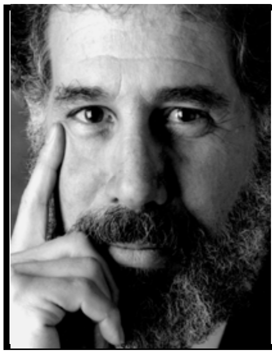

Leimberg's Think About It

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Estate Exemption Planning and The *Crummey*-style ILIT: Questioning Conventional Wisdom

Introduction

Say you've met a married couple with a combined net worth of $10 million. You've taken basic estate planning information from them, and have determined that they have "I love you" wills—documents that leave all assets to the surviving spouse at the first death, and the kids at the second death.

You've described the federal estate tax problem for them. At the second death, based on this year's exemptions and tax rates, their kids can expect about $3.6 million of wealth to be lost to federal estate taxes. The clients are disturbed, and are interested in your answers to their problems.

What are the standard solutions?

First, implement exemption planning wills or trusts to expand the amounts exempt from estate taxes this year from $2 million to $4 million.

To implement exemption planning in this example, the clients might divide up their assets between them. Then they might each create wills that leave $2 million of assets to their children at the first death. The children's bequest might be an outright gift, or a transfer in trust.

The $2 million earmarked for the kids is taxable in the estate of the first spouse to die. However, if the husband's death occurs in 2008, his estate tax exemption would eliminate any federal estate tax due. The other $3 million that would be transferred to the surviving wife would escape federal estate taxes due to the unlimited marital deduction.

At the wife's subsequent death in 2008, her $8 million estate--$5 million of her own, and $3 million inherited from her late husband—would go to the kids. The first $2 million would be covered by the wife's federal estate tax exemption, but the next $6 million would be taxed at 45%. That means $2.7 million of federal estate taxes--$900,000 less than with the "I love you" plan.

After implementing exemption planning, the next part of the standard plan is to manage the taxes that can't be avoided. For most, that means purchasing an appropriate amount of life insurance in an irrevocable life insurance trust (ILIT).

An ILIT is treated as if insurance owned by it is owned by the kids for estate tax purposes. That is, if life insurance is owned by a properly created, funded and administered ILIT, the death proceeds should be excluded from the insured's taxable estate.

This two step plan—exemption management in conjunction with an ILIT—is the conventional way life insurance producers deal with a married couple's estate tax issue. Is it the right solution for every situation? This issue of THINK ABOUT IT will explain why and where the conventional wisdom won't fit.

Estate Exemption Planning

Implementing the plan

Estate exemption planning isn't hard, but it does require paying attention to some details. There are two keys to its successful implementation:

- Create one or more transfer documents that passes wealth in the optimal way
- Adjust title on the assets to conform to the transfer documents

Say we're working with our married couple with a combined $10 million net worth. If they decide to implement exemption planning, that might mean selecting from the following transfer documents:

- Wills for husband and wife
- Joint revocable trust
- Individual revocable trusts
- Beneficiary designations
- Transfer on death (TOD) designations

Wills or revocable trust planning requires an attorney to properly draft the needed documents. In general, the lawyer will include verbiage that creates a *credit shelter* or *exemption* trust at the first spouse's death, and allocates an amount of assets to that trust equal to the exemption amount—$2 million in 2008.

It is also possible to use beneficiary or TOD (transfer on death) designations to achieve the same tax results. Say that part of the $10 million estate consists of $4 million in wife's name. She could designate the couple's children as beneficiaries of $2 million of the account. In the event of her death in 2008, the $2 million would be transferred to her children and be sheltered by the estate tax exemption.

While beneficiary or TOD designations can achieve the same tax efficiency as testamentary documents, they are usually not nearly as flexible. A properly drafted credit shelter trust can provide income and limited access to principal for the surviving spouse. It would be hard to get estate assets to both spouse and kids in an efficient estate tax manner by simply using a designation.

Correct titling of assets is also critical to making exemption planning work. For instance, if the entire $10 million estate is made up of jointly-owned assets, at the death of one of the spouses, all title automatically passes to the survivor. Under those circumstances, a perfectly drafted exemption will or trust is of no effect.

Tax Reasons not to Choose Exemption Planning

Normal exemption planning may not be a fit for clients due to a number of tax-related reasons.

