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 beneficiaries, improvements in drafting techniques, 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, irrevocable life insurance 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 regarding (i) *Crummey* withdrawal rights, (ii) generation-skipping transfer tax (GSTT) matters, (iii) changes in the tax laws, and (iv) life insurance policy issues. This article will explore different techniques that an attorney can use to fix some of these ailments and will provide a checklist to avoid certain problems before they occur.

How to Deal with Ignored or Neglected *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.

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Fixing Damaged ILITs (Plus a Checklist to Avoid Problems)

By Robert J. Adler and Michael J. Hausman

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Was Any Notice Provided? What about Oral Notice?

If a beneficiary received oral notice, have the beneficiary acknowledge in writing that he received oral notice for the "missing" years. The fact that this is done prior to any challenge from the IRS would show that it was in fact done in good faith and not in response to an audit. To document oral notice, consider having the beneficiary sign a written statement confirming the date of each gift, the withdrawal right associated with each gift, and the beneficiary's action with respect to that withdrawal right.

File a Late Gift Tax Return Reflecting the Gifts

Consider filing a late US gift tax return (assuming a gift tax return was not previously filed for the tax year in question), detailing the reasons that the annual gift tax exclusions are allowable. Under Treas. Reg. § 301.6501(c)-1(f), the statute of limitations will close three years after filing of the US gift tax return with respect to the issue if it is adequately disclosed. On the chance that the gift tax return is selected for audit, it is still better to be dealing with the IRS while memories are fresh and the donor is alive, rather than waiting decades until the federal estate tax audit.

Create *Crummey* Withdrawal Right in Letters of Gift Transmission

A possible method of securing a gift tax annual exclusion where the ILIT does not contain *Crummey* withdrawal rights is to create *Crummey* withdrawal rights in a letter of gift transmission to the ILIT trustee. The gift letter would inform the trustee of the gift being made, the terms of the gift, which trust beneficiaries have withdrawal rights, the amount of the withdrawal right, the time period in which a withdrawal right lapses, etc. *See* Pvt. Ltr. Rul. 8445004, where this technique was used to increase an annual withdrawal right from $3,000 to $10,000.

I'm Involved in an Estate Tax Audit—What Now? Consider the Position That No Notice Is Required

The emphasis in *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968), 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. In fact, the court in *Crummey* acknowledged that it was unlikely that certain beneficiaries would ever know of the contributions. Said the court, "[I]t is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust. They probably did not know when contributions were made to the trust or in what amounts." A similar distinction between possession of a right of withdrawal versus notice or knowledge of the right to withdraw is found in *Estate of Holland v. Commissioner,* 1997 T.C.M. (CCH) 3236.

To buttress the position that no notice is required, consider analogizing to Internal Revenue Code (I.R.C.) §§ 2041(a), 2056(b)(5), and 2503(c)(2). I.R.C. § 2041(a) provides for inclusion in a decedent's gross estate of the value of all property with respect to which the decedent possesses a general power of appointment. "General power of appointment" is defined by I.R.C. § 2041(b)(1) as a power exercisable in favor of the holder, his estate, his creditors, or the creditors of his estate. It is established that the mere possession of a general power of appointment triggers inclusion under I.R.C. § 2041(a), regardless of whether the holder was ever competent to exercise the power. *See, e.g., William R. Boeving v. United States,* 650 F.2d 493 (8th Cir. 1981); *Estate of Nancy E. Rosenblatt v. Commissioner,* 633 F.2d 176 (10th Cir. 1980); *Estate of Anna Lora Gilchrist v. Commissioner,* 630 F.2d 340 (5th Cir. 1980); *Estate of Fannie Alperstein v. Commissioner,* 613 F.2d 1213 (2d Cir. 1979), cert. denied, 446 U.S. 918 (1980); *Clarence Blagen Fish v. United States,* 432 F.2d 1278 (9th Cir. 1970). I.R.C. § 2056(b) is the general power of appointment marital deduction provision. If the surviving spouse is given the requisite income interest in the property, coupled with a general power of appointment, the inability of the surviving spouse to exercise the power of appointment because of incapacity or a lack of knowledge of the power will not disqualify the interest for the marital deduction. *See Estate of Frank E. Tingley v. Commissioner,* 22 T.C. 402 (1954), aff'd sub nom. *T. Everett Starrett v. Commissioner,* 223 F.2d 163 (1st Cir. 1955); Rev. Rul. 75-350, 1975-2 C.B. 366 (testamentary general power of appointment); Rev. Rul. 55-518, 1955-2 C.B. 384 (inter-vivos general power of appointment).

In short, the theory underlying the above-described treatment of general powers of appointment is analogous to the theory that the existence of the legal right to withdraw the contribution, and not the notice of such right or the appointment of a guardian or conservator for a minor, incompetent, or disabled beneficiary, is what creates a present interest and allows the donor to use the gift tax annual exclusion.

