

CRUMMEY and DEFECTIVE MEANS ... FANTASTIC!
(PRACTICAL TIPS on CREATING FLAWLESS ILITs)

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presented by
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**CRUMMEY and DEFECTIVE MEANS ... FANTASTIC!
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I. This Practitioner's Comprehensive View of the Basic Components of Estate Planning
(the **A-B-C-Ds**)

Estate planning begins with the **Accumulation** of asset values

B. = Benefit

When sufficient net worth has been achieved and family obligations permit, it is time to reap the **Benefits** of your wealth accumulation efforts with careful and thorough retirement planning

C. = Conserve

The uncertainties of life and aging coupled with the high cost of dying make it necessary to take active steps to **Conserve** your accumulated property for yourself and your family during lifetime, and ultimately for your heirs and beneficiaries

D. = Distribute

The final step in the estate planning process is to arrange for the desired and orderly **Distribution** of your estate to the chosen objects of your bounty

*The foregoing will provide the general framework
for the balance of this presentation*

II. The Effective Uses of Life Insurance in Each of the Basic Components of Estate Planning

A. Accumulating an Estate

1. For young couples, life insurance provides essential family protection in the event of premature death; it also builds an instant estate
2. The policy's beneficiary designation governs the distribution of that estate at death and, particularly when minor children are involved, requires the same care and careful planning as would apply to any other estate assets; unfortunately, these beneficiary designations are too often prepared with little or no thought

Here's a designation to consider (either primary or contingent, depending on the circumstances) in those situations where there are minor beneficiaries and where no estate planning has yet been done (e.g., there is no living trust):

"Children of the insured in equal shares per stirpes; provided, however, if any beneficiary is under age 21, that beneficiary's share shall be paid to *(name of responsible adult)* as Custodian for that beneficiary until age 21 under the Alaska Uniform Transfers to Minors Act; Successor Custodian: *(name of another responsible adult)*"

- The Role of Other Members of the Estate Planning Team -- preparation of wills with testamentary trusts or revocable living trusts and pour-over wills
3. For those who have suffered significantly reduced asset values as a result of recent economic conditions, whether in real estate, stock market investments, or business values, life insurance can replace those lost values for the family
 - a. This can be thought of as "Gap Insurance", i.e., life insurance to fill the gap caused by the economic downturn
 - b. Consider a minimum of \$1,000,000 of inexpensive convertible term insurance which you can then convert to permanent coverage after the economy recovers

B Benefiting from One's Accumulated Assets

1. Permanent non-MEC life insurance policies (often variable or indexed policies), specially designed to maximize the cash accumulation by minimizing mortality costs, are often used by individuals to supplement their personal retirement benefits
 - HOT IDEA: With the current high (temporary?) lifetime gift tax exemption, have the husband create and fund an ILIT that benefits the wife, and have the ILIT purchase such a policy; the policy will produce retirement income, yet its death benefit proceeds will be free of estate taxes in the current generation

2. These same types of policies are also one of the most popular means of informally funding employer-provided non-qualified deferred compensation and salary continuation plans for corporate officers and other highly compensated employees
 - The Role of Other Members of the Estate Planning Team -- preparation of deferred compensation and/or salary continuation agreements, and possibly rabbi trusts, along with other necessary ERISA documents; these arrangements also require appropriate GAAP accounting procedures for the employer
3. Both deferred and immediate annuities have also become useful planning tools

C. Conserving Your Property for Self and Family

1. During Lifetime.

Life insurance policies with long-term care riders, annuities with linked LTC benefits, or stand-alone LTC policies, are essential tools in protecting against the infirmities of aging, both physical and mental

- See the discussion below of life policies with LTC Riders owned by ILITs in the section entitled "ILITs: Crummey and Defective Means ... Fantastic!"

