WHAT'S UP WITH THOSE CRUMMEY WITHDRAWAL POWERS?

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Has the Tax Court put life irrevocable life insurance trusts at risk?

IN A VERY RECENT DECISION, the United States Tax Court ruled that "Crummey" withdrawal powers were to be ignored when there was an implied understanding that the withdrawal rights would not be exercised. If this rationale were applied to irrevocable life insurance trusts, the estate planning impact could be very significant.

THE MECHANICS OF LIFE INSURANCE TRUSTS • Although personally owned life insurance is not subject to income taxation, the insurance proceeds will be includable in the insured's estate for federal estate tax purposes if the insured possesses an "incident of ownership" of the policy. Internal Revenue Code §2042. (All section references are to the Internal

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Revenue Code unless otherwise indicated.) Estate taxation of the insurance proceeds can be avoided, however, if the insurance policy is acquired and owned by an irrevocable trust. For the insurance proceeds to be excluded from the insured person's estate, the insured cannot retain any rights over the policy, such as the right to change beneficiaries, the right to cancel or surrender the policy, the right to pledge the policy as collateral for a loan, or the ability to borrow against the policy. *Id.* A policy transferred to a properly structured irrevocable trust more than three years before the death of the insured also will avoid estate taxation. §2035(a).

When an irrevocable trust is created to own an insurance policy, consideration must be given to how policy premiums will be paid by the trustee. In most cases, the grantor of the trust will make annual contributions to the trust to provide the trustee with the necessary funds to pay premiums. Because transfers to an irrevocable trust are considered to be completed gifts of a future interest, absent special planning, such transfers will not qualify for the annual gift tax exclusion. §2503(b); Treas. Reg. §25.2503-3(a). However, in *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968), the Ninth Circuit Court of Appeals ruled that a contribution to an irrevocable trust will qualify for the annual exclusion if the beneficiary (or beneficiaries) are given the unrestricted right to withdraw the amounts contributed to the trust for a specific period of time. *See also* Rev. Rul. 73-405, 1973-2 C.B. 321; Pvt. Letter Ruls. 9625031, 8712014, 8118051, 8007080, 7947066, 7909031, and 7826050; TAMs 8445004, and 7902007.

Beneficiary's Powers and Knowledge

In the IRS's opinion, for the contribution to qualify for the annual exclusion, the beneficiary must either receive timely notice or have actual knowledge of his or her right to immediately withdraw the contribution. Rev. Rul. 81-7, 1981-1 C.B. 474; TAM 7946007. The IRS also takes the position that to qualify for the annual exclusion, the holder of the withdrawal power must have a beneficial interest in the trust. *See* TAMs 9731004 and 9045002. However, in *Estate of Cristofani v. Comm.*, 97 T.C. 74 (1991), withdrawal powers held by the donor's grandchildren were found to be sufficient to qualify gifts to the trust for the annual exclusion, even though the grandchildren possessed contingent remainder interests.

A beneficiary's power to withdraw contributions to an irrevocable trust constitutes a general power of appointment. If the beneficiary fails to exercise the power of withdrawal, then the lapse of that power is considered to be a taxable gift by the power holder to the extent the amount that could have been withdrawn exceeds the greater of $5,000 or five percent of the value of the trust assets. *See* §2514(e). To avoid this gift, a "hanging" withdrawal power might be used. A hanging withdrawal power is one which lapses only to the extent the power does not exceed the "5×5" limitation. It is important to note that the 5×5 limitation applies per power holder, not per donor. As a result, the use of a 5×5 withdrawal power is complicated if the power holder is a beneficiary of more than one trust.

GST Effects

The existence of a withdrawal power also affects the person who is considered to be the "transferor" to the irrevocable trust for generation-skipping transfer tax purposes. The final GST regulations provide that the grantor of an irrevocable trust which includes withdrawal powers is treated as the transferor of the entire trust estate for GST tax purposes only to the extent that the powers of withdrawal held by the beneficiaries of the trust lapse within the limitations of section 2514(e). Treas. Regs. §26.2601-1(b)(1)(v)(A); 26.2652-1(a)(5) (Example 5). The power holder will be regarded as the transferor of any additional amounts which could have been withdrawn.

IMPLIED OR PREARRANGED UNDERSTANDINGS REGARDING WITHDRAWAL POWERS • The IRS has sought to deny the annual exclusion for contributions to irrevocable trusts that are subject to withdrawal powers when the facts and circumstances of a particular case demonstrated that (in the IRS's opinion) there was a prearranged understanding that the withdrawal power would not be exercised. *See* TAM 9628004. The Tax Court, however, has allowed the annual exclusion when the IRS asserted there was an understanding between the donor and the beneficiaries that the withdrawal rights would not be exercised. *See Estate of Kohlsaat*, 73 T.C.M. (CCH) 2732 (1997); *Estate of Holland v. Comm.,* 73 T.C.M. (CCH) 3236 (1997). However, in the United States Tax Court's recent decision in *Estate of Trotter v. Comm.,* 82 T.C.M. (CCH) 633 (2001), the court, for apparently the first time, held that a power to withdraw annual contributions to an irrevocable trust would be ignored for tax purposes when the surrounding facts indicate there was an implied understanding that the withdrawal rights would not be exercised. *Id*. at 637.

The *Trotter* Case

In *Estate of Trotter*, the decedent transferred her residence to an irrevocable trust that gave each of her grandchildren the right to withdraw the lesser of (1) the actual amount contributed by the donor or (2) $10,000 per grandchild. None of the beneficiaries attempted to exercise their withdrawal power, and the donor continued to use the residence without paying rent. The IRS asserted that section 2036(a)(1) resulted in the property being included in the decedent's taxable estate because she retained possession and enjoyment of the property until her death. The estate argued that section 2036(a)(1) did not apply because "the beneficiaries were given an immediate right to withdraw trust assets and thereby to defeat all other rights." *Id.* at 637. Furthermore, the estate argued that with the decedent's payment of all occupancy expenses related to the condominium, including maintenance expenses, utilities, property taxes, condominium fees, and premiums for insurance, she had in essence paid for her use of the property.

It seems clear that the property should have been included in the decedent's estate under section 2036(a)(1). As the Court stated: "in sum, courts have been unwilling to decide that no interest was retained within the meaning of section 2036(a)(1) where objective evidence has shown that the decedent's relationship in fact to the property, beyond the transfer of bare legal title, remained largely unchanged." *Id.* at 637. The facts clearly indicate that such was the case here.

Implied Understandings and Difficulties in Using Powers

The disturbing part of the Court's decision relates to how it disposed of the estate's argument that the existence of the withdrawal powers was sufficient to preclude the application of section 2036(a)(1). In that regard the Court stated:

"Moreover, we are satisfied that the logical conclusion to be drawn…is not negated by the withdrawal provisions upon which the estate so heavily relies. The numerous indicia discussed above are equally supportive of an implied understanding that the withdrawal rights would not be exercised, an interpretation buttressed by the awareness that the beneficiaries were the decedent's grandchildren (and three of the five were minors). *We cannot blind ourselves to the reality of the family relationships involved, and the estate has failed to show that the withdrawal rights were anything more than a paper formality without intended economic substance. In*