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Life Insurance and Life Insurance Trusts: Basics and Beyond

By Bradley E.S. Fogel

After bypass trusts, life insurance trusts are probably the most frequently used estate planning device. The reason for their popularity is simple: enormous transfer tax savings. Indeed, by excluding assets from the insured's estate, a life insurance trust can more than double the amount of policy proceeds payable to heirs.

Transfer tax savings are clearly the primary reason for creating life insurance trusts. There are, however, also non-tax advantages of holding a life insurance policy in trust. For example, life insurance trusts may provide meaningful advantages when planning for elective share rights of a surviving spouse. In some states and under the Uniform Probate Code, however, life insurance held by the decedent at the time of death is subject to the surviving spouse's right of election. Unif. Prob. Code § 2-205(1)(iv); Minn. Stat. § 524.2-205(1)(iii). In contrast, life insurance held by a life insurance trust is generally not included in the augmented estate, even under the Uniform Probate Code. In most states, life insurance is not subject to a surviving spouse's elective share regardless of whether it is held in a life insurance trust. See, e.g., N.J. Stat. Ann. § 3B:8-5; Mont. Code Ann. § 72-2-222(3)(c). Other non-tax advantages of having the policy proceeds paid to a trust include flexibility, professional management, and spendthrift protection from the beneficiary's creditors.

There are some disadvantages to setting up a life insurance trust. The primary disadvantage of a life

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insurance trust is that, in order to take advantage of the possible transfer tax benefits, the trust must be irrevocable. Thus, the insured must irrevocably designate the beneficiaries of the trust. Moreover, the insured will need to surrender the economic benefits in the policy, such as access to its cash surrender value. Treas. Reg. § 20.2042–1(c)(2).

The cost of setting up and the moderate complexity of maintaining a life insurance trust are also disadvantages. Although these disadvantages must be considered by both client and attorney, for many clients the disadvantages pale when compared to the possible transfer tax savings obtainable through an irrevocable life insurance trust.

Because the prime advantage of life insurance trusts is their transfer tax savings, they are quite sensitive to changes in the estate tax. The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107–16, 115 Stat. 38, repealed the estate tax for decedents dying after December 31, 2009. Code § 2210(a). This repeal is itself repealed, and the estate tax thus reinstated, on December 31, 2010. EGTRRA § 901. Legislative action to prevent this one year repeal of the estate tax seems likely. It is, of course, unclear whether this legislative action will permanently repeal the federal estate tax, eliminate the temporary repeal, or follow another path.

Except for the one year that the estate tax is repealed (calendar year 2010), EGTRRA has made few changes that directly affect life insurance trusts. EGTRRA has increased the applicable exclusion amount—the amount that can pass through an estate free of estate tax. The applicable exclusion amount is $1 million for 2002. It slowly increases to $3.5 million in 2009, only to fall back to $1 million in 2011 when the estate tax is resurrected. The increase in the exclusion may make transfer tax planning irrelevant for some clients who would otherwise consider creating a life insurance trust. Because the increased exclusion is temporary, it seems wise to plan as if the exclusion amount were $1 million, unless an increase is made permanent.

Estate Taxation at the Death of the Insured

Life insurance is included in the insured's gross estate if he possessed "incidents of ownership" in the policy at the time of his death. Code § 2042(2). "Incidents of ownership" is a broad term that includes not only outright ownership of the life insurance policy but also the right to change the beneficiary of the policy, to borrow against the policy, or to use it as collateral for a loan. Treas. Reg. § 20.2042-1(c)(2). In order to prevent the proceeds from a

policy held by a life insurance trust from being included in the insured's estate, the trust must be drafted so that the insured has none of these powers in the policy, either individually or as trustee. Treas. Reg. § 20.2042-1(c)(4); cf. Rev. Rul. 84-179. Therefore, the insured's control over, and rights to the economic benefit from, a policy held by a life insurance trust is greatly limited. For example, the insured may not have the power to designate the beneficiaries of the policy and should not be a trustee of his own life insurance trust.