2. At Death

Life insurance policies, properly arranged to be free of estate taxes, gift taxes, and often even generation-skipping transfer taxes, have long been recognized as the pre-eminent tool for providing the liquidity necessary to pay estate taxes (as well as income taxes on IRD) with 100% dollars, i.e., dollars that are themselves not taxed

- a. This avoids the necessity of forced liquidations of non-liquid property
- b. It also keeps the estate intact for heirs and beneficiaries
- c. It can also be highly effective in situations where Section 6166 extensions may be available for closely-held business interests, either as an alternative to Section 6166, to protect against the possibility that the estate will not qualify for Section 6166, or hand-in-hand with an elected Section 6166 extension
- d. These techniques have not gone out-of-style despite the new (temporary?) high transfer tax exemption amounts
 - The Role of Other Members of the Estate Planning Team -- total estate planning, including preparation of irrevocable trust agreements and other estate planning documents, implementation of asset protection strategies, and necessary accounting and trust services; (see the section below entitled "ILITs: Crummey and Defective Means ... Fantastic!")

D. Distributing the Estate to One's Heirs and Beneficiaries

1. With second marriages, particularly with a younger second spouse, it can be used to provide separately for the children of the first marriage, generally with an ILIT
2. When not all children are involved in a family business, it can "equalize" benefits for the children who are not active in the business, again often by using an ILIT
3. It can be used to provide for special needs beneficiaries without short-changing other family members, generally with a separate special needs trust
4. It can be used to buy the time necessary for other arrangements to pay off, whether they be business ventures, stock market, real estate, or other investments, or other estate planning tools such as GRATs, even a series of GRATs with different maturities, or qualified personal residence trusts
5. It can be used to complete an installment sale that is incomplete at death, such as a sale to an intentionally defective irrevocable trust
6. For estate owners who wish to leave a substantial part, or perhaps all, of their estate for philanthropic purposes, it can be used to provide the family's inheritance, or replace the value of the donated property, generally with an ILIT often referred to as a "wealth replacement trust"

SEE Mortal Thoughts Article

- The Role of Other Members of the Estate Planning Team -- all of these ideas and techniques are part of the total estate planning process and all require various estate planning documents as well as accounting and trust services

III. ILITs: Crummey and Defective Means ... Fantastic!

Reflections and Suggestions from a Life Insurance Professional Who Has Worked with Many Fine Estate Planning Attorneys Over the Years

A. Crummey Beneficiaries

1. In most situations, make the list of potential Crummey power holders as large as feasible under the Cristofani case guidelines
 - a. For example, do not limit the list to only known living beneficiaries such as children, but include spouses and descendants, whether now known or not, and perhaps even parents and/or nieces and nephews

- This practitioner has seen many cases where a new policy is purchased with a premium commitment that exceeds the available annual exclusions for the specified Crummey beneficiaries, resulting in either gift tax problems or complicated loan monitoring
 - But query whether including more remote descendants automatically causes unexpected generation-skipping tax problems (see below)
- b. For both protection and flexibility, it is suggested that a provision be included that gives any trust donor(s) the right, in connection with any transfer to the trust, to limit or eliminate the withdrawal rights of any beneficiary
 - This should not be considered the reservation of a prohibited power over the trust, but rather nothing more than the right to determine to whom future gifts will be made
- 2. It may well be advisable to include some future trust benefit, even a relatively small benefit, for those to whom Crummey gifts are actually made over the years so as to be sure the gifts are deemed “legitimate” in the eyes of the IRS

B. Amount of Each Beneficiary’s Withdrawal Right

1. Make each beneficiary’s withdrawal right as large as possible (subject to being limited as suggested above to the amount of actual gifts) so as not unnecessarily to restrict potential gifts to amounts less than available gift tax annual exclusions
 - a. For example, do not limit the withdrawal right to the limits of the 5 x 5 rule (the greater of \$5,000 or 5% of the trust value), but rather to the lesser of the amount of the gift to that individual or the available gift tax annual exclusions, dealing with the 5 x 5 problem as discussed below
 - b. And make the reference to the amount of the gift tax annual exclusion generic to what is permitted at any time under the Internal Revenue Code rather than specific only to the amount allowed by law at the time the trust is created or at any given time in the future
 - c. And so as to avoid potential gift or estate tax problems for those holding withdrawal rights that exceed the 5 x 5 amount, include either a non-general power of appointment or a (carefully drafted) so-called “hanging power” over the excess amount; either of these techniques should avoid a potential completed gift being made by the holder of the withdrawal power to the other trust beneficiaries of the excess over the 5 x 5 amount on non-exercised withdrawal rights