How to Deal with a Life Insurance Policy That Is No Longer Adequate or Appropriate

If the current life insurance policy is no longer adequate or appropriate or is too costly, or if a newer type of life insurance product would better suit the needs of the grantor, consider the following.

Tax Deferred Exchange of Life Insurance Policy

I.R.C. § 1035 permits owners of life insurance and annuity contracts to exchange their contracts for similar or related types of contracts without the recognition of any unrealized gain that may have accrued in the contract surrendered in the exchange. Although such exchanges would ordinarily be taxable transactions with gain or loss measured by the difference between the fair market value of the new policy and the owner's basis in the old policy, exchanges that meet certain basic requirements are granted nonrecognition treatment by I.R.C. § 1035. I.R.C. § 1035 does not provide a permanent income tax exclusion for gains on such exchanges but merely a deferral—since the basis of the contract given up is carried over as the basis of the new contract received.

Painful income tax consequences can accompany the lapsing or cancellation of a life insurance policy whose cash value has previously been substantially depleted through policy loans.

Caution: Debt Release as Boot

If an exchange comes within I.R.C. § 1035, except that other property or money is also received "to boot," gain (in the policy given up) is recognized up to the value of the boot received. I.R.C. § 1031(b).

If a policy that is subject to an outstanding loan is exchanged in a transaction otherwise qualifying for nonrecognition under I.R.C. § 1035, the balance of the loan at the time of the exchange is treated as "boot" to the extent that it exceeds the amount of any loan balance outstanding on the new policy received. Treas. Reg. § 1.1031(b)-1(c). This rule prevents abuse of the nonrecognition provision in a disposition transaction intended to yield cash (which would otherwise be taxable as boot) by structuring the transaction as a nontaxable loan followed by a nonrecognition exchange.

If a policy subject to an outstanding loan is exchanged for a new policy, and the new policy is issued with an identical outstanding loan amount, there is no boot. I.R.S. Priv. Ltr. Rul. 8604033 (n.d.); I.R.S. Priv. Ltr. Rul. 8816015 (July 1, 1988). If the new issuing company will not issue a policy subject to indebtedness, another way of avoiding boot is to pay off the loan on the old policy prior to the I.R.C. § 1035 exchange and then, if necessary, borrow against the new policy.

Prepare a New ILIT and Obtain a New Life Insurance Policy

Sometimes, the existing ILIT is woefully inadequate either for tax reasons or because of changed circumstances. If the grantor is insurable at reasonable rates, the grantor can stop funding the existing ILIT, establish a new ILIT, fund the new ILIT, and then have the new ILIT purchase a life insurance policy that is better suited to the grantor's current situation. Obviously, this solution has the benefit of being "clean" for tax purposes; however, it is not viable where insurance is no longer available on the life of the grantor at a reasonable cost or where the grantor is uninsurable. Once the new ILIT is operational, the old ILIT can continue as an investment vehicle, be terminated through discretionary distributions, or be terminated because it is no longer economical to continue the trust.

Caution: Painful income tax consequences can accompany the lapsing or cancellation of a life insurance policy whose cash value has previously been substantially depleted through policy loans. Life insurance contracts have traditionally been accorded highly favorable income tax treatment. One of the most important of these benefits is the tax-free inside build-up of cash value in a policy (as long as it satisfies the Code's definitional parameters for a life insurance contract). Not only may the cash value accumulate within the policy without current taxation, but this untaxed income may even be utilized by the policy owner, still without income recognition for tax purposes, in the form of an interest-bearing policy loan. The nonrecognition of this income will become permanent when the insured dies and the death benefit (net of any policy loan balance) is paid. Under the general rule of I.R.C. § 101, the death benefit under a life insurance contract is excluded from gross income. This avoidance of income recognition, however, will not be permanent when a policy loan is effectively retired by offset against the cash value in connection with cancellation (or lapse) of the contract. In such an event, the income recognition will be only deferred, and it must be recognized at the time of cancellation (or lapse) of the policy.

Checklist

Below are several additional items that a practitioner should consider when advising on ILITs. This checklist assumes that the practitioner has experience and knowledge concerning tax law, estate planning, and trust drafting.

1. Avoid ETIPs and Taxable Releases

The spouse's withdrawal right should be limited to the five-by-five safe harbor amount of I.R.C. § 2514(e) and the withdrawal right should lapse 60 days after the date of contribution (not 60 days after notice). This will avoid the GSTT estate tax inclusion period (ETIP) issue for the spouse. 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 is the I.R.C. § 2026 estate tax problem when the spouse's lapse of a withdrawal right is greater than the five-by-five safe harbor resulting in the spouse making a transfer with a retained interest.

2. Avoid Naked *Crummey* Withdrawal Rights

The IRS frowns upon beneficiaries who have *Crummey* withdrawal rights and are merely contingent remainder beneficiaries. 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 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. An especially 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, or a specific dollar amount to

each "unvested" contingent remainder beneficiary who has a *Crummey* withdrawal right.