If the proceeds from a life insurance policy are "receivable by the executor" of the decedent's estate, they will be included in his gross estate regardless of whether he held any incidents of ownership in the policy. Code § 2042(1). Even if the policy proceeds are not payable directly to the executor, they will be included in the insured/decedent's gross estate if they are subject to a "legally binding" obligation to pay estate obligations, such as the estate tax owed. Treas. Reg. § 20.2042-1(b)(1).

At first blush, this limitation seems to severely restrict the possible uses of life insurance held by a life insurance trust. This requirement can, however, be circumvented if the trust agreement provides that policy proceeds *may* be used for estate obligations. Specifically, the trustee should be given the discretionary power, instead of a "legally binding" obligation, to use policy proceeds to pay estate obligations, including the estate tax. Treas. Reg. § 20.2042-1(b)(1); Rev. Rul. 77-157; PLR 9748029. This discretionary power will not, by itself, cause the policy proceeds to be included in the insured's gross estate. The policy proceeds actually paid pursuant to this discretionary authority, however, may be included in the decedent's gross estate. Therefore, whenever possible, policy proceeds should be used to provide estate liquidity through loans made by the trust to the estate or the purchase by the trust of estate assets. Both the decedent's will and the life insurance trust should permit these transactions.

Creation of Irrevocable Life Insurance Trusts and the Three Year Rule

Once the insured has created the trust, the trustee should apply for the life insurance policy on the client's life. If the client, rather than the trustee, obtains the policy and then transfers it to the trustee, then the policy proceeds will be included in the insured's gross estate if he does not survive the transfer by at least three years. Code § 2035(a).

Although it is advantageous to have the trustee purchase the policy, it will not always be possible to do so. For example, the insured may own a substantial policy at the time the trust is created. Although it would be possible to avoid the reach of Code § 2035 by surrendering the existing policy and having the trustee obtain a new policy, this approach may not be economically efficient or even possible, depending on the insured's wealth. In this case, the existing policy may be transferred to the trust in the hope that the insured will survive the transfer by the requisite three years.

Since Code § 2035 does not apply to transfers for adequate and full consideration, it may be possible to avoid its reach

if the insured sells the life insurance policy to a life insurance trust or to a beneficiary. Code § 2035(d). Although theoretically possible, this course of action is rife with hazards. Specifically, the value of the policy may be quite substantial, especially if the insured is ill. Moreover, the sale would be a transfer of the policy for value, which would engender adverse income tax consequences. Code § 101(a)(2). Further, if the insured created a trust, funded the trust, and then sold the policy to the trust, the transaction could be attacked as a step transaction.

Transfer of an Existing Policy

If an existing policy is transferred to a life insurance trust without adequate consideration, that transfer is a gift. The amount of the gift is the fair market value of the policy, which is the sale price of a comparable policy. Treas. Reg. § 25.2512-6(a). For example, the value of a newly purchased policy is,

generally, its purchase price. Treas. Reg. § 25.2512-6(a), Ex. (1).

In some cases, it will be impossible to determine the purchase price of a comparable policy because of the unavailability of a sufficiently similar policy. In this case, the value of the policy is its "interpolated terminal reserve" plus the portion of the last paid premium that covers the period of time after the gift. Treas. Reg. §§ 25.2512-6(a), 25.2512-6(a), Ex. (4). In a nutshell, the interpolated terminal reserve of a policy is the amount that has been set aside, based on actuarial principles, on the insurer's books to satisfy its obligation. It should slightly exceed the cash surrender value of the policy. If the insured is terminally ill, however, the value of the policy is based on the insured's life expectancy. Thus the value of the policy is approximately its face amount. *Pritchard v. Commissioner*, 4 T.C. 204 (1944). As discussed below, if an existing policy must be transferred to the trust, it may be possible to use *Crummey* powers to obtain the federal gift tax annual exclusions to offset part or all of the gift.