First, exemption planning may fail to get some highly appreciating assets out of the estate of the surviving spouse in the most efficient way. Say in our $10 million estate, we identify an asset in the husband's name worth $3 million that is expected to grow at 20% each year. Let's also assume that the husband passes away this year, and the surviving wife's life expectancy is 20 years.

If the parties implement normal exemption planning, only $2 million of the $3 million asset would be allocated to the exemption. The other $1 million would be transferred to the surviving spouse.

At 20% annual growth, the asset will roughly double in size every four years. At the end of 20 years—the surviving wife's life expectancy—that $1 million asset may grow to $32 million in value. If the top federal estate tax rate goes to 55% in 2011 and beyond as it is scheduled to do, more than half of the then-current value would be lost at the second death.

Under that example, if all the assumptions prove correct, it would be more efficient to pay the 45% tax rate on the extra $1 million today.

Second, federal exemption planning may have undesirable state death tax consequences. For example, in the State of Tennessee, earmarking $2 million for the kids at the first spouse's death will trigger about $83,000 in state inheritance taxes.

Third, the unlimited marital deduction is not available for those who are not married or in situations where the surviving spouse is not a United States citizen. Since the unlimited marital deduction is the second key to avoiding estate taxes at the death of the first significant other, the fact that it isn't available makes exemption planning beside the point.

Fourth, if most or all of the estate assets are in qualified money—IRAs or pension plan accounts—exemption planning may not make *income* tax sense. We usually recommend that the surviving spouse be the 100% beneficiary of an IRA, as the income tax rules allow the spouse to continue the plan as if the spouse owns it. Naming a beneficiary *other* than the surviving spouse will require the balance to be distributed completely within five years, or the beneficiary may start taking regular taxable distributions over the beneficiary's lifetime within a year.

If a credit shelter trust is the beneficiary of an IRA, the spousal continuation choice will likely be unavailable. Further, depending on how the trust is drafted, the lifetime stretch opportunity may be unavailable, too. For those reasons, in estates with large IRA or qualified plan balances, exemption planning needs to be carefully evaluated.

Finally, in light of the estate tax uncertainty, some clients may not want to commit to exemption planning. Under the rules as they are today, the federal estate tax exemption will be $2 million for the rest of this year, $3.5 million in 2009, unlimited in 2010, and $1 million in 2011.

Most of us expect the rules to change within the next 18 months. A client may decide to defer planning until the change happens.

Practical Reasons not to Choose Exemption Planning

In addition to the tax considerations, clients may choose to avoid exemption planning for practical reasons.

Implementing an exemption plan means that the surviving spouse's access to part of the estate will be more limited than it would be with traditional "I love you" planning. While a credit shelter trust can give the surviving spouse some access to principal, it can't allow the spouse to treat the trust assets as a personal piggy bank.

In some cases, spouses are much more concerned about taking care of the survivor than they are about maximizing the kids' inheritance. This tends to be true particularly where the amount of wealth is less than $5 million. For those cases, "I love you" planning may be implemented, even though it might increase the estate tax exposure at the second death.

Conversely, in some cases exemption planning doesn't provide ***enough*** assets for the kids at the first death. For example, in a second marriage, at the first death the deceased spouse may want to take care of his or her own kids, to the ***exclusion*** of the surviving spouse. A plan of that type could accelerate federal estate taxes to the extent that amounts left to children exceed the federal estate tax. Likewise, in a troubled marriage situation, spouses might choose to earmark wealth directly for children rather than planning to use the marital deduction.

Where traditional exemption planning is not a fit, using life insurance in an ILIT still may be implemented to

- Take care of a "significant other" who does not qualify for the marital deduction,
- Take care of kids at a first death who might not otherwise be adequately provided for,
- Earmark funds specifically for other charitable or non-charitable beneficiaries, or
- Pay for unavoidable federal or state estate taxes in the traditional manner.

ILIT

The ILIT is one of the most conservative, reliable, tested and versatile estate planning tools around. We usually think of it in its *Crummey*-style implementation.

Implementing the Plan

Say we have a married couple with estate tax issues. To help manage the problem, one of the spouses creates an irrevocable trust which is designed to own life insurance. The trust provides that it is for the benefit of the grantor's spouse during her lifetime, and for the benefit of the children thereafter.

The trustee of the trust makes the decision to apply for insurance on the life of the insured grantor. The insured makes gifts to the trustee of the ILIT to cover the premiums.

