Estate Planning: The Use of Irrevocable Life Insurance Trusts

C. Daniel Yates*
Michael O. Chenoweth**

The creation of an irrevocable life insurance trust has become an established and commonly used federal estate planning technique. In fact, due to recent changes in the tax laws, an irrevocable life insurance trust remains one of the few viable methods to reduce federal estate tax. An irrevocable trust funded with life insurance provides the opportunity to create wealth for the benefit of the settlor's family without the imposition of federal estate tax and to provide liquidity for the estate of the settlor.

While Congress has periodically considered and ultimately rejected the notion of subjecting the internal cash build-up of life insurance to federal income taxation, recent revisions of the Internal Revenue Code of 1986, as amended ("Code"), and administrative pronouncements issued by the Internal Revenue Service ("IRS") during the survey period covered by this publication have significant estate tax ramifications relating to the creation and implementation of an irrevocable life insurance trust. This discussion is limited to the factual situation in which an irrevocable trust is funded solely with insurance policies on the settlor's life, of which the trust is the owner and beneficiary.

I. Recent Developments

There are certain emerging concerns that may affect the viability of an irrevocable life insurance trust. The provisions of new Code section 2036(c), enacted as part of the Omnibus Budget Reconciliation Act of 1987 and as amended under the Technical and Miscellaneous Revenue Act of 1988, conceivably could apply to and restrict the use of irrevocable life insurance trusts. Code section 2036(c) was specifically adopted to nullify certain estate planning techniques used to "freeze" the value of

* Partner, Henderson, Daily, Withrow & DeVoe, Indianapolis, Indiana. B.A. Indiana University, 1969; M.B.A. Indiana University, 1973; J.D. Indiana University School of Law, 1973.

** Associate, Henderson, Daily, Withrow & DeVoe, Indianapolis, Indiana. B.A. Amherst College, 1966; M.B.A. University of Pennsylvania, 1968; J.D. Indiana Univeristy School of Law, 1986.

business and investment assets for estate tax purposes.[1] Prior to the passage of Code section 2036(c), the freeze was accomplished by allocating future appreciation in such assets to family members in a younger generation, generally by means of a preferred stock recapitalization or a multi-class partnership.[2] However, the broad concepts and expansive language of Code section 2036(c) arguably encompass certain aspects of the traditional irrevocable life insurance trust.

The fair market value, determined as of the date of the death of the transferor, of any transfer within the purview of Code section 2036(c) is included in the transferor's taxable estate, regardless of the duration of time between such transfer and the death of the transferor.[3] The definitional elements of a transfer subject to the provisions of Code section 2036(c) are as follows: (1) The transferor holds a substantial interest in an "enterprise"; (2) the transfer embodies a disproportionately large share of the potential appreciation in the interest of the transferor in the enterprise; and (3) the transferor retains an interest in the income of, or right in, the enterprise.[4]

Code section 2036(c) is of concern in the context of an irrevocable life insurance trust because of the spousal unity rule in subsection 3(C) thereof.[5] The spousal unity rule, by definition, treats spouses in all respects as one person for purposes of this statute.[6] Therefore, if a life insurance policy can be classified as an enterprise, then the transfer of the policy to an irrevocable life insurance trust in which the spouse of the settlor is granted an income interest and/or Crummey power[7] exercisable during the life of the settlor triggers the application of Code section 2036(c), resulting in the proceeds of such life insurance policy being included in the taxable estate of the settlor.[8]

The analysis as to whether a life insurance policy is an enterprise and thus subject to the provisions of Code section 2036(c) was frustrated by the fact that the term "enterprise" was not defined in the statute. The attempt to discern the scope of this term by reference to congressional

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1. *See generally* Adams, Herpe & Abendroth, *Technical Corrections Cause New Tremors and Aftershocks*, 128 Tr. & Est. 39 (1989); Bettigole, *Use of Estate Freeze Severely Restricted by Revenue Act of '87*, 68 J. Tax'n 132 (1988); Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules* (parts 1 & 2), 70 J. Tax'n 14, 74 (1989); Schachne & Barasch, *More on Avoiding the Grasp of Section 2036(c)*, 128 Tr. & Est. 37 (1989).

2. *See* sources cited *supra* note 1.

3. I.R.C. § 2036(a)(1989).

4. *Id.* § 2036(c)(1)(A), (B).

5. *Id.* § 2036(c)(3)(C).