Group Term Policies

Another situation in which it will be impossible to have the trustee purchase the life insurance is with respect to the group term life insurance. Group term life insurance, which is provided by many employers, is a frequently overlooked candidate for inclusion in the insured's life insurance trust. In fact, because group term generally has no cash surrender value, the insured may be more willing to part with the economic benefits of his group term policy than a whole life policy. Therefore, group term is uniquely suited for inclusion in life insurance trusts.

Although the insured may effectively cancel a typical group term policy by terminating his current employment, the IRS has ruled that such possibility is not an incident of ownership. Rev. Rul. 72-307. Thus, by irrevocably transferring all of his rights in the group term policy to a properly drafted life insurance trust, the insured may effectively part with all incidents of ownership in the policy. As with the transfer of any existing life insurance, the policy proceeds will be included in the insured's gross estate if he does not survive the transfer by at least three years. Code § 2035.

When the insured's employer pays the premiums on the group term policy, it is an indirect gift by the insured to the trust. Rev. Rul. 76-490. In order to assure that the federal gift tax annual exclusion is available to offset these indirect gifts, the beneficiaries are given *Crummey* withdrawal powers. As discussed below, however, *Crummey* powers require special care when the trust holds group term life insurance.

Premium Payments

Typically, the insured will pay the premiums on the life insurance held by the trust. Generally this is done by the insured's making a gift to the trust. The trustee will then use the gift to pay the policy premium. The insured may pay the premiums directly, which will also be a gift to the trust. Rev. Rul. 72-307. Since payment of premiums is not an incident of ownership in the policy, premium payment will not compromise the tax benefits of the trust. Code § 2042. Regardless, the insured's direct payment of the premiums makes the entire arrangement appear somewhat contrived. Moreover, if the insured pays the premiums directly, the formalities of the *Crummey* powers (discussed below) become somewhat more complicated. Therefore, it is recommended that the insured pay the premiums through cash gifts to the trustee, rather than by direct payment to the insurer.

When the insured makes the transfer to the trust to pay the policy premiums, he is making a gift to the beneficiaries of the trust. Unless the gifts are covered by the annual exclusion, the transfers will be taxable gifts. As a result, some of the insured's unified credit (a/k/a "applicable credit amount") will be used or gift tax may be owed.

Gifts of future interests do not qualify for the annual exclusion. Code § 2503(b). Gifts made in trust are, generally, at least partially future interests. Treas. Reg. § 25.2503-3(b). Thus, gifts to the trust to pay the premiums will not, in and of themselves, qualify for the annual exclusion.

Crummey Powers

In order to obtain the annual exclusion for gifts made to the trust, the beneficiaries of the trust are given rights—*Crummey* powers—to withdraw an aliquot share of the gift to the trust. This immediate, albeit temporary, right to withdraw the gift made to the trust makes the transfer a present interest, which qualifies for the federal gift tax annual exclusion. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). This is true even though the withdrawal power lapses.

A typical *Crummey* withdrawal power lapses 30 days after the gift is

made to the trust. Although never explicitly ruled on, this seems the shortest period of time that will pass muster with the IRS. Rev. Rul. 81-7; PLR 9232013; PLR 9030005; PLR 8922062; PLR 8022048. For example, in TAM 9131008 the IRS ruled that a 20-day period too severely restricted the beneficiary's possible exercise of the power. Courts have allowed annual exclusions based on *Crummey* powers that have lapsed after less than 30 days. *Crummey*, 397 F.2d at 83 (power lapsed after twelve days); *Cristofani v. Commissioner*, 97 T.C. 74 (1991) (power lapsed after 15 days). These cases do not, however, specifically address the time period. Further, a few older private rulings seem to allow the exclusion even though the power lapsed in less than 30 days. PLR 8111123 (10 days); PLR 7922107 (3 days).

