# Fixing A Damaged Irrevocable Life Insurance Trust (With Drafting Example)

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Few ILITS can get damaged beyond all repair—but repair can be tricky.

**BECAUSE AN ILIT** is irrevocable and generally designed to last for decades and possibly centuries (in the case of a GST dynasty ILIT), it is impossible for a grantor or a practitioner to contemplate all the permutations of change that could affect the ILIT. No matter how well an ILIT is drafted, and no matter how much flexibility has been built into the ILIT to deal with changing circumstances, at some point, a long term irrevocable trust, such as an ILIT, may need an overhaul or a fix. This article discusses how to fix an irrevocable trust, which by definition is incapable of being changed, and therefore cannot be easily or inexpensively changed or fixed. Put another way, there is no perfect and safe—and certainly no inexpensive—way to fix a "damaged" irrevocable trust.

**OVERVIEW OF A DAMAGED ILIT** • Long term irrevocable trusts may need to be fixed at some point because of poor design, sloppy implementation, negligent maintenance, changes in tax laws, changes in the financial and investment environment, changes in beneficiaries, old style "income only" trust provisions, improvements in drafting technique, changes in the grantor's family or financial situation, or changes in a beneficiary's circumstances. In addition to the normal difficulties associated with irrevocable trusts, ILITs have special problems related to the fact that the primary trust asset is life insurance. ILITs are most likely to incur damage and need fixing with regard to: (i) *Crummey* withdrawal rights, (ii) changes in the tax laws, (iii) life insurance policy issues, and (iv) trust provisions that are no longer necessary, desirable, or appropriate under the current circumstances. This article will explore different techniques that an attorney can use to fix some of these ailments.

*Caution*: All of these techniques must be analyzed for potential tax consequences. Income tax issues could arise over transfer for value questions, potential gain to the policy owner, and the realization of gain or loss under IRC section 1001(a) because of a change in the beneficiaries' legal entitlements, pursuant to *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). Estate, gift, and generation skipping transfer tax consequences could also arise, especially as a result of the effect on a GST grandfathered trust. *See generally,* Chapters 2, 3, 4, 5, and 6 of Grassi, *Drafting ILIT*s. And the employment of these techniques (other than the exercise of a power of appointment) must be done consistent with a trustee's fiduciary duty to the trust beneficiaries. *See*, section 9.2 of Grassi, *Drafting ILITs*.

**Practice Points**

The attorney for the trustee should advise the trust beneficiaries that the attorney represents the trustee only; and that the beneficiaries have the right to retain independent counsel to review and advise them concerning any proposed reformations or modifications to the trust.

When undertaking a fix, consider the effects of: (i) a spendthrift clause, and (ii) a no contest clause. Will either of these clauses prevent a desired outcome? For example, even if all of the beneficiaries consent to the termination of a trust, they cannot compel termination if it would thwart a material purpose of the trust. *Restatement (Second) of Trusts* section 337(2) (ALI 1959). A typical spendthrift clause that prevents a beneficiary from alienating his or her interest in the trust is considered a material purpose. *Id.* (comment l).

**EXAMPLES OF A DAMAGED ILIT** • Examples of a damaged ILIT include:

- Crummey withdrawal right notice formalities were ignored or neglected.
- The ILIT does not contain Crummey withdrawal rights.
- The ILIT's Crummey withdrawal rights are ambiguous, inadequate, or out of date.
- Tax problems as a result of poor drafting or changes in the tax law.

- The life insurance policy owned by the ILIT is no longer appropriate under the current circumstances.
- The ILIT does not possess an insurable interest in the life of the insured-grantor.
- Because of the passage of time or a change in circumstances, the ILIT no longer fits the grantor's and/or a beneficiary's needs, or certain provisions of the trust are no longer appropriate or desirable, or after the insured's death the beneficiaries disagree as to the trust's investment policies or to other issues.