6. *Id.*

7. *See infra* notes 40-45 and accompanying text.

8. I.R.C. §§ 2036(c)(1), (3)(C) (1989).

intent as documented in underlying committee reports has not been informative. However, this concern has been temporarily relieved by the issuance on September 18, 1989, of Internal Revenue Notice 89-99, which specifically stated that a life insurance policy is personal use property and thus outside the scope of Code section 2036(c).[9]

Reliance on Notice 89-99 in the creation of an irrevocable trust is tempered by the fact that it is an administrative pronouncement, the terms of which can be modified, amended or superseded at any time by the issuance of regulations by the IRS concerning this matter. In addition, according to footnote 18 of this notice, funding an irrevocable life insurance trust in excess of the premium requirements of the policy held in trust would cause the trust to become an enterprise with respect to such excess funds.[10]

An additional concern threatens the economic bases underlying life insurance in general and an irrevocable life insurance trust in particular. Recent tax proposals considered by Congress have had provisions that would subject the internal cash build-up of a life insurance policy to income taxation. Such a provision would impose income tax liability on an unfunded irrevocable life insurance trust and those beneficiaries holding Crummey powers in the trust, unless the policy held by the trust is a term plan. While such proposals have been vigorously opposed by the insurance industry and have not become law, there can be no assurance that the federal government will continue to exempt this significant potential revenue source from income taxation.

II. Attributes of an Irrevocable Life Insurance Trust

An irrevocable life insurance trust may be drafted so that the policy proceeds will not be included in the taxable estates of the settlor and his[11] spouse, subject to the "three year rule."[12] This type of trust is especially useful for a second to die policy on the lives of the settlor and his spouse under current federal estate tax laws, because their estates may be planned so that the estate tax is payable only upon the death of the second spouse. This Article does not address the generation-skipping transfer tax under Code sections 2601 to 2663, as its application is dependent upon the dispositive terms of the trust agreement.

In addition to the proceeds of a life insurance policy owned by an irrevocable trust being removed from the taxable estates of the settlor,

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9. I.R.S. Notice 89-99, 1989-38 I.R.B. 4.

10. *Id.* at n.18.

11. The use of masculine pronouns shall be deemed masculine or feminine, as appropriate.

12. *See infra* notes 28-30 and accompanying text.

the post death payment of the insurance proceeds will be exempt from income taxation by application of section 101(a) of the Code, unless the "transfer for value" provisions of the Code are applicable.[13] Such death proceeds provide a source of funds which may, in the discretion of the trustee, be loaned to the settlor's estate or used to purchase estate assets, thereby providing liquidity for the payment of death taxes and other liabilities of his estate.

As does any trust, an irrevocable life insurance trust may also provide certain non-tax benefits, including the following: (1) control over disposition of the income and corpus of the trust; (2) professional management of the trust corpus; (3) avoidance of guardianships for minors or incompetent beneficiaries of the trust; (4) insulation of the trust corpus from the claims of creditors or dissipation by the beneficiaries; and (5) avoidance of probate of trust assets. However, an irrevocable life insurance trust, by definition, is not easily amended or revoked should the settlor desire for reasons such as changes in financial or personal circumstances and wishes, revisions of the Code or other extrinsic factors. In addition, the settlor no longer has ownership of any insurance policy he transferred to the trust. Thus, if the settlor later decides not to fund the premium by annual contributions to the trust, because the trust terms no longer fulfill his desires, but then wishes for such policy to remain in force, ownership of the policy must be transferred from the trust. This transfer may present certain tax and practical problems, including the possible application of the transfer for value rule,[14] the determination of the purchase price for such policy, and distribution of any remaining corpus.

Code section 2036(a)(1) mandates that the corpus of any trust be included in the estate of the settlor, if he retains, for life or for any period not ascertainable without reference to his death or which does not in fact end before his death, any right, directly or indirectly, to the income of the trust or to any enjoyment of the benefits of trust corpus.[15] Consequently, if during the lifetime of the settlor, an irrevocable life insurance trust may benefit the settlor or be used to discharge support obligations of the settlor, the corpus of the irrevocable trust will be included in his taxable estate. Therefore, the trust agreement should specifically preclude, during the settlor's lifetime, the use of any trust property for the benefit of the settlor or for the payment of his support obligations.