Tax Issues

Under normal gift tax rules, a donor can make federal gift tax free transfers to a family member of up to $12,000 each year. However, gifts of "future interests" (gifts where the donee does not have the immediate, unfettered, and ascertainable right to use, possess, or enjoy the gift) in trust generally do not qualify for the annual exclusion. See Internal Revenue Code Section 2503 (b). A gift must be one of "present interest" to qualify for the annual exclusion.

To overcome the fact that gifts into a trust would not otherwise qualify for the gift tax exclusion, the ***Crummey*-style** ILIT was developed. In the case of ***Crummey v. Commissioner***, 397 F.2d 82 (9th Cir. 1968), the federal court ruled that gifts into a trust can qualify as present interest gifts if the beneficiary has the immediate right to take the gift out of the trust.

Since ***Crummey*** was decided, there have been a number of rulings, cases and Service pronouncements refining how its principles are applied to ILITs. For example:

1. The IRS has decided that Section 2514 (e) creates a possible trap for the beneficiaries of an ILIT. If a beneficiary has a right to take a withdrawal from ILIT, and the beneficiary

fails to do so, that beneficiary is considered to be making a gift to the other trust beneficiaries. The gift is taxable—to the extent the unexercised right is worth ***more*** than $5,000 or 5% of what's in the trust—whichever is greater. This is the so-called "five and five" limitation.

2. In Revenue Ruling 81-7, 1981-1 CB 474, the IRS said that a trust beneficiary must actually know that a gift has been made to the trust, and that the beneficiary has the right to withdraw it, before the gift qualifies as a present interest.

3. ***Crummey*** withdrawal windows open for at least thirty days in the year the gift is made have been recognized as valid by the Service. See Private Letter Ruling 8004172.

4. In ***Estate of Cristofani v. Commissioner***, 97 T.C. 74 (29 July 1991), the ILIT provided that remote contingent beneficiaries could be given ***Crummey*** withdrawal rights. The Service argued that only the withdrawal rights of ***current*** trust beneficiaries should be recognized for gift tax purposes. The Tax Court ruled that ***all*** the beneficiaries' rights of withdrawal would be recognized.

In addition to the string of cases refining our understanding of withdrawal powers, there are also a number of cases which may test the estate tax objectives of ILITs. For example:

1. The reciprocal trust doctrine may cause two complementary ILITs implemented for the benefit of each of the spouses and children to be includible in the estate of the decedent. See Private Letter Ruling 9235025.

2. The grantor's right to remove the trustee and appoint a replacement trustee who is *subordinate* to the grantor may cause trust-owned life insurance to be included in the grantor's taxable estate. See Revenue Ruling 95-58.

3. Transfers of existing life insurance to an ILIT are subject to inclusion in the insured's estate if the transfer occurred within three years of death. See Internal Revenue Code Section 2036. If the details of implementation are incorrectly done, the "three year rule" may be unexpectedly applied, even if new coverage is purchased to be owned by the ILIT.

Tax Reasons not to Choose **Crummey** ***ILITs***

One of the things that is sometimes forgotten when ILITs are implemented is that a client may already have implemented an annual gifting program to family members. If the annual exclusion is being used for regular cash gifts or more sophisticated family giving, there may be no room left for Crummey gifts. In that case, the client must consider another plan.

Also, a client may already have a Crummey ILIT in place. The beneficiaries of the ILIT might be getting more than $5,000 each year in premium allocated to them, and those beneficiaries are bumping into problems with the five and five limitation. If that's the case, a Crummey ILIT for new coverage might not be a good fit.

Practical Reasons not to Choose* Crummey *ILITs

In a perfect world, Crummey ILITs are implemented this way:

1. The ILIT is created and funded by the grantor.
2. The trustee of the ILIT sends ***Crummey*** notices to the beneficiaries.
3. After the beneficiaries decide not to withdraw the money,
4. The trustee decides to apply for insurance on the life of the grantor.
5. The insurance is approved.
6. The trustee pays the premium.

The reason for these theoretical steps is to conform to the requirements of the Crummey case and its subsequent set of rules, regulations and cases.

In the real world, it's rare for a client to create and fund an ILIT before the client knows whether life insurance is available for a reasonable price. A real world implementation might go like this:

1. The life insurance application is taken.
2. The coverage is approved for delivery within a short period of time.
3. The client tries to persuade his attorney to draft an ILIT within the delivery window.
4. For various reasons, the ILIT cannot be drafted—much less funded—within that window.
5. The client pays for the coverage personally because he's afraid his insurability might be adversely affected by waiting for the ILIT.
6. The coverage is actually put into the trust ***after*** the insurance is put into effect.