Although it may be possible to obtain the federal gift tax annual exclusion through the use of a *Crummey* power that lapses after less than 30 days, little is gained by the shorter time period. *Crummey* powers are very rarely exercised, regardless of the length of the time the withdrawal power remains outstanding. Indeed, many attorneys draft *Crummey* powers that lapse 60 or more days after the gift. See, e.g., PLR 8022048.

If the *Crummey* withdrawal power provisions of the trust agreement are not acceptable to the donor, it is possible to vary the terms of the withdrawal right in the instrument by which the donor makes the gift to the trustee. It may be wise to anticipate this possibility in the trust agreement. Such a variance might, for example, be appropriate if the withdrawal power provisions of the agreement fail to account for inflation adjustments in the annual exclusion or to exclude a beneficiary who has demonstrated a propensity to exercise the withdrawal power.

No court has ever required that the beneficiary be given notice of his withdrawal right. Indeed, in *Crummey*, the court noted that some of the beneficiaries were likely unaware of his rights. 397 F.2d at 87–88. Despite this observation, the annual exclusions were allowed. The IRS has, however, repeatedly ruled that the beneficiary must know of the existence of the withdrawal power. Rev. Rul. 81-7; TAM 953201. Theoretically, it should be sufficient if the beneficiaries had actual knowledge of their withdrawal rights. *Holland v. Commissioner*, 73 T.C.M. (CCH) 3236 (1997). The lack of a written notice, however, presents obvious difficulties in trying to prove the requisite knowledge. In practice, most attorneys instruct the trustee to send (or assist the trustee in sending) written notices, called "*Crummey* notices," to the beneficiaries.

A *Crummey* notice should include the amount of the gift, the date the withdrawal power will lapse, and the extent of the beneficiary's power. It should be sent to the beneficiary. If the beneficiary is a minor, the notice should be sent to his court-appointed guardian, if any, or his natural guardian. PLR 8143045; PLR 8922062; PLR 8806063. *Crummey* notices are commonly drafted so that the beneficiary is prompted to inform the trustee if he chooses not to exercise his withdrawal power. This is frequently a mistake. Instead, the *Crummey* notice should instruct the beneficiary to do nothing if he wishes to allow the power to lapse as discussed.

A *Crummey* withdrawal power is a general power of appointment for gift tax purposes. Code § 2514(c). The lapse of a *Crummey* power is deemed a release of the power of appointment that, in turn, is a gift. Code §§ 2514(b), 2514(e). But a lapse is treated as a gift only to the extent it exceeds the greater of $5,000 or 5% of the trust principal. Code § 2514(e). Therefore, if a beneficiary allows a *Crummey* power restricted to the "five and five" amount to lapse, the lapse will not be deemed a gift and, therefore, no adverse gift tax consequences ensue. The lapse of a greater power may be at least partially a taxable gift by the power-holder.

It is important to note that this five and five exclusion is available only if the *Crummey* withdrawal power lapses. If the beneficiary releases the power, the five and five exclusion would not apply and the entire amount of the lapsed withdrawal right may be a taxable gift. To avoid this result, the *Crummey* notice should instruct the beneficiary to simply do nothing if he wishes not to exercise the *Crummey* power. Moreover, it may be wise to provide in the trust agreement that an attempted release of the *Crummey* power is ineffective.

Special issues arise regarding *Crummey* powers if the trust holds group term life insurance or if the insured pays the premiums directly. In these cases, the trustee may be unable to satisfy an exercised *Crummey* power if the trust holds only the insurance. If permitted by the terms of the policy, the trustee could assign a fractional interest in the policy to the beneficiary. In the alternative, the trustee could either sell the policy and distribute the proceeds or distribute the entire policy to the beneficiary and attempt to recover the difference between the value of the policy and the exercised power from the beneficiary. Both options suffer from significant logistical difficulties and may be a transfer of the policy for value. Code § 101. A more palatable alternative is for the insured to initially fund the trust with a small amount of cash. The trustee could hold this cash in reserve to satisfy an exercised *Crummey* power. In any event, upon hearing that a power has been exercised, the insured may decide to make an additional cash gift to the trust to enable the trustee to exercise the power.