Additionally, even if the corpus of the trust is not included in the taxable estate of the settlor, retention by the settlor of any incident of

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13. *See infra* notes 25-27 and accompanying text; *see also* I.R.C. § 101(a)(2) (1989).
14. *See supra* note 12.
15. I.R.C. § 2036(a)(1) (1989).

ownership in a life insurance policy transferred to an irrevocable life insurance trust will cause the face amount of such policy to be included in his taxable estate.[16] Incidents of ownership are rights or interests in a life insurance policy whereby the settlor has the power, directly or indirectly, to: (1) control the existence of the policy; (2) revise or rearrange the economic interests therein; or (3) effect the policy benefits.[17] The mere retention of the power to veto the disposition of a life insurance policy is sufficient to cause the proceeds to be included in the taxable estate of the settlor.[18]

There has been a split of opinion as to whether an interest in a life insurance policy exercised by the settlor of an irrevocable life insurance trust solely in a fiduciary capacity, as trustee of the trust, constitutes an incidence of ownership under Code section 2042.[19] The IRS has acknowledged that the exercise of such power by the settlor in his capacity as a trustee of an irrevocable life insurance trust may not expose the settlor to estate tax liability provided (1) the settlor acquired the power after he had divested himself of all interests in the policy; and (2) the trust precludes the exercise of the power for the personal benefit of the settlor.[20] Therefore, the settlor should neither be the trustee nor retain any incident of ownership in any insurance policies on his life.

However, even if the settlor never held any incidents of ownership in an insurance policy on his life or paid any premiums in connection therewith, the proceeds of the life insurance policy would still be included in his estate to the extent that such funds are restricted to the discharge of estate obligations.[21] In order to insure that the tax benefits of an irrevocable life insurance trust are preserved, the trust agreement should provide that the trustee may, but is not directed to, use the proceeds of a life insurance policy held in trust to satisfy the death taxes and other liabilities of the estate of the settlor.

III. Funding the Trust

An irrevocable life insurance trust may be funded by the issuance of a new policy on the settlor's life applied for by the trust or the transfer to the trust of an existing policy on his life.

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16. *Id.* § 2042(2).

17. Treas. Reg. § 20.2042-1(a)(2) (as amended in 1974).

18. *Id.* § 20.2042-1(c)(4) (as amended in 1972).

19. *See, e.g.*, Rose v. United States, 511 F.2d 259 (5th Cir. 1975); Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972); Estate of Fruehauf v. Commissioner, 427 F.2d 80 (6th Cir. 1970).

20. Rev. Rul. 84-179, 1984-2 C.B. 195.

21. Treas. Reg. § 20.2042-1(b)(1) (as amended in 1974).

A. Issuance of New Policy

To avoid the transfer for value rule[22] and the three year rule,[23] an irrevocable life insurance trust may be funded by the issuance to the trust of a new policy on the life of the settlor. The application for the life insurance policy would be submitted by the trustee, naming the trust the designated owner and beneficiary of the policy. Thus, the trust would be the owner and beneficiary of the insurance policy on the settlor's life at the time it is issued. This means of funding an irrevocable trust is only feasible if the settlor is insurable, at a reasonable premium, at the time the trust is created.

B. Transfer of Existing Policy

The transfer of a life insurance policy owned by the settlor on his life to an irrevocable trust effectively removes the full face amount of the policy from his taxable estate, provided the settlor survives the transfer by three years. By such transfer or assignment, the settlor is deemed to have made a completed gift to the trust beneficiaries, the fair market value of which is subject to gift tax at the time of transfer.[24]

In addition, by borrowing against the policy prior to its assignment to an irrevocable trust, the settlor can control the value of the transfer subject to gift tax. Consequently, the gift of a life insurance policy may be planned to subject the settlor to little, if any, gift tax liability. Furthermore, unless a life insurance policy has significant cash value which was not borrowed prior to its assignment to an irrevocable life insurance trust, the assignment of the policy does not deprive the settlor of the use or control of an asset having substantial current value or benefit.

If an irrevocable life insurance trust is to be funded by transfer of an existing life insurance policy, it is imperative that the transaction be structured in such a manner as to avoid the imposition of the "transfer for value rule."[25] Under the transfer for value rule, the proceeds of a life insurance policy purchased for its fair market value are subject to

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22. *See infra* notes 25-27 and accompanying text.

23. *See infra* notes 28-30 and accompanying text.

