CRUMMEY POWERS

Background

Crummey powers are instrumental in funding irrevocable life insurance trusts ("ILITs") and certain other trusts with annual exclusion gifts.

Annual exclusion gifts can help individuals funds ILITs (and certain other trusts) while preserving their lifetime gift and estate tax exemption exclusions ($5,430,000 in 2015). However, qualifying a gift in trust as an annual exclusion gift to the trust beneficiaries requires careful planning regarding the selection of *Crummey* powerholders, the drafting of *Crummey* power provisions and complying with the notice and withdrawal provisions in practice.

Despite several favorable Tax Court decisions, the Internal Revenue Service ("IRS") continues to closely scrutinize ILIT (and other trust) contributions and their qualifications as annual exclusion gifts, emphasizing the importance of following best practices when implementing and administering *Crummey* powers. Accordingly, the proper administration of these notices can mean the difference between contributing cash and other property to a trust with only the use of recurring annual exclusion amounts vs. paying gift taxes and/or losing lifetime gift/estate and generation-skipping transfer ("GST") tax exemptions due to the contributions.

Attempts to short-cut the administrative process or extend the use of *Crummey* powers beyond present limits may create adverse gift, estate and GST tax results.

<u>Overview –*Crummey* Powers & Annual Exclusion Gifts</u>

Generally, the first $14,000 (in 2015) of an individual's annual gift to a donee is excluded from federal gift tax. A gift qualifies for the gift tax annual exclusion only if the donee has a "present interest" in the gift (e.g., a direct gift to the donee). Gifts to trusts, including ILITs, however, do not meet this present interest requirement unless the trust gives the beneficiaries the power to withdraw the gift (referred to as a "*Crummey* withdrawal power"). The trust beneficiaries typically receive notice of gifts to the trust and their power to withdraw all or a portion of the gift, up to a designated amount (e.g., the gift tax annual exclusion amount). If the power to withdraw is not exercised within a specified period of time (e.g., 30 days), the *Crummey* withdrawal power lapses and the gift remains in trust to be invested or used by the Trustee as provided in the Trust document (e.g., to pay life insurance premiums).

Although a simple concept, *Crummey* powers require careful attention in administration, given the IRS's continued focus on their use. Failure to adhere to best practices in handling *Crummey* powers may result in limits on the amount of annual exclusion gifts an individual may make to the trust beneficiaries, characterization of all contributions to the trust as taxable gifts, the unanticipated imposition of federal gift tax and/or the loss of gift and GST tax exemption.

<u>Planning for *Crummey* Powers</u>

1. <u>Determine the ILIT's Annual Funding</u>. Generally, annual gifts to an ILIT depend on (a) the amount and timing of insurance premiums, and (b) the client's objectives. Funding an ILIT with annual exclusion gifts preserves an individual's lifetime federal gift/estate tax exemption or provides additional gifting bandwidth for those who have already exhausted their exemption. Funding an ILIT through annual exclusion gifts requires that the ILIT have sufficient *Crummey* powerholders to manage the payment of annual insurance premiums.

2. **<u>Select the *Crummey* Powerholders</u>.** Although more powerholders will permit more annual exclusion gifts to an ILIT (or other trust), the recipients of those Crummey powers should be considered carefully. It may be advisable to exclude certain beneficiaries as powerholders, for example, if a beneficiary is estranged from the family, has difficulty managing finances or has creditor issues (especially because creditors may reach the property subject to the beneficiary's withdrawal right, depending on applicable state law). To address these concerns, the trust document can limit the powerholders who can make withdrawals, permit the donor to exclude one or more trust beneficiaries from making withdrawals from his/her contribution, or provide the Trustee with the power to exclude a beneficiary, or to vary the withdrawal rights of each powerholder.