- If the trust is divided into distinct sub-trusts for each power holder from the outset, including more remote descendants (although this latter is probably not what the client desires in most cases), these techniques are probably not necessary, but this practitioner prefers the “pot” trust approach in most situations during the lifetime(s) of the insured(s)
 - But again consider whether, when more remote descendants have withdrawal rights, the “pot” trust approach automatically causes unexpected generation-skipping tax problems (again see below)
- e. In the typical case, the cumulative excess-over-5 x 5 amount will grow over the early years of the trust while the value of trust assets is less than \$100,000 and the \$5,000 amount is thus greater than 5% of the trust principal, but as soon as the value of the trust assets exceeds \$100,000, the 5% amount will exceed \$5,000 and will continue to grow until it eventually actually exceeds the amount of the annual withdrawal right
 - When this occurs, the cumulative amount subject to the power of appointment or hanging power can be “worked off” annually until it disappears, and if it has not entirely disappeared by the time the life insurance death proceeds are received by the trust, it will almost certainly disappear at that time

C. Notice to Beneficiaries of Their Withdrawal Rights

1. The cases and rulings all require that the Crummey power holders be given notice when a contribution is made to the trust with respect to which they have a withdrawal right
 - a. This means that, if multiple gifts are made to the trust each year, perhaps because the premium mode is other than annual (i.e., semi-annual, quarterly, or monthly, perhaps via automatic withdrawals), multiple Crummey notices are probably required each year, thereby resulting in excessive trust administration issues
 - b. It appears desirable, then, to have premiums paid annually; this is also less costly than other premium modes
 - Query: if it is known that a series of equal gifts will be made to the trust during the year at known intervals, is it legally sufficient to provide a single notice with the first gift so notifying the beneficiary?
2. Some practitioners include a statement at the bottom of the Crummey notice for the beneficiary to sign and return stating that the beneficiary chooses not to exercise the withdrawal right

- a. That would appear to be the release of a general power of appointment rather than the lapse of the power, thereby causing unwanted tax consequences
- b. Instead, simply have the beneficiary acknowledge receipt of the notice

D. Making the Trust a Defective Grantor Trust for Income Tax Purposes

1. There are several reasons why this can be advantageous

- a. It allows an existing policy to be sold to the trust rather than gifted to the trust, thereby avoiding both the potential three-year estate inclusion rule and also a potentially large gift based on the then value of the policy
 - i. There should be no income tax consequences or adverse transfer-for-value rule results since, for income tax purposes, the grantor and the trust will be considered to be one and the same
 - ii. And where the value of the policy is significant enough to have caused gift tax problems if the policy itself had been gifted, the annual gift can be kept within desired limits by using private financing (discussed below) with a note payable over several years
- b. Income-producing property can be transferred to the trust by sale or by gift with the income from the property then used to pay life insurance premiums
 - i. If by sale, whether for a lump sum or in installments, there should be no income tax or capital gains tax consequences since the grantor and the trust will be considered to be one and the same (for income tax purposes)
 - ii. And in either case, since the income from the property will be taxed to the grantor rather than to the trust, which has been ruled not to be a taxable gift to the trust, the effective result is additional tax-free gifts to the trust
- c. Private financing can also be a very attractive option
 - i. For example, liquid assets can be loaned to a defective (grantor trust) ILIT for nine years, thereby qualifying the loan for the federal mid-term interest rate, with the excess earnings in the ILIT used to pay premiums
 - ii. With today's unusually low interest rates, even the federal long-term rate is low enough to make longer loans highly attractive
 - iii. Another extremely appealing and effective alternative is an installment sale of an income producing non-liquid asset to a defective (grantor trust) ILIT under a similar arrangement

