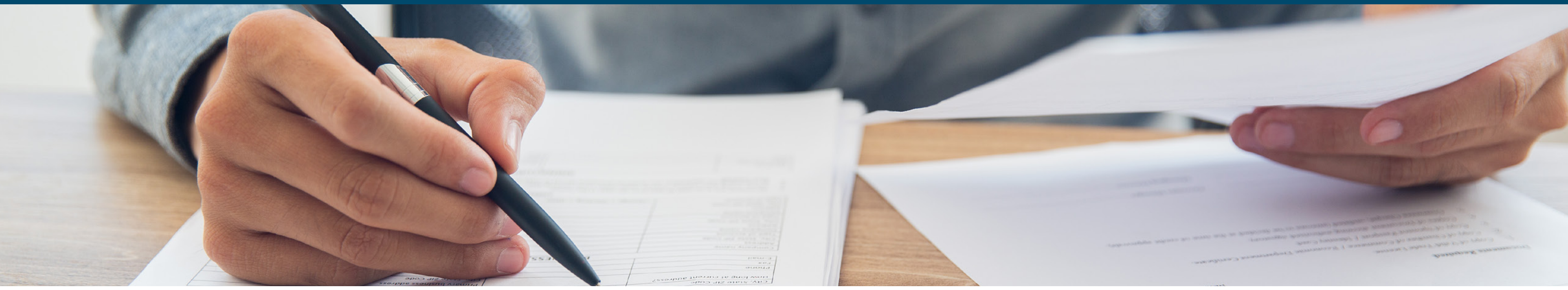
by Terri Getman, JD, CLU, ChFC, RICP AEP(Distinguished)



Does the Premium Need to Stay in the Trust for the Full *Crummey* Period?

Situation: The secondary no-lapse guarantee life insurance product has been a popular estate planning contract because it provides guaranteed coverage at a guaranteed premium. However, the policy guarantees can be jeopardized unless they are managed properly. Specifically, if premiums are not paid on time the lifetime guarantees can be put at risk.

Financial representatives are all aware of the grace period that protects a life insurance policy from lapsing during the 30 days following the premium due date. The grace period allows policy owners to pay premiums during the grace period without concern about a reduction in the policy's death value. Secondary no-lapse policies also offer a 30-day period. However, the payment of a premium after the anniversary date, but within the grace period, can jeopardize the lifetime guarantee of the contract. (Payment of premium before the anniversary date may also endanger the lifetime guarantee of the contract.) The timing of premium payment has significant implications to trust owned life insurance policies.

In a perfect world, contributions to a trust to pay premiums on a life insurance policy will be left in cash form in the trust bank account until the *Crummey* power lapses. However, we don't live in a perfect world. Grantors don't always make contributions to the trust far enough in advance of the anniversary date of a no-lapse product. When this happens, I receive calls from financial representatives seeking solutions to avoid jeopardizing the lifetime guarantee on a secondary no-lapse contracts. The financial representative typically asks one, or both, of the following questions:

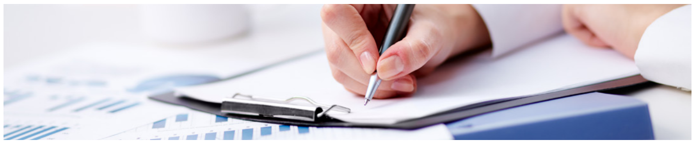
- Does a trustee have to wait until the *Crummey* withdrawal period ends before paying life insurance premiums?
- Can the withdrawal time period be shortened by having the *Crummey* beneficiary waive or release his withdrawal right?

In addition to the timing of the premium payment, I get calls inquiring whether the premium payment can be made directly to the insurance company instead of the trust. This *Counselor's Corner* will provide insight to these premium payment questions.

Solution: Let's refocus the questions to the real issue by doing a quick review of what a *Crummey* withdrawal right is and why it is important.

A *Crummey* withdrawal right gives trust beneficiaries a demand right to withdraw gifts made by the grantor during a stated time period, usually 30 days or longer from the time the notice was given. *Crummey* provisions are used to ensure that gifts to a trust will be considered "present interest gifts" that qualify for the annual gift tax exclusion.

Even though it may be unlikely that any of the beneficiaries will exercise their *Crummey* withdrawal rights, the power cannot be illusory. When a *Crummey* power holder is provided with notice of a gift to the trust and his/her right to withdraw assets, there must be enough trust assets "available" to satisfy this demand right. The real question in the administration of an irrevocable life insurance trust (ILIT) is whether the trust assets must be kept in cash form to be considered "available."