24. Treas. Reg. § 25.2511-1(a) (as amended in 1983) (the value for gift tax purposes of an unmatured premium paying whole life policy is its interpolated terminal reserve value increased by any unearned or prepaid premiums and/or dividend accumulations, and reduced by any outstanding policy loans). The gift tax value of a single premium or paid-up policy is the single premium which would be charged for the issuance of a comparable policy based on the insured's age at the time of the gift. Treas. Reg. § 25.2512-6(a) (as amended in 1963).

25. I.R.C. § 101(a)(2) (1989).

income taxation, to the extent such proceeds exceed the sum of the consideration paid by the transferee in acquiring the policy and the amount of subsequent premiums paid.[26]

However, the transfer for value rule has two important exceptions, one of which is relevant to the acquisition of an existing life insurance policy by an irrevocable trust. The transfer for value rule does not apply when the basis of the policy in the hands of the transferee is determined in whole, or in part, by reference to its basis in the hands of the transferor (*e.g.*, the transfer is a gift in whole or in part).[27] Therefore, if the proceeds of a life insurance policy are to be totally exempt from income taxation, an existing life insurance policy must be acquired by the irrevocable trust, at least in part, by gift. In most cases the settlor merely transfers by gift an insurance policy on his life to the irrevocable trust, after borrowing any cash value, which avoids the application of the transfer for value rule.

While the Economic Recovery Tax Act of the 1981 ("ERTA") limited the application of Code section 2035 for decedents dying after 1981,[28] Congress did retain the "three year rule"[29] for gifts of life insurance. Under the three year rule, the estate of a decedent includes the proceeds of all insurance policies transferred by him within three years of his death.[30]

The three year rule also presented a potential barrier to the use of group term insurance to fund an irrevocable trust. Because term insurance is renewed periodically (annually for most group master policies), there has been some concern as to whether each renewal constitutes a new transfer by the settlor of his interest in the policy. If so, annually renewable group term life insurance assigned to a trust would always be included in the estate of a decedent by application of Code section 2035(d).

In Revenue Ruling 82-13, the IRS reversed its original position and held that the automatic renewal of a master policy of group term insurance will not be considered purchases of new policies by the insureds, so long as evidence of insurability is not required.[31] Furthermore, a change in insurance carriers by an employer within three years of the death of the insured does not cause the proceeds from the group policy to be included in the taxable estate of the insured, provided that the group policies are virtually identical and the original assignment of the

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26. *Id.*
27. *Id.* § 101(a)(2)(A).
28. *Id.* § 2035(d)(1).
29. *Id.* § 2035(d)(2).
30. *Id.*
31. Rev. Rul. 82-13, 1982-2 I.R.B. 9.

interest of the insured was made more than three years before his death.[32] Therefore, the assignment of group term insurance remains a viable method of funding an irrevocable life insurance trust.

IV. Payment of Premiums

Prior to the enactment of ERTA, the proceeds of a life insurance policy were included in the estate of the settlor if the policy was issued to a trust at his direction within three years of his death for which he paid the premiums, directly or indirectly.[33] Recent Tax Court decisions interpreting new Code section 2035(d) have held that the payment by a decedent of premiums on a life insurance policy on his life, issued within three years of the date of his death, is not the controlling factor in determining whether the proceeds of such a policy are included in his taxable estate.[34] Rather, the Tax Court has held that the dispositive issue under subsection (d) is whether the decedent possessed any incidents of ownership in the policy during the three year period prior to his death.[35] However, the transfer of funds to an irrevocable trust for the payment of life insurance premiums must still be structured properly to avoid adverse gift tax consequences.

A. Crummey Powers

Transfers to an irrevocable trust of funds for the payment of the premiums on a life insurance policy held in trust represent completed gifts to the trust beneficiaries, and subject the donor to gift tax liability.[36] Such transfers are generally considered gifts of future interests because the right of the trust beneficiaries to receive property from the trust is

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32. Rev. Rul. 80-289, 1980-2 C.B. 170.

33. In Bel v. United States, 452 F.2d 683 (5th Cir. 1971), the payment by the decedent of the initial premium on a life insurance policy on his life was characterized as a constructive transfer of the ownership of the policy for purposes of I.R.C. § 2035, even though the decedent never possessed any ownership interest in such policy. The rationale of *Bel* was applied in the context of an irrevocable life insurance in Estate of Kurihara v. Commissioner, 82 T.C. 51 (1984), wherein a monetary gift by the decedent within three years of his death to a trust and used by the trustee to pay the initial premium on a life insurance policy on the life of the decedent owned by the trust constituted sufficient basis for the proceeds of the policy to be included in the estate of the decedent.

