceiling lapses each year. The excess amount carries over into future years. Any carryover powers lapse in subsequent years to the extent the gifts in such years are less than the "5 and 5" ceiling. If the power holder dies before the ILIT terminates, the hanging powers in existence at his death are included in his gross estate.

Internal Revenue Service Perspective

The Service generally will not contest annual exclusions for *Crummey* powers if the trust has documentation of the notices. The grantor might consider filing annual gift tax returns reporting these gifts and claiming the annual exclusion (attaching the trust instrument and stating that the withdrawal rights qualify the gifts for the annual exclusion). If the grantor-insured accurately reports and adequately discloses the gifts on the return, the three-year statute of limitations runs. After that, the Service can no longer challenge the valuation or whether the gift is a present interest that qualifies for the annual exclusion. Treas. Reg. § 20.2001-1(b); Treas. Reg. § 25.2504-2(b). The Service will contest such powers if it suspects that there is a pre-arranged understanding that the beneficiaries will not exercise their withdrawal rights. AOD 1996-10 (*Cristofani)*.

Generation Skipping Transfer Tax Issues

The generation skipping transfer (GST) tax applies to any transfers to donees (other than spouses) more than two generations below the grantor or to anyone more than 37.5 years younger than the grantor. Such beneficiaries are generally referred to as "skip persons." I.R.C. § 2613(a). If all of a trust's beneficiaries (for future distributions or termination of the ILIT) fit into these definitions, it would also be a skip person. A transfer to such a trust is referred to as a "direct skip." I.R.C. § 2612(c)(1). Transfers to trusts having both non-skip and skip persons are not considered direct skips.

Generation skipping transfers occur if one or more of his children predecease the grantor and the ILIT provides that a deceased child's descendants receive the child's share. I.R.C. § 2632(d)(1). (There may be retroactive allocation under such circumstances). Generation skipping transfers also occur if the ILIT provides that a child's interest does not vest until the child reaches a certain age and the child dies before one or more gifts are made to the trust. An exception applies if a gift or bequest is made to or for the benefit of a grandchild whose parent has died before such transfer. In that case, the grandchild steps into the child's shoes with respect to that transfer.

Calculating the GST Tax Rate

One calculates the effective GST tax rate by multiplying the section 2641(a) inclusion ratio by the maximum federal estate tax rate. I.R.C. § 2641. The inclusion ratio is the percentage of property to which the GST exemption has not been allocated. A zero inclusion ratio means that there is no GST tax. The inclusion ratio should be either zero or one (either wholly exempt or wholly taxable). One achieves a zero inclusion ratio by allocating the remaining exemption amount equal to the value of the transferred property or by making only transfers to which the GST annual exclusion applies.

Allocating the GST Tax Exemption

Each individual is entitled to a GST exemption. For 2014, that exemption is $5,340,000 ($5,000,000 indexed for post-2011 inflation). I.R.C. §§ 2631 & 2010(c); Rev.Proc. 2013-35, 2013-47 I.R.B. 537.

The GST exemption is allocated automatically to direct skips and lifetime indirect skips to GST trusts unless the transferor or executor elects otherwise. I.R.C. § 2632(b) & (c). Relatively confusing rules determine whether a trust qualifies as a "GST trust," gifts to which constitute indirect skips that automatically attract GST exemption.

The allocation amounts depend upon the timing of valuation of the assets. For the first gift, or for any later gift when the inclusion ratio is zero, the trust obtains an inclusion ratio of zero if the donor allocates GST exemption to the trust equal to the transfer's value on a timely filed gift tax return. Although a transferor or the transferor's executor may allocate the GST exemption at any time from the date of the transfer through the date of filing the estate tax return, the deemed effective date of the transfer determines the allocation amount. Treas. Reg. § 26.2632-1(a). Automatic allocations to lifetime direct skips or GST trusts are effective as

of the date of transfer. Treas. Reg. § 26.2632-1(b)(1)(ii) & (2)(ii).