The conservative approach is to leave the gift in cash form in the trust bank account until the *Crummey* power lapses. This often becomes a problem on a newly issued policy because the time period in which the premium must be paid often runs out before the end of the *Crummey* period. Moreover, with group term life insurance and payroll deduction plans, premiums are made directly to the insurance company without funds being transferred into the trust.

Some advisors take the position that it is unnecessary to maintain liquidity if the trustee has the authority to satisfy the *Crummey* withdrawal demands using policy cash values and the policy has sufficient cash value to satisfy withdrawal demands. This position is based on Reg. § 25.2503-3(c) Example 6, which states:

"L pays premiums on a policy of insurance on his life. All incidents of ownership in the policy (including the right to surrender the policy) are vested in M. The payment of premiums by L constitutes a gift of a present interest in the property."

Unfortunately, the Internal Revenue Service (IRS) has not consistently applied this reasoning to case facts. Private Letter Ruling (PLR) 8111123 addressed a *Crummey* trust that was funded with $50,000 in cash and a group term life insurance policy. The trust provided that "any trust assets, including life insurance policies" could be used to satisfy the withdrawal demand. The IRS held that this interest was sufficient to qualify as a present interest and permitted an annual exclusion. Again, in PLR 8134135, where the *Crummey* trust was funded initially with minimal cash ($500), four whole life policies, two term policies, and two group term policies, the IRS found that the beneficiaries had "the present right to use, possess, or enjoy the property" and upheld the annual gift tax exclusion despite the illiquid nature of the trust assets.

However, in PLR 8118051, the IRS stated that the annual exclusion was available for a gift made to the trust only "to the extent that there is cash or assets reducible to cash in the trust to satisfy [the] demand rights." At the creation of an irrevocable life insurance trust, if life insurance premium payments are made before the expiration of the withdrawal period, the only trust assets available to satisfy the demand right would be the cash surrender value. At this point, the policy would have little or no cash surrender value to satisfy the withdrawal request, thus rendering the beneficiaries' power meaningless.

Whenever the policy has accrued cash surrender value to satisfy the withdrawal obligations, it may be possible to make life insurance payments before the expiration of the withdrawal period. However, in *Estate of Trotter*, where the decedent transferred her residence to an irrevocable trust, the Tax Court questioned the reality of the *Crummey* withdrawal rights stating: "We cannot blind ourselves to the reality of the family relationships involved, and the estate has failed to show that the withdrawal rights were anything more than a paper formality without intended economic substance. In addition, such construction is strengthened still further by the fact that the trust's having been funded solely with a single piece of real estate would have made any attempt to effectuate a withdrawal complex and burdensome at best. While it is not entirely clear from the document how the provision would operate in this circumstance, we doubt that any beneficiary would seriously have contemplated forcing the trustee to sell the home so that he or she could collect $10,000."[1]

Thus, the risk remains that this reasoning could be applied to *Crummey* trusts holding only life insurance policies and the withdrawal rights found to lack true economic substance unless liquid assets are available.

Another frequently asked question is whether the period can be shortened by having the *Crummey* beneficiaries sign a waiver of their withdrawal rights. Under this technique, when all beneficiaries have signed a waiver, the demand period is closed and the premium is remitted to the insurance carrier.

There are practitioners who feel that the “waiver method” presents a tax risk, because the proactive waiver of a right to withdraw may not technically qualify as a “lapse” (which implies inaction) under the Internal Revenue Code. As discussed in another *Counselor’s Corner*, a beneficiary’s failure to exercise his *Crummey* right is considered a lapse of a power of appointment and is a taxable gift to the other trust beneficiaries to the extent the lapse exceeds the greater of $5,000 or 5 percent of the trust. The 5 X 5 limit shelters the beneficiary from gift tax; however, this safe harbor applies only to a lapse. If the IRS does not treat a beneficiary’s waiver of his/her *Crummey* withdrawal as a lapse, a taxable gift would occur. The *Crummey* power holder will have to file a gift tax return and use a portion of his/her applicable exemption amount.

In Summary. Most commentators indicate that the safest approach is for the trustee to make premium payments after the expiration of the demand period. This ensures that the trust holds sufficient liquid assets to validate the beneficiaries’ right to withdraw. As always, the client and his/her attorney should discuss the alternatives and risks they present before implementing any plan.

---

[1] *Estate of Trotter, T.C. Memo 2001-250*

5501 Excelsior Boulevard | Minneapolis, MN 55416