34. *See, e.g.*, Estate of Leder v. Commissioner, 89 T.C. 235 (1987), *aff'd*, 893 F.2d 237 (10th Cir. 1989); Estate of Headrick v. Commissioner, 93 T.C. 18 (1989); Estate of Chapman v. Commissioner, 56 T.C.M. (CCH) 1415 (1989).

35. *Leder*, 89 T.C. at 235. However, the IRS has not accepted this position and recently prevailed in a federal district court on this issue, in a decision in which *Leder* was not mentioned. Hardwood v. U.S. ____ F. Supp. ____ (S.D. Fla. 1989).

36. Treas. Reg. § 25.2511-1(a) (as amended in 1983).

either not immediate or is at the discretion of the trustee.[37] Even if trust beneficiaries are given a present income interest, no exclusion is available if an irrevocable trust holds only a life insurance policy that produces no income or all of the income held by the trust must be used to pay premiums.[38] Consequently, it is essential that the trust agreement be drafted in such a manner so that these transfers to the irrevocable life insurance trust constitute gifts of a present interest which qualify under Code section 2503(b) for the annual gift tax exclusion of up to $10,000 per year per donee.[39]

The traditional method for transforming conveyances to an irrevocable life insurance trust into gifts of a present interest is to provide that such transfers are subject to a "Crummey" power of withdrawal. The disignation of such withdrawal rights as Crummey powers derived from *Crummey v. Commissioner*,[40] the case in which the Court of Appeals first held that as a transfer to a trust subject to limited withdrawal rights transformed the conveyance into a gift of a present interest for gift tax purposes.[41] A Crummey power gives the powerholder an immediate right to withdraw transfers to the trust, even though the power is not intended by the settlor to be exercised.[42] The Crummey power attaches to each transfer made to the trust, but lapses if not exercised within a limited time period.[43] The right of a Crummey powerholder to withdraw funds transferred to an irrevocable life insurance trust transforms such conveyances into gifts of present interests for gift tax purposes.[44] Even if the Crummey power is held by a minor for whom no guardian has been appointed, the gift tax exclusion will be allowed so long as there is no impediment under the trust agreement or local law to the appointment of a guardian for such purpose.[45]

Obviously, the settlor does not intend that a Crummey power be exercised; to do so would undermine the very purpose for which the irrevocable life insurance trust was created. In order to minimize the possibility, the period of time during which such power can be exercised is expressly limited by the provisions of the trust agreement. The shorter

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37. Rev. Rul. 79-47, 1979-1 C.B. 312; Treas. Reg. § 25.2503-3 (as amended in 1983).

38. Treas. Reg. § 25.2503 (as amended in 1983).

39. The annual gift tax exclusion is presently $10,000 per year per donee; however, if the spouse of the donor consents to "split" the gift, an amount of up to $20,000 per year per donee may be gifted without subjecting the donor to any gift tax liability.

40. 397 F.2d 82 (9th Cir. 1968).

41. *Id.* at 88.

42. *Id.*

43. *Id.* at 83, 88.

44. *Id.* at 88.

45. Naumoff v. Commissioner, 46 T.C.M. (CCH) 852 (1983).

the duration of the life of the Crummey power, the less likelihood that such power will be exercised. IRS pronouncements have indicated that as little as four days between the notice of the transfer of property to an irrevocable life insurance trust and the expiration of the Crummey power to withdraw such property is sufficient to transform such transfer into a gift of a present interest, qualifying for the gift tax exclusion.[46] Notwithstanding, a three day period in which to exercise a Crummey power has been found to be an unreasonable impediment, resulting in the denial of the annual gift tax exclusion.[47]

The holder of a Crummy power must have actual notice of the transfer of property to the trust, as well as a reasonable opportunity to exercise such withdrawal right prior to its lapse, if such a conveyance is to qualify for the annual gift tax exclusion.[48] IRS private letter rulings regarding irrevocable life insurance trusts have allowed the delivery to the Crummey powerholders of a schedule of future premium payments to serve as "continuing notice" to persons holding Crummey powers.[49]