Certain classes of Crummey powerholders require additional planning, including:

- **Spouses.** Spouses, as trust beneficiaries, can hold *Crummey* powers. The power will qualify the withdrawal amount for the federal gift tax marital deduction. However, if the donor intends to allocate GST tax exemption to the trust, to ensure timely allocation the spouse's Crummey power should be limited to the *greater of $5,000 or 5% of the aggregate value of the trust's assets, and the withdrawal period should be no longer than 60 days.* These restrictions create an exception to rules of the estate tax inclusion period ("ETIP"), during which (a) a gift to a trust is includible in the gross estate of the donor and donor's spouse and therefore (b) prevents to donor's current allocation of GST tax exemption to the trust. If the donor's spouse has a *Crummey*power, the spouse effectively has a general power of appointment over part of the trust, which would cause inclusion in the spouse's estate, resulting in an ETIP. Limiting the spouse's *Crummey* power as provided above qualifies for an exception to the ETIP rules and permits the donor to allocate GST tax exemption to the trust.

- **Minor or Incapacitated Beneficiaries.** Who may exercise *Crummey* powers on behalf of minor or incapacitated beneficiaries? Trust provisions should be drafted to specifically identify who may act on behalf of such a beneficiary and/or give the Trustee or another person the power to designate such an individual. *The Trust document should specifically prohibit the donor of the gift (whether as parent, guardian or designated agent for the beneficiary) from exercising a Crummey power on behalf of a minor or incapacitated beneficiary.*
- **Grandchildren.** Grandchildren and more remote descendants are considered "skip persons" for GST tax purposes. Providing grandchildren with *Crummey* powers increases the annual exclusion gifts that may be contributed to an ILIT (or other Trust). However, as most typical ILITs are often structured as discretionary dynasty trusts for multiple beneficiaries, the gifts ***will not*** simultaneously qualify for the annual GST transfer tax exclusion. Thus, the donor's GST tax exemption likely will need to be allocated to these gifts or GST tax will be imposed when ILIT property is distributed to a skip person ("Taxable Distribution") or when the interests of all non-skip persons in the ILIT terminate ("Taxable Termination"). While the so-called "automatic allocation" rules may help in these situations (as

they automatically allocate GST tax exemption to any contribution made to a "GST Trust"), they are complicated, and the client is responsible for tracking the GST tax exemption automatically allocated each year. Accordingly, clients may want to file a federal gift tax return solely to document the allocation of GST tax exemption to annual exclusion gifts to GST-exempt ILITs, even if a gift tax return is not otherwise required.

3. **Ensure Powerholders Have a Beneficial Interest.** A *Crummey* powerholder must have a beneficial interest in the ILIT (or other trust). Current income and principal beneficiaries of a trust satisfy this requirement. In addition, the Tax Court has held that a *Crummey* powerholder's contingent remainder interest in a trust is a sufficient beneficial interest for annual exclusion purposes. However, *Crummey* powers granted to individuals who have no other interest in the trust ("naked powers") will not qualify.

4. **Take Into Account Other Annual Exclusion Gifts.** For each donee, the annual exclusion applies, in chronological order, to all gifts made by the donor to that donee during the calendar year. Accordingly, clients need to consider whether they plan to make, or have made, other annual exclusion gifts to the selected *Crummey* powerholders apart from the ILIT (or other trust) contributions. For example, clients may have elected to make excess contributions to Section 529 plans for their children. This involves a large, up-front contribution to the Section 529 plan and an election to allocate that contribution ratably over a 5-year period, qualifying the allocated amount for the annual exclusion for each of those 5 years. If a client also creates an ILIT (or other trust) that benefits the same Section 529 plan beneficiaries and provides them with *Crummey* powers, then the amount the client can contribute to the ILIT (or other trust) as annualexclusion gifts will be reduced by the annual exclusion gifts deemed made to the Section 529 plans.

5. **<u>Gift-Splitting</u>.** Spouses often seek to leverage the annual exclusion gifts by electing to use gift-splitting, which permits the gifts made by one spouse to be treated as if made by both. In effect, this allows a married donor to *double* the annual exclusion to the ILIT (or other trust). The non-donor spouse must consent to gift-splitting (which consent applies to *all* gifts made during the year). However, subject to limited exceptions, a spouse cannot consent to split a gift to a trust if he or she has a non-ascertainable (i.e., discretionary) interest in the trust. Therefore, if the non-donor spouse will be a trust beneficiary, the trust document must provide that any discretionary spousal interest is subordinate to the exercise of *Crummey*powers held by third parties (e.g., children and grandchildren). In this situation, transfers to the ILIT (or other trust) that are subject to the third-party Crummey powers should be treated as gifts to those powerholders, rather than gifts to the ILIT (or other trust) in which the spouse has a discretionary interest. Those gifts should qualify for split-gift treatment.

