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Checklist Of Issues For Drafting An ILIT

CHAPTER OVERVIEW

This book assumes that the practitioner has some experience and knowledge concerning estate planning and trust drafting. This chapter considers, in a checklist format, twenty-five issues that a practitioner should consider when drafting an ILIT.[1] Some drafting issues that are discussed in other chapters are not reiterated here.[2] Nearly half of the checklist items deal with a beneficiary's right to withdraw gifts made to the ILIT. Properly structuring and administering the beneficiary's withdrawal right is crucial if a gift to the ILIT is to be eligible for the gift tax annual exclusion. The Chapter also discusses the easily overlooked tax trap created by reciprocal trusts, reciprocal withdrawal rights, and reciprocal powers of appointment, and provides suggested solutions to deal with these problems. To avoid the three-year rule of IRC section 2035, the ILIT should be drafted and funded prior to the ILIT trustee's submission of an application for life insurance. However, a non-binding test application by the insured (typically showing "an

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[1] Additional drafting issues are scattered throughout this book.

[2] For example: (i) the ILIT should be irrevocable *(see*, section 1.1, above), (ii) the beneficiaries should have *Crummey* withdrawal rights (*see*, section 3.5, above), and (iii) the *Crummey* withdrawal rights should lapse in a manner that does not constitute a taxable release (*see*, sections 3.11, 3.12, 3.13, 4.6, and 5.21, above). *See also*, Chapters 11 and 12, below, for additional drafting issues.

ILIT to be drafted" as the potential owner) should avoid an IRC section 2035 issue. *See*, section 4.12, above.

§10.1 AVOID ETIPS AND TAXABLE RELEASES—LIMIT THE SPOUSE'S *CRUMMEY* WITHDRAWAL RIGHT TO FIVE-BY-FIVE AND 60 DAYS AFTER THE CONTRIBUTION

The spouse's withdrawal right should be limited to the five-by-five safe harbor amount of IRC section 2514(e) and the withdrawal right should lapse 60 days after the date of contribution (not 60 days after notice). This will avoid the GST estate tax inclusion period ("ETIP") issue for the spouse. *See*, section 5.17, above. Also, the spouse should not be given a hanging power of withdrawal since it does not come within the ETIP safe harbor rules set forth in Treas. Reg. §26.2632-1(c)(2)(ii). Another concern, as previously mentioned in Chapters 3 and 4, above, is the estate tax problem of the spouse's lapse of a withdrawal right greater than five by five in conjunction with the spouse's retained interest in the trust as a beneficiary. IRC sections 2035, 2036, 2037, and 2038. *See*, Paragraphs 3.1(A) and 3.2(D) of Sample ILIT.

§10.2 AVOID NAKED *CRUMMEY* WITHDRAWAL RIGHTS

The IRS frowns upon beneficiaries who have *Crummey* withdrawal rights and are discretionary beneficiaries or contingent remainder beneficiaries. TAMs 9731004, 9045002, 8727003. Therefore, if possible, draft the ILIT so that there are multiple present-interest beneficiaries, who hold a current income interest, a current right to principal distributions, or a vested remainder interest. Fortunately for taxpayers, the Tax Court disagrees with the IRS concerning contingent remainder beneficiaries who hold *Crummey* withdrawal rights, and the Tax Court has permitted contingent remainder beneficiaries (grandchildren, who would take only if their parents (the current income beneficiaries) predeceased them) to be recognized as valid *Crummey* beneficiaries for whom the gift tax annual exclusion was available to the grantor. *Estate of Maria Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result only,* 1996-2 C.B. 1. *See*, section 15.4(g), below. The IRS has, however, stated that it will not recognize *Crummey* withdrawal rights granted to persons whose only interest in the ILIT is the *Crummey* withdrawal right itself, i.e., the person has what is commonly referred to as a "naked" Crummey withdrawal right.[3] TAM 9628004. *But see*, *Estate of Lieselotte Kohlsaat*, T.C. Memo 1997-212 (1997) (gift tax annual exclusion available to 16 contingent remainder beneficiaries who held *Crummey* withdrawal rights and no present interest in the trust itself other than the withdrawal rights); and Priv. Letter Rul. 9030005 (gift tax annual exclu-

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[3] "A memorandum advising or describing gifts to an irrevocable life insurance trust usually will not require preparation of a covered opinion [under IRS Circular 230], because, although the arrangement may very substantially reduce estate and GST taxes, it does so merely by obtaining the general tax benefits intended by Congress and the Code for lifetime gifts of appreciating assets. Additionally, the IRS has no reasonable basis for opposing the desired tax treatment of such gifts.