The trust agreement may even provide that the settlor may, from time to time, stipulate that a transfer is not subject to withdrawal by a certain Crummey powerholder.[50] Such a provision would enable a settlor to continue to fund an irrevocable trust in the event of a threatened or actual exercise of a Crummey power of withdrawal. However, by so stipulating, the settlor would not be entitled to the gift tax exclusion for any such restricted Crummey powerholder.[51]

In order for a Crummey withdrawal right to constitute a valid present interest, the property to which it attaches must be in, or converted to, a form that can be withdrawn by the powerholder. If such funds are not readily accessible by the Crummey powerholder, his withdrawal rights could be perceived as illusory and thus subject to challenge.[52] The issuance by the settlor of a check made payable to the trustee for payment of a periodic premium on a life insurance policy held in trust does not create a liquid fund against which the powerholder could exercise his Crummey withdrawal right.[53] Until such check is cashed by the trustee, it could be asserted that the gift is incomplete because the settlor still retains dominion and control over the funds.[54] Therefore, property trans-

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46. Priv. Ltr. Rul. 79-22-107 (Mar. 5, 1979).
47. Tech. Adv. Mem. 79-46-007 (July 26, 1979).
48. Rev. Rul. 81-7, 1981-1 C.B. 474; Priv. Ltr. Rul. 81-26-047 (Mar. 31, 1981).
49. Priv. Ltr. Rul. 81-33-070 (May 21, 1981); Priv. Ltr. Rul. 81-21-069 (Feb. 26, 1981).
50. *See, e.g.*, Estate of Edmonds v. Commissioner, 72 T.C. 970 (1979).
51. *Id.*
52. Estate of Kurihara v. Commissioner, 82 T.C. 51 (1984).
53. *Id.*
54. McCarthy v. United States, 806 F.2d 129 (7th Cir. 1986).

ferred to an irrevocable trust should be reduced to cash or liquid investment and maintained in an account of the trust throughout the Crummey withdrawal period.

Another important element in drafting an irrevocable trust agreement is deciding to what extent and to whom Crummey powers should be granted. Because the donor of property to an irrevocable life insurance trust is entitled to a gift tax exclusion for each powerholder, it is possible to shelter the full amount of any transfer to such a trust from the imposition of the gift tax merely by naming a sufficient number of Crummey powerholders. For this reason, it was common practice for persons to be designated Crummey powerholders in an irrevocable trust agreement, even though they were not otherwise beneficiaries of the trust.

This practice is generally not used today, because of a recent private letter ruling.[55] In this ruling, the IRS disallowed gift tax exclusions relating to those persons who held Crummey powers in an irrevocable trust, but who were not vested beneficiaries of the trust.[56] The IRS asserted that the mere grant of a Crummey power of withdrawal does not endow the powerholder with a "sufficient interest" in an irrevocable trust for the annual gift tax exclusion to apply, unless and only to the extent that such withdrawal right is actually exercised.[57] To date, however, there has been no guidance from the IRS with respect to what constitutes a sufficient interest in an irrevocable trust for purposes of qualifying a Crummey power for the annual gift tax exclusion.

B. Lapse of Crummey Power

The right to withdraw property from a trust by a holder of a Crummey power is deemed a general power of appointment for federal transfer tax purposes.[58] The lapse of such a power is treated as a taxable transfer by the powerholder to the trust beneficiaries, to the extent that the property reachable by the power exceeds the greater of $5,000 or 5% of the total value of the property subject to appointment ("5 and 5 Rule").[59]

In order to preserve the corpus of an irrevocable life insurance trust, Crummey powers generally are drafted in the trust agreement so as to attach only to the periodic transfers, not the accumulated corpus of the irrevocable trust. Under such a provision, the 5% lapse limitation would

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55. Priv. Ltr. Rul. 87-27-003 (Mar. 16, 1987).
56. *Id.*
57. *Id.*
58. *See, e.g.*, Quatman v. Commissioner, 54 T.C. 339 (1970).
59. Priv. Ltr. Rul. 89-01-004 (Sept. 16, 1988).

only be applicable if a transfer to an irrevocable life insurance trust, either in the form of the initial assignment of a life insurance policy or the transfer of funds for the subsequent payment of the premiums, exceeded $100,000. This is a rather remote possibility given the technique discussed above for reducing the value of a life insurance policy to be transferred to the trust by means of a policy loan and the option to fund a life insurance policy by payment of periodic premiums. Therefore, with respect to the vast majority of irrevocable life insurance trusts, the lapse of a Crummey power to withdraw trust property in excess of $5,000 will subject the designated Crummey powerholder or his estate to liability for gift or estate taxes, respectively, even though he did not receive any funds from the trust with which to pay these taxes.