Crummey powers are rarely exercised. Thus, the difficulty in satisfying an exercised *Crummey* power may be more theoretical than practical. It is, however, important to make sure that the withdrawal power is legally enforceable. *Holland*, 73 T.C.M. (CCH)

at 3236. Further, assuring that the power could be satisfied will help defend against an argument that the power is illusory. Moreover, although no rulings have turned on this issue, the IRS has noted that the exclusion will be denied unless the trust holds sufficient assets that are "reducible to cash" so that an exercised power can be satisfied. PLR 8118051.

It is important to realize that the nuances of life insurance trusts seem bizarre to the average client. In particular, *Crummey* powers and *Crummey* notices seem like irrelevant technicalities rather than acts that have significant tax ramifications. Indeed, lay trustees who have not adhered to the *Crummey* notice requirements are common. The lawyer must stress the importance of these "technicalities" to the client and trustee.

Annual Exclusions for Substantial Premiums

When a *Crummey* power is restricted by the five and five limitation of Code § 2514(e), the insured/donor will obtain an annual exclusion that is similarly limited. If the premium on the life insurance held by the trust is substantial, other methods must be found to assure that the entire transfer by the insured to the trust is covered by the annual exclusion.

One possibility is to allow the beneficiaries (other than the donor's spouse) to withdraw the full amount covered by the annual exclusion, $10,000 (as of calendar year 2001) or $20,000 if the donor splits the gift with his spouse. Code §§ 2503(b), 2513. This may engender adverse gift tax consequences to the power-holder. It may, however, be an acceptable cost. *Crummey* power-holders are frequently of a younger generation than the donor/insured, and efforts to minimize their estate tax may be wasted. This is especially true considering the uncertain future of the federal estate and gift tax and the possibility that the beneficiary's assets may never exceed the applicable exclusion amount. Moreover, even if the temporary estate tax repeal never becomes permanent, the increased unified credit may.

Another possibility is to draft the trust so that no individual other than the particular power-holder has an interest in his share of the trust. For example, if trust income and principal can be distributed only to the power-holder or his estate, then the lapse of the *Crummey* power cannot be a taxable gift by the power-holder for want of a donee. PLR 8142061. This technique requires that each power-holder have a fully vested share in the trust, which may be inconsistent with the insured's estate plan. Further, the

power-holder's share of the trust will be included in his gross estate at his death. Code § 2041.

Even if there are other beneficiaries of the trust, if the beneficiary is given a power of appointment over the trust assets, the lapse of the withdrawal power will not be a completed gift. PLR 8517052; PLR 8229097. Thus, lapse of the power will not be a taxable gift.

A third option is the use of "naked" *Crummey* powers. Traditionally, only beneficiaries with relatively substantial interests in the trust were given *Crummey* powers. In order to obtain additional annual exclusions, however, trusts would sometimes be drafted so that individuals with minimal (or no) interests in the trust would also be given *Crummey* withdrawal powers. The IRS has repeatedly attacked these arrangements as shams. TAM 9731004; TAM 9628004; TAM 9045002. The IRS's efforts have, however, been uniformly rebuffed by the courts. *Kohlsaat v. Commissioner*, 73 T.C.M. (CCH) 2732 (1997); *Holland v. Commissioner*, 73 T.C.M. (CCH) 3236 (1997); *Cristofani v. Commissioner*, 97 T.C. 74 (1991).

Because it is the power-holder's immediate right to withdraw the contribution to the trust that creates the present interest, rather than the beneficiary's other interest in the trust, the IRS's arguments against naked *Crummey* powers are largely specious. Bradley E.S. Fogel, *The Emperor Does Not Need Clothes—The Expanding Use of "Naked"* Crummey *Withdrawal Powers to Obtain the Federal Gift Tax Annual Exclusion*, 73 TUL. L. REV. 555 (1998). The IRS's demonstrated willingness to litigate this issue should, however, give the careful practitioner pause in recommending this technique.

