Insurance in Irrevocable Trust Held IRS-proof

By Helen Murphy, CLU, ChFC

The use of life insurance in irrevocable trust has been made easier by a series of recent court decisions involving life insurance and the three-year rule of Section 2035 of the Internal Revenue Code.

In a string of cases – first in the Tax Court, and later in three different Circuit Courts of Appeal – the Internal Revenue Service has consistently lost on its "beamed transfer theory." By the IRS reckoning, the payment of death processed to a trustee from a trust created less that three years before a decedent's death is a transfer; thus the process should be included in the decedent's estate.

Starting with a Tenth Circuit case two years ago, the court have consistently held that when someone other than the insured is the owner of the policy from its initiation, the policy will not be included in the insured's estate, even if the insured dies within three years ad even if the insured or his corporation pays the life insurance premium *Estate of Leder,*893 F.2d 237 (10th Cir. 1989).

A year later, the Sixth Circuit followed that rationale in *Estate of Headrick,* 918 F.2d 1263 (6th Cir 1990) *Headrick* is significant because of its somewhat extreme fact situation.

The decedent was a young tax attorney who drafted his own irrevocable trust agreement, appointing a bank as trustee of the trust. On the day after the decedent assigned $5,900 to the bank, the bank as trustee applied for a $375,000 policy on the life of the decedent. The bank as trustee was listed as policy owner and beneficiary. Decedent signed the policy application as the insured.

Subsequently, the decedent became a member of the bank's trust committee. In that role he routinely reviewed on a quarterly basis the trust for which the bank acted as trustee. His own trust was on of those that was periodically reviewed. About two and a half years after the start of the policy the decedent was killed in an auto accident.

The IRS argued that the payment of the death proceeds to the trustee was a transfer within the meaning of Section 2035(a) because the trust was created less that three years before decedent died. The proceeds, therefore, should be included in the decedent's estate.

No Incidence of Ownership

The Tax Court followed its decision in *Leder*, and the Sixth Circuit later affirmed. The Tax Court fond that the decedent had no incidence of ownership in the policy under Section 2042, so the bring back provision of section 2035 did not apply.

After losing in the Tax Court in *Leder* and subsequent cases, the IRS embarked upon a circuit court search, looking for a court that would accept its beamed-transfer argument. It struck out, however, with *Leder* in the Tenth Circuit, *Headrick* in the Sixth, and again in the Fifth. *Estate of Perry*, 927F.2d209 (5thCir. 1991).

This time, the Service raised the white flag of surrender. The *Perry* court hinted broadly at the conclusion of its three-year rule beamed-transfer theory would cost the IRS attorneys' fees for the taxpayer. In fact, the estate's attorney in *Perry* quickly filed for an award of attorneys' fees, which was granted. Shortly thereafter, the IRS said, in a Action – on Decision (AOD 1991-012 (7/15/91)) announcement, that it would no longer litigate the issue.

It is now settled law, therefore, that when an irrevocable life insurance trust is set up and a life insurance policy is taken out with the trustee as the owner and beneficiary form the beginning, the policy is out of the insured's estate. If the insured should die in the first three years fo the policy, it will not be included in his estate.

How It Works

In an irrevocable life insurance trust, the trust is the owner and beneficiary of one or more life insurance policies on the life of the estate owner. Properly arranged, the life insurance will be outside the insured's estate for estate tax purposes. The beneficiaries of the trust are the insured's estate beneficiaries: normally, his children.

The insured estate owner usually will gift the necessary premium payments to the trust. In order to have these gifts treated as present interest gifts, and thereby qualify for the $10,000 gift tax annual exclusion, the beneficiaries are given so called Crummey withdrawal powers. The trustee gives the beneficiaries written notice – usually 30 days – that they have the right to withdraw their proportionate share of the recent gift to the trust. When the time has elapsed, the trustee sends his check to the insurance company to pay the premium. The premium should be paid on an annual basis to avoid the need for multiple Crummy letter during the year.

The Crummey name comes our of an old Ninth Circuit case where the court held that notification to a minor child of a withdrawal right was sufficient. *Crummy v. Commissioner*, 398 F.2d82 (9th Cir. 1968). All that was necessary was the possible under local law that a guardian could be appointed to act for the child. It was not necessary, the court held, that a guardian actually be appointed.