As a result of the difference between the annual gift tax exclusion of $10,000 per person and the $5,000 limitation relating to the lapse of a general power of appointment, there is an inherent conflict between the settlor and the Crummey powerholders in an irrevocable life insurance trust with respect to the grant of Crummey powers in excess of $5,000. The settlor of an irrevocable life insurance trust generally desires that each Crummey powerholder be granted in the trust agreement the right to withdraw annually a portion of the property transferred to the trust up to the maximum annual gift tax exclusion amount, presently $10,000. Conversely, the Crummey powerholder does not want the power to exceed $5,000 annually, so that the lapse of such power will not expose him to any gift tax liability.

Drafters of irrevocable life insurance trust agreements have attempted to resolve or, at least, minimize the conflict by the use of several different approaches. A common practice is to specifically limit the annual amount of property which may be withdrawn by each Crummey powerholder to the greater of $5,000 or 5% of the value of the property transferred. Although such a limited grant reduces the annual exclusion available to the settlor with respect to each powerholder and, therefore, may necessitate the appointment of more powerholders, it does insure that the lapse of a Crummey power will not impose any gift tax liability on the powerholder.

A second approach eliminates the potential gift tax liability by giving each powerholder a special testamentary power of appointment over the property transferred to the trust which causes any gift that results from the lapse of the Crummey power to be incomplete. Nevertheless, the grant of a testamentary power of appointment may only defer the recognition of the taxable transfer. Code section 2041(a)(2) requires the inclusion of a pro-rata portion of the trust in the taxable estate of any Crummey powerholder who dies holding a testamentary power of appointment while the trust is still in existence.[60] Therefore, in order to minimize this potential

60. I.R.C. § 2041(a)(2) (1989).

estate tax liability resulting from a lapse of a Crummey power, a testamentary power of appointment is generally granted only to those Crummey powerholders whose life expectancies are significantly greater than that of the settlor.

A third alternative has been to provide in the trust agreement that such Crummey powers lapse only to the extent of the amount protected by the 5 and 5 Rule; the power to withdraw amounts in excess of the statutory limitation remains in force. These open powers are commonly referred to as "hanging powers"[61] and are subject to lapse in future years to the extent then permitted under the 5 and 5 Rule. Hanging powers are particularly well suited to life insurance policies based on limited premium paying periods (i.e., minimum deposit, limited pay life or vanishing premium). In this regard, hanging powers are superior to testamentary powers of appointment. While both alternatives effectively preclude the imposition of a gift tax on the lapse of a Crummey power, only the hanging powers provide a mechanism for reducing or eliminating the resulting estate tax liability during the term of the trust.

However, in a recent private letter ruling, the IRS disregarded the hanging Crummey power provisions in an irrevocable trust agreement and held that the lapse of a Crummey power resulted in a current taxable gift by the powerholder of the full amount of the property subject to the power in excess of the amount protected by the 5 and 5 Rule.[62] The IRS reasoned in this instance that the hanging Crummey powers constituted non-quantifiable conditions subsequent that frustrated the determination of the gift tax liability and rendered examination of the gift tax return ineffective; and thus, were invalid.[63] Therefore, certain tax risks exist regarding the use of the hanging Crummey power until this issue is resolved.

V. Conclusion

This Article is not intended to be an exhaustive analysis of the matters discussed herein, or a comprehensive study of all issues relating to the use of irrevocable life insurance trusts. Rather, the intent is to convey a sense of the complex and dynamic factors which affect and should be considered in deciding whether to create this type of trust. The use of such an instrument with its irrevocable character requires careful analysis. The favorable federal estate tax consequences of an irrevocable life insurance trust make it an important consideration in the formation of an estate plan. Because the laws governing irrevocable

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61. Covey, *Powers of Withdrawal*, ____ Prac. Drafting ____ (1982).
62. Priv. Ltr. Rul. 89-01-004 (Sept. 16, 1988).
63. *Id.*

life insurance trusts are complex and subject to change, they must be monitored in order to determine if they adversely affect the benefit of this estate planning technique.