Another possible means of circumventing the five and five limitation is the use of "hanging" *Crummey* powers. The donor's annual exclusion with respect to each *Crummey* withdrawal power is limited to $10,000 per year ($20,000 if the donor is married and the gift is split). Code §§ 2503(b), 2513. In contrast, adverse gift tax consequences to the beneficiary ensue only if the withdrawal power exceeds the more modest five and five limitation. Code § 2514(e). The crux of a hanging *Crummey* power is to allow the donor's annual exclusion to be determined by the more generous provisions of Code § 2503 yet to limit the lapse to merely the five and five amount.

A hanging *Crummey* power allows the beneficiary to withdraw the full amount of his aliquot share of a gift to the trust, up to the annual exclusion. But the power lapses only to the extent that the lapse will be covered by the five and five limitation of Code § 2514(e). The unlapsed portion "hangs" until the next year. Presumably, this hanging portion will lapse in later years when gifts are no longer made to the trust or when the value of the trust principal increases so that the 5% portion of the five and five limitation allows for greater annual lapses.

It is important to exercise care when drafting hanging *Crummey* powers. If the amount of the lapse is explicitly tied to the gift tax ramifications to the power-holder, the gradual lapse will be disregarded, for gift tax purposes, as a "condition subsequent." *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944);

TAM 8901004. The amount of the lapse must be determined prospectively. For example, the power should lapse only to the extent of $5,000 or 5% of the trust principal. This should accomplish the desired result of allowing the power to lapse only to the extent such lapse is not a taxable gift without running afoul of *Procter*.

During the one-year repeal of the estate tax, the availability of the annual exclusion is explicitly tied to income tax consequences. Specifically, during 2010 a transfer in trust will be a taxable gift unless the trust is a grantor trust for federal income tax purposes. Code § 2511(c). Thus, to qualify for the annual exclusion a transfer to a trust must not only be a present interest; in addition, the trust must be a grantor trust for income tax purposes. Code §§ 2503, 2511(c).

As discussed below, life insurance trusts are generally grantor trusts. Because a life insurance trust is a grantor trust, a transfer to it will not automatically be a taxable gift under Code § 2511(c). Therefore, if the transfer is a present interest that meets the requirements for the annual exclusion of Code § 2503, the transfer should not be a taxable gift despite Code § 2511(c). Thus, it seems that the use of *Crummey* withdrawal powers in life insurance trusts has not been significantly affected by EGTRRA.

Terms of a Typical Irrevocable Life Insurance Trust

There is great flexibility in selecting the terms of an irrevocable life insurance trust without compromising the tax advantages. For the most part, life insurance trusts tend to be categorized as either a single life or a joint and survivor (a/k/a "second to die") life insurance trust. A single life life insurance trust is intended to hold insurance on the life of an individual insured. In contrast, a second to die life insurance trust typically holds life insurance upon the joint lives of husband and wife, that is, life insurance that pays upon the death of the surviving spouse.

Both single life and joint and survivor life insurance trusts hold insubstantial assets, other than the life insurance policy, during the insured's (or insureds') life. As a consequence, distributions during the insured's life should be minimal. An exception, of course, is in the unlikely event of an exercised *Crummey* power.

During the insured's life, it may be wise to give the trustee the discretionary power to distribute all trust assets to a beneficiary and, therefore, terminate the trust. For example, in a single life trust, the trustee could be given the discretionary power to terminate the trust and distribute all assets to the insured's spouse. This allows the trust to be terminated if it becomes unnecessary. Possibilities include some or all of the changes made by EGTRRA becoming permanent.