If the Crummey withdrawal power is not given to the beneficiaries, then the gift to the trust of the premium amount by the grantor-insured is a gift of a future interest. Such a gift is taxable and would cause the grantor to use part of his unified credit. Although no tax would be sue until the cumulative premium amount exceeds $60,000 such gifts will be added back into the grantor's estate at death and could push him into a higher marginal estate tax bracket.

The use of the Crummey withdrawal power in the trust document allows the grantor to shelter form gift tax $10,000 per beneficiary annually; $20,000 per beneficiary if the spouse joins in the gift. Thus, for example, if three children are beneficiaries of an irrevocable life insurance trust, a married insured could gift $60,000 each year to the trust for premiums with no gift tax consequences.

While such gifts equal to the annual exclusion create no tax problems for the grantor, they can cause potential gift tax problems fro the beneficiaries.

This lapse-of-a-power gift is protected from taxation by a tax law provision that exempts the greater of $5,000 of 5 percent to the trust corpus from taxation. I.R.C. &&2514(e), 2041©. Assuming, again, a $60,000 premium gift to a trust with three beneficiaries, when child A allows his power over $20,000 to lapse he is deemed to make a taxable gift of $15,000-$7,000 each to B and C. Such gifts of a future interest, and thus not protected by the annual exclusion.

They are, of course, protected by the unified credit. The use of the unified credit by a beneficiary may not be seen as a major problem because of the many years that he can expect to pass before the beneficiary's death, particularly if he or she is currently a minor or even an infant. If the ultimate tax consequences may not be expected to occur until death – 50, 60, of more years in the future – it cannot be a worrisome problem today. Because of the effects of inflation over 50 or more years, the ultimate tax consequence will likely be de minimis nature.

Another solution, one that has been proposed by estate planning specialist, is the use of hanging powers in the trust. The idea is to suspend the lapse of the amount above the protected $5,000 to some time in the future. The future point in time would be when annual gifts into the trust have stopped because life insurance policy premiums have "vanished" due to sufficient cash value build up in the policy. Beginning in the year of the premium "vanish" the powers that have been suspended are released in portions that fit with the $5,000 of 5 percent rule.

The IRS has signaled its displeasure with the hanging powers in Private Letter Ruling 89-011004. The use of hanging powers has not yet been tested in a court case, however, although some practitioners feel strongly that it should stand up to any court challenge by the IRS.

Multiple Beneficiaries

A recent Tax Court case may provide relief to the "5 and 5" problem by allowing for multiple Crummey beneficiaries. *Estate of Cristofan*, 97 T.C. No 5. In that case, the court held that the gifts in trust which were subject to Crummey withdrawal rights be the donor's grandchildren possessed only a contingent remainder interest in the trust itself.

The Tax Court noted that beneficiaries of a trust do not need a vested remainder inters in corpus or income in order to qualify such gifts for the annual exclusion; all that is necessary is the legal right to exercise the withdrawal power. The court concluded that the grantor's motives do not change this result. If contingent beneficiaries can have valid Crummey withdrawal rights, then a gift of premium to an irrevocable trust can be divided into enough pieces as to keep each gift at $5,000 per donee of less. Then when the Crummey power of each donee is allowed to lapse, these will be no taxable transfer among beneficiaries.

This extension of valid Crummey withdrawal powers to contingent beneficiaries can also be helpful to the donor-grantor when the premium exceeds the normal allowable annual exclusion. For example, if the premium is $100,000 and there is only one beneficiary(i.e., only one child), the donor could on a split basis, could only protect $20,000 with the annual exclusion. If the child, however had four children, these grandchildren of the doror could be made contingent beneficiaries and given Crummey withdrawal rights of $20,000 each – thereby soaking up the remaining $80,000 premium amount under the annual exclusion protection.

The *Cristofani* decision, however, is not the only recent Crummey beneficiary development. Prior to *Cristofani,* the IRS announced in a Technical Advise Memorandum its displeasure with multiple Crummey beneficiaries.