- In all of these scenarios, there should be no income tax or capital gains tax consequences since, for income tax purposes, the donor and the trust are considered to be one and the same
 - d. In general, having a “defective” grantor trust allows more flexibility in trust administration over the years
- 2. Different practitioners choose different provisions to make the trust “defective”
 - a. Some practitioners believe that all trusts holding life insurance policies that still have premiums payable are automatically grantor trusts because of the ability to use trust assets to pay premiums
 - But query: if the trust prohibits the use of trust income for this purpose, will it still be considered defective?
 - b. Perhaps the most “benign” provision to use is the ability of the grantor to substitute property of equal value
 - But query: if the major (or only) trust asset is a life insurance policy on the life of the grantor, will this be deemed to give the grantor an incident of ownership in the policy, thereby making the policy estate taxable?
- 3. For greatest flexibility down the line, consider including a provision that gives the grantor the right to release the power that makes the trust defective, or, alternatively, a provision authorizing the trustee to reimburse the grantor for the tax paid on trust income
 - These provisions make it possible to shift the income tax on trust income to the trust in future years, perhaps when no further premium payments are due

E. Trustee Powers and Duties Over Life Insurance

1. Many trusts contain only meager and/or outdated specified trustee powers over life insurance policies held in the trust
 - a. In view of the complexity of modern life insurance policies and the myriad potential transactions that can take place regarding policies held in the trust, it seems desirable to this practitioner to include very broad trustee powers
 - b. And in view of the litigious world we live in, it also seems desirable to impose a duty on the trustee(s) to review trust-owned policies periodically so as to be sure they are performing adequately and still meeting their intended purpose

SEE Trusts & Estates Article

- c. Certain outdated powers -- or, more accurately, restrictions on powers -- can well be counter-productive
 - For example, a provision requiring the trustee to apply dividends on Whole Life policies to the payment of premiums effectively prevents the trustee from having those dividends used more productively to purchase paid-up additions, which paid-up additions could either
 - Result in an ever-increasing death benefit under the policy or
 - Accelerate the time when dividend values can be the source of future premium payments (erroneously known as “vanishing premiums”)
2. While not a practicing attorney, this practitioner will provide, upon request, some suggested broad language dealing with trustee powers over life insurance to consider including in trusts that hold or may hold life insurance policies

F. Other Important Matters

1. Generation-Skipping Provisions and Problems

- a. Since many trusts have at least the potential of a generation-skipping transfer somewhere down the line, it appears highly desirable to include appropriate generation-skipping provisions in the trust
 - This can assure that, for generation-skipping tax purposes, there will only be sub-trusts with inclusion ratios of zero (“exempt”) or one (“non-exempt”), and nothing in-between
- b. And depending on the nature of the trust, it may be appropriate to elect to apply part or all of generation-skipping tax exemptions to transfers to the trust
- c. An interesting question arises when Crummey withdrawal powers are given to grandchildren, for example, in a “pot” trust
 - i. While this will qualify transfers to the trust for available gift tax annual exclusions as gifts of present interests to the grandchildren, what about the generation-skipping tax annual exclusion, which requires that the transfer be a direct skip (i.e., no intervening generation has an interest)?
 - ii. The key seems to be whether a grandchild’s interest will be deemed to be under the dispositive provisions of the trust (clearly not a direct skip) or under the withdrawal right itself (which this practitioner believes could be effectively argued to be a direct skip)