After the death of the insured(s), the trust will hold more substantial assets, specifically the policy proceeds. At that point, depending on the estate plan, the assets could be held in further trust or distributed to the beneficiaries outright. In the case of a single life trust, the insured's surviving spouse (if any) will likely be a beneficiary of the trust, even though the policy proceeds will not be subject to the spouse's right of election. See, e.g., MO. REV. STAT. § 474.160; N.Y. EST. POWERS & TRUSTS LAW § 5-1.1; UNIF. PROB. CODE § 2-205(1)(iv).

For the most part, the surviving spouse's interest in the trust can be as substantial as the insured/client desires, provided that the spouse does not have a general power of appointment over the trust assets. Since the assets held in the trust will pass to the beneficiaries without inclusion in the surviving spouse's gross estate, distributions to the surviving spouse should be limited to the extent consistent with the estate plan.

One possible means of limiting the assets distributed to the surviving spouse, while still assuring that the proceeds are available to him, is through the use of a five and five withdrawal power. Specifically, as opposed to requiring that income or principal be distributed to the surviving spouse, the surviving spouse may be given the power to withdraw the greater of $5,000 or 5% of the trust principal, per annum. As discussed above in the *Crummey* context, to the extent the surviving spouse allows this power to lapse, the lapse will not be a taxable gift, but the assets will remain in the trust. Code § 2514(e).

Another beneficial provision in a single life life insurance trust is a backup distribution in a manner that qualifies for the federal estate tax marital deduction. The marital distribution would be made only if policy proceeds are included in the insured's gross estate. For example, if the insurance trust held a policy given to it by the insured, the trust agreement could provide that, if the insured does not survive the transfer by at least three years, the policy proceeds are paid to the surviving spouse outright. In this case, the marital deduction would offset the inclusion of the policy proceeds in the insured's estate. Code §§ 2035(a), 2056. To the extent not expended, the assets will, of course, be included in the surviving spouse's gross estate upon his later death. Code §§ 2033, 2044.

Income Tax Issues

Generally, an irrevocable life insurance trust holds only the policy and the funds used to pay the premiums. Thus, the trust will have little, if any, taxable income. Because trust income may be applied to pay premiums on life insurance on the grantor's life, any taxable income will be taxed to the grantor under the grantor trust rules. Code § 677(a); *Rand v. Commissioner*, 40 B.T.A. 233, 238–39, aff'd, 116 F.2d 929 (8th Cir. 1941). To assure such treatment, it may be wise to include other provisions that assure grantor trust status without compromising transfer tax treatment.

Although Code § 678(a) provides that trust income is taxed to the *Crummey* power-holder since the power-holder has the power to vest the trust corpus in himself, Code § 678(b) provides that Code § 678(a) does not apply if income would otherwise be taxed to the grantor. But Code § 678(b) applies only to a "power over income." In fact, a *Crummey* power is a power over trust principal. Despite this distinction, the IRS has ruled that trust income is taxed to the grantor,

rather than to the *Crummey* power-holder. PLR 9141027. Upon the grantor's death, the trust, assuming that it continues, is taxed as a separate taxpayer. Id.

Generation-Skipping Transfer Tax Issues

If the insured's grandchildren or other skip persons are potential beneficiaries (even contingent remainder beneficiaries) of the life insurance trust, then consideration must be given to the federal generation-skipping transfer tax. Although a trust can be a skip person, the typical life insurance trust is not since the insured's spouse and/or children likely have an interest in the trust. Code §§ 2613(a), 2652(c).

A possible generation-skipping transfer tax trap awaits in a typical life insurance trust if the insured and his descendants do not die in the usual order. For example, assume a trustee of a life insurance trust is required to distribute the proceeds to the insured's issue, *per stirpes*, upon the death of the insured. If a child of the insured predeceased the insured, distributions may be made from the trust to skip persons, the deceased child's descendants.