Clients may have a hard time getting their minds around how an ILIT works. They may balk at the idea of having to spend time with a lawyer to have documents drafted. They may have trouble with the idea of giving up control of an important asset to a trustee. In our experience, clients often struggle with the idea that their beneficiaries must be given a right to take the money out of the ILIT before it is spent for the life insurance.

All these issues may cause the parties to think about the alternatives.

Alternatives

The simplest alternative to a Crummey ILIT is to have each of the adult children own and be beneficiary of a policy on the parent or parents. The parents can make gifts to each child to cover the premium.

While this alternative can work well where all the children are responsible adults, clients don't often have the luxury of those circumstances. Also, if access to the policy's death benefit to help surviving spouse is desired, it's hard to achieve that result when the adult children are the owners of the coverage.

For those who like the flexibility of an ILIT without having to implement the details of Crummey, a non-Crummey ILIT can work. In that kind of a trust, gifts would not be subject to withdrawal by the beneficiaries. The downside is that the grantor would have to use up part of his or her lifetime gift exclusion to offset the trust contribution.

On the plus side, the grantor keeps the money out of the hands of the beneficiaries. Because there is no lapse of a gift, the beneficiaries don't have to deal with the five and five limitation between them. And finally, there's nothing wrong with putting life insurance into a non-Crummey trust.

Sophisticated estate planners have advocated for years the idea of using a family limited partnership (FLP) or limited liability company (LLC) to own life insurance. The grantor can fund the LLC or FLP with money, and give minority interests in the company to children or other beneficiaries. Such gifts should qualify for the annual gift tax exclusion.

The LLC or FLP could purchase insurance on the life of the grantor, and the coverage could be partly or completely free from estate taxes. For a complete discussion of this technique, see the July 2008 issue of Think About It.

Another technique to provide more control than an ILIT in the hands of a grantor is the Standby ILIT. This can be used to help a married couple keep short-term control of a survivorship policy's cash value. It's also a technique to hedge against the possibility that estate taxes might not be a long term concern for the couple. Here's how it works.

Say husband and wife are insured under a survivorship policy. The spouse with the shorter life expectancy is named the initial owner of the policy. The more insurable spouse is named as primary contingent owner.

The spouses draft and execute an ILIT, but do not fund it. The ILIT is named the second contingent owner and beneficiary of the life insurance. While the first spouse is alive--say it's the husband--he has full access to cash value accumulations in the policy. He can use those accumulations tax-free to supplement retirement income.

At husband's first death, the wife becomes the owner of the policy. If there are no estate tax concerns, she can continue to use the cash values for supplemental retirement income. She can direct the death proceeds directly to her beneficiaries or to a trust set up for their benefit.

If estate taxes are a concern, wife can disclaim her interest in the survivorship policy. Her disclaimer would allow the policy to pass to the secondary contingent owner; the ILIT. The cash value of the policy would be included in the husband's taxable estate and force utilization of his exemption amount. If the cash value is greater than the exemption amount, then estate taxes will have to be paid.

Since the disclaimer by the wife results in her never having owned the policy, she is not a transferor for purposes of Section 2035 and the three-year look back rule will not apply.

If the wife dies first, the husband continues to own policy and use cash values as needed. He can direct the death proceeds directly to his beneficiaries or to a trust for their benefit.

If estate taxes continue to be an issue, at wife's death, husband can absolutely assign the second to die policy to the ILIT. Section 2035's three-year rule does apply and the gift is taxable, subject to the $1 million gift tax exemption amount. However, once the three year period ends, the death proceeds will be excluded from the husband's taxable estate.

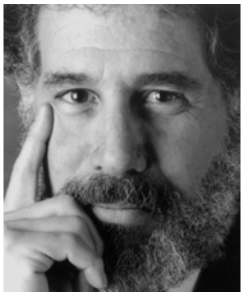
The list of alternatives to the Crummey ILIT is not meant to be complete. Depending on the client's objectives, these are a sampling of what might fit.

Conclusion

For many married couples with estate tax issues, the conventional planning wisdom—to implement an exemption trust and an ILIT—still works.

The professional planner should not assume that these tools are right for every job. The client's objectives with regard to control, taxes or family issues may suggest a different solution.

However, there's no reason to fear Plan B. There are still plenty of life insurance opportunities in the non-conventional estate tax planning pathways.



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