In TAM 91-41008, the IRS was faced with the issue of how many annual exclusions are available to a trust for the benefit of the decedent's three children containing a limited power for her three children and 32 grand-children and great grandchildren. The IRS ruled that the descendent was only entitled to annual exclusion for the primary beneficiaries, her three children. The ruling found it significant that none of the 32 contingent beneficiaries ever exercised any withdrawal rights over a four-year period.

The IRS inferred that the beneficiaries had reached a prior understanding with the donor that the withdrawal rights would not be exercised. It further found fault with the 20-day withdrawal period, stating that it severely restricts the time in which a demand right can be exercised. Thus, the IRS is saying it will look at the intend of the donor concerning Crummey gifts. Subsequently, the *Cristofani* court said that the intent was not significant. The ruling in TAM 91-41008 may be an example of the adage that "bulls make money and bears make money, but hogs get slaughtered."

In addition t their use with a brand new policy, life insurance trust can have existing life insurance policies transferred into them. This can happen when an estate owner decided that it is on longer practical – from an estate tax standpoint – to continue to personally own an insurance policy.

The tax rules relating to a transfer of the policy to an insurance trust are relatively straightforward.

First, it is clear that under I.R. C. section 2035 the owner-insured must live three years after the transfer to keep the death proceeds form being brought back into the estate.

Second, since the policy is being gifted to the trust, the measure of its value for gift tax purposes is the interpolated terminal reserve plus any unearned premium. For policies that have been in existence for several years or more, this generally means the policy cash value at the date of transfer.

Insuring Against Greed

With the attractive benefits that life insurance can provide, it makes almost no sense for an estate planning perspective to have the insurance owned by the insured, and thus subject to federal estate taxes at hi or her death. If the insurance is owned by the insured, it can be subject to estate taxes at marginal rates up to 55, or even 60 percent. It is self-defeating to purchase life insurance to pay estate taxes only to have 55 percent of the insurance proceeds be lost to taxes. So it is practically mandatory proper estate planning, therefore, to have the insurance out of the insured's estate at death.

One way to accomplish this is to have someone other than the insured own the policy. This alternative, however, presents its own problems, which comes under the heading of that side of human mature known as greed. It can cause the beneficiary of the life insurance policy death proceeds to use the dollars for personal wants or needs, rather that complying with the estate plan of the deceased.

All kind of potential mischief can be done to an estate plan by such personal ue. If, for example, we assume a joint and last-to-die policy on a husband and wife owned equally by their two children, the plan would be for the children to provide the insurance proceeds to the estate of the second spouse to die in order to pay estate taxes. The problem that can arise is that one of the two children dose not do what6 his suppose to, but rather decides to spend his one-half share of the death proceeds for his own uses. The uses could include such mundane needs as paying college tuition, buying a new house or car or paying for a long desired vacation. If the other child follows his parents' estate plan and provides the insurance cash proceeds to the estate, only one half of the monies will be available to pay estate taxes (or other estate liquidity needs).

Because of the shortfall the estate may be forced to sell assets quickly at "fire Sale" prices to raise needed cash, This may result in a family feud situation. The child who did the "right" thing and provided the insurance proceeds to the parent's estate may understandably be very angry at his sibling who reined the estate plan by "misappropriating" the share of insurance for his own uses.

Windfall for In-laws

The other problem that can occur with personally-owned insurance is the proceeds can end up going to in-laws; say, the spouse of the son or daughter who was the original policy owner.

For example, if a married daughter is the owner of a life insurance policy on her parent's life, and the daughter predeceases the parent-insured, the policy may inadvertently pass to the daughter's husband under his will. The policy would be a probate asset in the daughter's estate and could pass under her will or by intestacy to her husband. The result: the son-in-law is the owner and beneficiary of a policy on his father-in-law.

If the son-in-law is not a beneficiary of his father-in-law's estate (and normally he would not be), he has no incentive to provided the insurance policy for the estate liquidity needs of his father-in-law. Again, the result of personally-owned insurance is a ruined estate plan.

This problem of the wrong beneficiary receiving the insurance proceeds can be prevented by initially naming another family member successor owner of the policy. Then a child predeceases the parent, the life insurance policy could still stay within the family. This step dose not solve the estate planning problem completely, however, because proper planning is to have the insurance proceeds pass to the same person(s) who is beneficiary of the parent's estate.