Many similar transfers would not be subject to the generation-skipping transfer tax because of the predeceased ancestor rule. Code § 2651(e). This rule provides that a transfer to a grandchild, or more remote decedent, is not a generation-skipping transfer if the transferor's descendant who was also the ascendant of the donee is deceased. The predeceased ancestor rule, however, applies only if the ancestor is deceased at the time of the transfer. Code § 2651(e)(1). In the case of a life insurance trust, the transfer occurs when gifts are made to the trust to pay premiums and as the *Crummey* powers lapse. Because this occurs before the distribution to the skip person, payment to such a skip person would be a generation-skipping transfer. Code § 2612(b). The unexpected generation-skipping transfer may require allocation of some (or all) of the transferor's generation-skipping transfer tax exemption. If insufficient exemption is available, generation-skipping transfer tax may be due.

Moreover, complexity is created in the generation-skipping transfer tax context because a typical life insurance trust may have more than one transferor. A typical life insurance trust is funded through the lapse of numerous *Crummey* powers. To the extent that the lapse is covered by the five and five exclusion of Code § 2514(e), the insured/donor is the transferor. Treas. Reg. § 26.2652-1(a)(5), Ex. (5); Code § 2652(a). If a portion of the lapse is not covered by the five and five exclusion of Code § 2514(e), however, the power-holder will be the transferor of that portion. This is another reason why it may be best for all lapses of *Crummey* powers to be covered by the Code § 2514(e) five and five exclusion, even, if necessary, through the use of hanging or naked *Crummey* powers.

If the generation-skipping transfer tax is an issue, it may be best to assure that the trust is generation-skipping transfer tax exempt. Transfers covered by the annual exclusion are, normally, exempt from the generation-skipping transfer tax. Code § 2642. In the case of annual exclusions that are obtained through the use of *Crummey* powers, however, the annual exclusion gift is generation-skipping transfer tax exempt only if (1) during the beneficiary's lifetime distributions may not be made to anyone but the particular beneficiary and (2) trust assets will be included in the beneficiary's estate if he dies before termination of the trust. Code § 2642(c)(2). In a nutshell, this limitation requires that no person other than the particular power-holder has an interest in that particular power-holder's share of the trust. This is not the case in a typical life insurance trust; thus, annual exclusion gifts to such a trust will not be generation-skipping transfer tax exempt.

Other than assuring that distribution to skip persons is impossible (or at least unlikely), perhaps the simplest generation-skipping transfer tax planning is to create a separate share in the trust for the benefit of each power-holder. Provided that no person other than that particular power-holder has an interest in that share of the trust, gifts to the trust subject to *Crummey* powers should be both gift tax and generation-skipping transfer tax exempt. Code § 2642(c)(2). Of course, the creation of a separate share for each beneficiary may not be practical or it may be inconsistent with the overall estate plan.

Another possibility is the allocation of generation-skipping transfer tax exemption to the trust. Every individual has a generation-skipping transfer tax exemption that, if properly allocated, can insulate transfers from the generation-skipping transfer tax. Between 2002 and 2009 the GST exemption tracks the applicable credit amount in its slow progression from $1 million to $3.5 million. Code § 2631(c). Under current law, the generation-skipping transfer tax is repealed for 2010, only to be resurrected in 2011. Code § 2664; EGTRRA § 901. In 2011, the exemption will fall back to $1 million plus an adjustment for inflation. Code § 2631.

If the generation-skipping transfer tax exemption is allocated to a life insurance (or any) trust, it is generally advantageous to create one trust that is fully subject to the generation-skipping transfer tax in which distributions to skip persons are impossible, or at least unlikely. A second trust should be used to make distributions to the skip persons. This trust should be allocated a sufficient amount of generation-skipping transfer tax exemption so that it will be fully exempt.

Conclusion

Life insurance trusts can greatly increase the life insurance policy proceeds actually enjoyed by the beneficiaries. Moreover, careful drafting can yield a life insurance trust that is fully consistent with the client's desires and estate plan without compromising the transfer tax benefits. Further, the trust can (and should) be drafted to anticipate possible changes in the estate and gift tax. By working together, with the lawyer carefully explaining to the client what needs to be done and why, the client can realize the benefits of one of the most powerful estate planning techniques. ■