***CRUMMEY* WITHDRAWAL RIGHT AILMENTS** • A poorly drafted, poorly implemented, or poorly maintained ILIT with *Crummey* withdrawal rights can have many negative consequences, including:

- Inability for a gift to qualify for the gift tax annual exclusion, thereby resulting in the unnecessary use of the grantor's $1 million gift tax applicable exclusion amount.
- Wasting of a beneficiary's lifetime gift tax applicable exclusion amount.
- Inclusion of the life insurance proceeds in the grantor's gross estate for federal estate tax purposes.
- Inclusion of some or all of the life insurance proceeds in a beneficiary's gross estate for federal estate tax purposes.
- Inability to effectively allocate GST tax exemption.
- Subverting the grantor's objectives.

**THE *CRUMMEY* CASE** • A review of the Crummey case and subsequent IRS pronouncements and court rulings is essential in understanding how to salvage a damaged Crummey withdrawal right.

In *D. Clifford Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the taxpayer-donors established irrevocable trusts for the benefit of each of their four children. Two of the children were minors (under the age of 21). The minor children lived with the taxpayers, and were supported by them. Each time a gift was made to a trust, the beneficiary was given the right to demand at any time, up to December 31st of the year in which the gift was made, the lesser of $4,000 or the amount of the gift. Contributions were made approximately two weeks before the close of the year. If the beneficiary was a minor at the time of the gift, his or her guardian could demand the money on the minor's behalf. If no demand was made by the beneficiary or the guardian, the gift irrevocably became a part of trust corpus. According to the court, "The whole question on this appeal is whether or not a present interest was given by the petitioners to their minor children so as to qualify as an exclusion under §2503(b)." The court held that although demands by the minors were not likely to be made, the gifts, coupled with the demand rights, constituted gifts of a present interest. In Crummey, no guardian or agent was ever appointed for the minor children for the years when the gifts under scrutiny were made and, in fact, there could be no demand made by the minors. The court also noted that it was unlikely that the minor beneficiaries knew (or would ever know) about the gifts that were made to the trusts.

The significance of *Crummey* is the ability to structure an irrevocable trust for a beneficiary (minor or adult) that qualifies for the annual gift tax exclusion even if the trustee has absolute discretion over trust distributions. Thus, the test under the case is: "Does the donee (or the donee's legal guardian) have the legal right to demand payment of the gift contribution amount, and is the trustee legally obligated to comply with that demand?" If the answer is yes, then the donee (even though a minor and no guardian has been appointed), has a gift of a present interest for gift tax purposes.

**HOW TO DEAL WITH IGNORED OR NE-GLECT-ED *CRUMMEY* WITHDRAWAL RIGHT NOTICES**

• Upon discovering that *Crummey* notice requirements have been neglected or ignored, do not assume that nothing can be done and that the gift tax annual exclusion is lost. Instead, consider the following:

Was any written notice provided?

Did the beneficiary otherwise have actual notice?

- If written or oral notice was not given, did the donee (or the donee's natural or legal guardian) know enough about the gift to have it qualify as a gift of a present interest? Can you provide notice now? Treat the grantor's contributions as a loan to the trust.
- Take the position that no notice is required. The emphasis in *Crummey* was on the possession of the right of withdrawal—not notice. The existence of the withdrawal right was itself sufficient to confer a present interest status on a contribution to an irrevocable trust. The court in *Crummey* never required that written notice, verbal notice, or other notice be given to the beneficiaries.
- File a late gift tax return(s) reflecting the gifts as present interest gifts.

**HOW TO DEAL WITH AN ILIT THAT HAS NO *CRUMMEY* WITHDRAWAL RIGHTS** • And what if the *Crummey* rights just aren't there?

There may be planning that can reduce the gift tax problems engendered by gifts to a life insurance trust that lacks a *Crummey* power or if the authority for *Crummey* powers were eliminated legislatively. These techniques include:

- Making non-excludible gifts and using up part of the donor's unified credit (applicable exclusion amount);
- Terminating the trust, distributing the policy to the beneficiary, and making gifts of the premium amounts directly to the beneficiaries;
- Converting an existing unfunded ILIT to a funded ILIT by making a large gift to the trustee, who could then use the income from that gift to pay the premiums; and