Annual Exclusion Amount

The annual exclusion amount for 2014 is $14,000.00. The GST exclusion applies only to direct skips that are outright transfers directly to skip persons and to transfers to certain trusts that have as the sole beneficiary only one skip person. I.R.C. § 2642(c). That beneficiary must have a testamentary general power of appointment.

If direct skips to an individual are protected by the gift tax annual exclusion (on a first-in, first-out basis), no GST exemption allocation or election is necessary. The same rule applies for medical or tuition payments that are paid directly to medical providers and qualified educational organizations.

Certain Transfers Excluded

Certain transfers do not qualify for the annual exclusion. The GST annual exclusion does not apply to direct skip transfers in trust for beneficiaries unless the ILIT provides: Distributions cannot be made to any person other than a single skip person beneficiary during that skip person's life; and, if the skip person dies prior to the termination of the ILIT, the ILIT assets must be included in the skip person's estate. I.R.C. § 2642(c). Otherwise, one must allocate the GST tax exemption to shield the transfer from the GST tax. GST annual exclusion amounts are also inapplicable to most *Crummey* trusts. If a child dies before the transferor, the ILIT might terminate in favor of a grandchild, thus exposing the ILIT to GST tax if the child did not have a general power of appointment, even if the transferor has unused GST exemption.

Elections Regarding the "Deemed Allocation" Rule

In making an election, one should elect to treat a trust as a GST trust or not as a GST trust to provide clarity. In most cases, the election should state that it applies to transfers during the current year and to all future transfers until the donor elects otherwise. This helps one attain the desired results even if future years' returns are late or not filed at all.

There are several reasons to elect out of the deemed allocation rule: One may be able to allocate GST exemption to future transfers—usually to future transfers of property that is likely to appreciate. One may allocate the exemption to a trust that accumulates income and contains appreciated assets. The indirect skip deemed allocation rule does not necessarily identify any trusts where the allocation is most beneficial to the transferor or transferor's executor. If the trust property decreases in value post-transfer without likelihood of recovery, a later allocation will use up less GST exemption.

Statute of Limitations

The statute of limitations period on the ILIT's GST exempt status begins to run when the distribution is made. Treas. Reg. § 26.2642-5.

Conclusion

Although ILITs are an excellent estate planning tool, one must be aware of the potential income, gift, and generation skipping tax traps. One should also make applicable elections in connection with filed tax returns in the year one creates and executes the ILIT. ■

Two Easy Ways to Access Valuable Materials from the Tax Section

Did you know that Tax Section members have access to thousands of pages of cutting-edge committee program materials presented at Section of Taxation Meetings? Using either our static, Section-hosted website, TaxIQ, or a searchable database powered by Westlaw, access is only a few clicks away.

Highlights

- Explore analysis of the latest federal tax policy, initiatives, and regulations
- Review planning ideas from the country's leading tax attorneys and government officials
- Search meeting materials quickly and easily by Keyword (Westlaw) or by Meeting Date (TaxIQ)

Visit www.ambar.org/taxiq and take your practice to the next level!

TAXIQ
Thoughtful Insights. Useful Analysis.

TaxIQ is a Section-hosted static listing of Section Meeting Materials. While it is not a searchable database, members are able to open full PDF documents from meetings dating back to 1999 by visiting the Meeting Material Archive at: **www.ambar.org/taxiq**.

Select the access link under the TaxIQ logo and you will be able to view materials by meeting date.

THOMSON REUTERS
A Publishing Sponsor of the ABA Section of Taxation

Through a sponsorship agreement with Thomson Reuters, members are able to access materials in a searchable database in Westlaw free of charge! You can access meeting materials in the database by also visiting **www.ambar.org/taxiq**.

Select the access link under the Thomson Reuters logo, log in, read and confirm the "User Agreement," and you are ready to search!