6. **<u>Structure the *Crummey* Power</u>.** Although *Crummey* powers have significant planning utility for the grantor, they also have the potential to create adverse results for the beneficiary. For example, *Crummey* powers are considered general powers of appointment with regard to a beneficiary's portion of a gift in trust. If the beneficiary dies during the withdrawal period, his or her interest in the gifted property may be includible in his or her estate. Furthermore, when a beneficiary allows the power to lapse, the beneficiary will make a taxable gift to the ILIT (or other trust) if the value of the lapsed power exceeds the greater of $5,000 or 5% of the aggregate value of the assets out of which the lapsed power could be satisfied ("5 and 5 amount").

To address the lapse concern, many ILITs (or other trusts) use so-called "hanging" Crummey powers, which lapse each year only to the extent of the 5 and 5 amount. The right to withdraw the excess continues into the following year (or years) until the value of the ILIT (or other trust) assets become sufficient to absorb the lapse (i.e., the lapse amount does not exceed 5% of the trust principal).

Even if hanging powers are used in a trust, clients should understand that hanging powers, while successful at protecting the beneficiary against a taxable lapse in the year of the gift, may still present issues. For example, the hanging withdrawal amounts may accumulate over time, particularly if the grantor is only making annual exclusion gifts to an ILIT equal to the premium payment amounts. In such case, the ILIT may be left with a principal value insufficient to absorb the hanging amounts over time, eventually giving the *Crummey* powerholder the ability to make substantial withdrawals from the ILIT. In addition, as discussed above, if the beneficiary dies while holding the right to withdraw the hanging amount, the excess will be included in the beneficiary's estate foe estate tax purposes.

7. <u>Provide Notice and Opportunity</u>. The IRS and the Tax Court have taken conflicting approaches regarding the requirements for providing powerholders with notice of, and the opportunity to exercise, *Crummey* powers to qualify a gift for annual exclusion treatment. The IRS has taken the position that *Crummey* powerholders must receive prompt notice of their withdrawal powers regarding any annual exclusion gift to the trust, and that a 30-day withdrawal period is sufficient. The Tax Court, however, has ruled that actual knowledge or notice of withdrawal rights did not affect the *Crummey* powerholders' legal right to demand withdrawals, and that a 15-day withdrawal period was reasonable. Generally, a withdrawal period of 30-60 days prior to lapse should be adequate for purposes of giving the beneficiary sufficient notice and opportunity.

Despite the Tax Court's rulings, the IRS continues to review and challenge ILIT (and other trust) contributions and qualifications as annual exclusion gifts during audits. ***Thus, we advise clients to give actual written notice to Crummey powerholders upon each gift to a trust. If these recommendations are not followed but the client has otherwise made the beneficiaries aware of their withdrawal rights, confirmatory Crummey notices should be provided to the beneficiaries as contingency planning.***Such notices reaffirm that a beneficiary was made aware of his or her withdrawal rights and elected not to exercise such right regarding each gift.

8. Provide the Trustee With Ability to Satisfy Withdrawals. During the withdrawal period, ILITS (and other trusts) should have the ability to satisfy *Crummey* withdrawal rights, if exercised. Otherwise, the *Crummey* powers may be deemed illusory. This situation occurs when the grantor pays the premiums on an ILIT-owned life insurance policy directly to the insurance company or in an employer-group policy setting, when the employer pays the premiums directly to the insurance company, which means no funds ever pass into the ILIT during the *Crummey* withdrawal period. Ideally, contributions will be made to the ILIT Trustee, who would hold the contributed amounts in trust for the designated withdrawal period. If this is not possible or does not occur, the Trust document may provide a "back-up" if it permits exercised Crummey powers to be satisfied by distributions of cash, other property (including interests in life insurance policies owned by the trust), or borrowing against the life insurance policies' cash values.