3. Provide Beneficiaries with Sufficient Time to Exercise Their *Crummey* Withdrawal Rights and Give the Trustee Broad Powers to Satisfy Any *Crummey* Withdrawal Right

According to the IRS, a beneficiary must have a reasonable amount of time to exercise the *Crummey* withdrawal right before it lapses, with 30 to 60 days being typical. Make sure that any *Crummey* withdrawal right may be satisfied not only against the contribution but also against other trust property, including any insurance policy or fractional interests in the insurance policy. This will provide substance to a *Crummey* withdrawal right, especially as concerns any split-dollar or group term policies held by the trust.

4. Noninsured Spouse as Trustee

A noninsured spouse who is a beneficiary of an ILIT (when the other spouse is the sole insured under the ILIT) can serve as trustee of the ILIT during the insured spouse's lifetime, provided (i) the noninsured spouse holds no powers as trustee that constitute a general power of appointment, (ii) the noninsured spouse is prohibited from making distributions that would have the effect of discharging that individual's legal obligations, including the obligation of support, and (iii) the noninsured spouse does not make any gifts to the ILIT (other than merely consenting to gift splitting under I.R.C. § 2513). After the death of the insured spouse, the noninsured spouse can serve as trustee of the ILIT, even if that individual is a beneficiary, provided the noninsured spouse holds no powers as trustee that constitute a general power of appointment.

5. Effect of Gift Tax Annual Exclusion upon GSTT Taxability

It is important to realize that a lifetime gift that creates an interest in a skip person (other than in the case of an I.R.C. § 2642(c) trust) is potentially subject to GSTT even though the gift qualifies as excludable from gift taxation. In other words, not all gifts that are excludable from gift taxation (by reason of the $17,000 (as indexed) gift tax annual exclusion) are excludable from the operation of the GSTT. Thus, it is necessary to allocate an appropriate amount of the GSTT exemption to gift tax annual exclusion transfers (other than in the case of I.R.C § 2642(c) trusts) in order to exempt future generation-skipping transfers.

6. Avoid the Creation of Reciprocal ILITs

In determining whether the reciprocal trust doctrine applies, the following factors should be considered and analyzed: (i) the similarity of the trusts' terms, (ii) the similarity of the trusts' corpus, (iii) the trustees, (iv) the beneficiaries, (v) the proximity of the trusts' execution date, and (vi) the grantors' intent concerning a pre-arranged plan.

To avoid the reciprocal trust doctrine, consider the following drafting suggestions: (i) Give one spouse (but not the other) a broad inter-vivos limited power of appointment; (ii) give each spouse a different form of entitlement under each other's trust—one spouse may be entitled to mandatory distributions of income and distributions of principal for health, education, support, and maintenance, but the other spouse may be entitled to receive distributions of income and principal in the sole discretion of an independent trustee; (iii) vary the terms of the trust—one trust may be a GSTT-exempt dynasty trust and the other trust may be for a specified length of years; and (iv) execute the trusts on different dates—the farther apart the better.

7. Vest Ownership of the Life Insurance Exclusively in the ILIT Trustee

The ILIT should provide that the grantor relinquishes all incidents of ownership over transferred policies and that any life insurance policy purchased by the ILIT on the grantor's life is owned exclusively by the trustee (i.e., the insured must not possess any "incidents of ownership" in the life insurance policy). I.R.C. § 2042.

8. Avoidance of the Three-Year Rule Problem When a New Policy Is Involved

Under I.R.C. § 2035(d)—the so-called three-year rule—if an insured person transfers an insurance policy to an irrevocable life insurance trust, even though the insured may no longer retain any incidents of ownership, but then dies within the three-year period following the transfer, the entire policy proceeds will be includable in the insured's gross estate, effectively defeating the major objective of the irrevocable trust plan. For the most part, the three-year rule problem can be eliminated by establishing the trust with a new policy (i.e., one never owned by the insured). This, of course, is not a viable alternative when an existing policy is involved.

In general, the trust should be established first, with a transfer of cash from the grantor to be used to pay the initial premium. The trustee would then submit the formal application, with the trust as the original applicant and owner. The grantor-insured would participate only to the extent of executing required health questionnaires and submitting to any required physical examination. The critical factor in assuring the inapplicability of I.R.C. § 2035(d) is that the grantor-insured not have possessed, at any time, anything that might be deemed an incident of ownership with respect to the policy.

In Technical Advice Memorandum (TAM) 9323002 (Apr. 20, 1998), the IRS held that reapplication by a third-party owner (such as an ILIT trustee) after the decedent initially applied for the insurance (with no money submitted with the "initial" application) within three years of death did not present a three-year rule problem. Central to the technical advice is the notion that an application for insurance (as long as money is not submitted with the application) is only an offer to contract. There being no contract between the parties, the decedent never held any incidents of ownership. ■