There are, however, several situations in which a practitioner may need to prepare a covered opinion [under Circular 230] regarding the creation and funding of an irrevocable life insurance trust. First, although the IRS has approved of the use of *Crummey* withdrawal powers to give a beneficiary a present interest in contributions to a trust so that they qualify for the gift tax annual exclusion, it has repeatedly questioned the efficacy of so-called naked *Crummey* powers, which are held by beneficiaries who lack a significant current interest in the trust. [*See*, Rev. Rul. 73-405, 1973-2 C.B. 321; Rev. Rul. 85-88, 1985-2 C.B. 201; Rev. Rul. 81-7, 1981-1 C.B. 474.] The IRS has lost all of the cases in which this was the principal issue, but they have not acquiesced and there is no reason to believe that they will not continue to challenge the claiming of the exclusion for a gift of a naked *Crummey* power. [*See*, *Estate of Holland v. Commissioner,* TC Memo. 1997-302; *Estate of Kohlsaat v. Commissioner*, TC Memo. 1997-212; *Estate of Cristofani v. Commissioner*, 97 TC 74 (1991).] Furthermore, the IRS certainly has at least a reasonable basis for asserting that a naked *Crummey* power does not create a present interest. Thus, a covered opinion may be required when recommending the use of a naked *Crummey* power as part of a plan to multiply the available gift tax annual exclusions.[Citation omitted.]

Second, in a 1989 private letter ruling, the IRS ruled against the validity of a so-called hanging *Crummey* power. [*See*, Priv. Letter Rul. 8901004.] While this ruling appears relevant only on the specific documents reviewed in that ruling, it may still be appropriate to provide a covered opinion when advising use of a hanging *Crummey* power. [*See*, section 3.13, above, for a discussion of hanging *Crummey* powers.]

A covered opinion [under Circular 230] may also be required if the insured uses any unusual method to finance the purchase of life insurance by the trust. The income and gift tax treatment of a low-interest or interest-free loan is already well established, as are the treatment of a split-dollar arrangement between the insured (or another person) and the trust. More inventive arrangements, including policy provisions with springing cash values, however, may require a covered opinion to evaluate the relevant legal issues." Howard M. Zaritsky, *Practical Estate Planning Under Circular 230*, ¶3.02[2][b][ii], (Warren, Gorham & Lamont of RIA, Boston, MA, 2005).

See, Form 3-5 in section ¶3.03[4] of *Id.* for a sample covered opinion under Circular 230 regarding an ILIT with a naked hanging *Crummey* withdrawal right.

sion available to grantor's children who were discretionary beneficiaries of "special needs"[4] principal distributions and who held contingent remainder interests that vested only if the grantor's wife (their mother) predeceased the grantor). *See*, section 15.4(j), below. *See*, Paragraph 3.1(A) of Sample ILIT.

> **Practice Point**: A cautious practitioner may want to consider giving the contingent remainder beneficiaries (such as the grandchildren) a certain percentage of the ILIT after the death of the surviving spouse (such as 10% to the grandchildren (or if deceased to the grandchild's estate) and 90% to the children), or a specific devise of $12,000 (the gift tax annual exclusion amount for 2007) to each "unvested" contingent remainder beneficiary who has a *Crummey* withdrawal right. This way the contingent remainder beneficiaries will have a vested interest in the ILIT.[5] Of course any distributions to beneficiaries who are skip persons (such as grandchildren) may attract GST tax if the ILIT is not GST tax exempt, but that may be a small price to pay to give the contingent remainder beneficiaries *Crummey* withdrawal rights and thus provide the donor with more gift tax annual exclusions. Alternatively, make the ILIT a GST trust so that the grandchildren are more than contingent remainder beneficiaries. Another way to avoid the IRS' "naked" power argument is to give all *Crummey* withdrawal right holders a discretionary right to

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[4] "Special needs" refers to the minor beneficiaries' needs related to travel, camping trips, theater, ballet, music lessons, special schooling, or instruction to enrich their lives. The term does not refer to distributions for the beneficiaries' regular support, health, education, and maintenance while they are minors. Nor does the term refer to distributions that are made to a disabled beneficiary under a so-called "special needs trust."

[5] "If the prospective grantor does not want to grant a current income and principal interest or a vested remainder interest in the trust to a potential powerholder, that powerholder should at least be given a contingent remainder interest in order to fall within the facts of *Cristofani* and *Kohlsaat*. If the grantor is not willing to give the powerholder a contingent remainder interest, then the grantor at least should give the powerholder a discretionary income and principal interest. Although the Service will not allow the annual exclusion in that context, a court might." Donald O. Jansen, "Giving Birth To, Caring For, And Feeding The Irrevocable Life Insurance Trust," 41 *Real Property, Probate and Trust Journal* 571, 606-607 (Fall 2006).