- If the latter argument holds up, this practitioner also suggests that a hanging power be used to avoid problems with the 5 x 5 rule rather than a non-general power of appointment; at least this gives the power holder some ongoing rights to acquire some of the trust property
2. Powers of the Trustee to Deal with the Estates (or Living Trusts) of the Grantors
 - a. Almost all clients who create irrevocable trusts will have a revocable living trust (or trusts) with a pour-over will as their basic estate planning instruments
 - Yet the trustee's powers that enable the trustee of the irrevocable trust to provide tax-free liquidity to the grantor's estate by lending money or purchasing assets are too often limited to dealing with the personal representative of the grantor's estate, namely, the executor
 - b. It is highly recommended that these powers be as broad as possible
 - i. They should authorize the trustee to deal not only with the personal representative of the grantor's estate but also with the trustee of any other trust created by the grantor
 - ii. And they should make it clear that this power can be exercised even if the trustee is one and the same as the personal representative of the estate or the trustee of the other trusts, as that is the most typical arrangement
 - This should negate any possible allegation of self-dealing by the trustee
- G. Life Insurance Policies with Long-Term Care Riders Owned by ILITs
1. Payments for long-term care are essentially a tax-free advance on the policy's death benefit, possibly consuming the entire death benefit; some policies even offer a second rider that can double the long-term care benefits but do not increase the death benefit
 - The primary appeal of the "rider-on-a-life-policy" approach to long-term care coverage rather than a stand-alone long-term care policy is that someone will always get paid at least the face amount of the life policy; in other words, there is no chance that the premiums for long-term care coverage will have been paid with no benefits ever received
 2. As with stand-alone long-term care policies, these riders can be either "reimbursement" (the most typical) or "indemnity" (at least one carrier)

- a. Reimbursement riders reimburse the policy owner for long-term care expenses actually incurred by the owner based on submitted bills; this means that the owner must have at least an assumed obligation to pay the insured's long-term care expenses
 - i. This makes it difficult to have a true third-party, such as an irrevocable trust, be the policy owner in an attempt to keep the policy's death benefit proceeds out of the insured grantor's estate for estate tax purposes
 - ii. However, since husbands and wives typically can and do pay each other's long-term care expenses, the best solution this practitioner has devised is to have a husband and wife each be the Owner (as separate property) and Primary Beneficiary of a life policy with a long-term care rider on the other's life, naming the Bypass Trust under their Wills or Living Trust as Successor Owner and Contingent Beneficiary; then, at the death of the first spouse to die:
 - (a) The death proceeds under the deceased spouse's policy will be received by the surviving spouse estate tax-free and may or may not be consumed during the survivor's lifetime (in other words, at least estate tax deferral will have been achieved), and
 - (b) The policy on the surviving spouse's life will pass into the Bypass Trust, which can pay the long-term care expenses of the surviving spouse as the trust's beneficiary; then, at the surviving spouse's death, the death proceeds of this policy will be received completely estate tax-free
- b. Indemnity riders, on the other hand (the same as stand-alone indemnity policies), pay the stated benefit to the policy owner upon receipt of proof that the insured needs long-term care; in other words, it can be paid to an owner that is not responsible for paying the insured's long-term care expenses, making it possible for an irrevocable trust or other third party to be the owner, thereby making the policy's proceeds estate tax-free
 - Query, however, whether there is an advantage to even having these long-term care benefits, since the indemnity payments will go to the same person or trust that will later receive the death proceeds (and cannot be used to reimburse the insured for the care expenses incurred); this practitioner believes there is, because the rider is quite inexpensive and provides the opportunity to have benefits paid from the policy before the insured's death and, if the trust is drawn with this in mind, to have benefits distributed to the trust beneficiaries during the insured's lifetime rather than only at the insured's death

- c. The Beneficiary Defective Inheritor's Trust (BDIT), as presented in many venues by Richard Oshins of Las Vegas, presents an interesting alternative
 - Since this type of Trust will not have been created by the insured, it can provide benefits to the insured beneficiary, without causing estate tax includibility, that the beneficiary could not provide for him or herself; there appears to be no reason, therefore, why the Trust could not own a life policy with a LTC Rider on the beneficiary's life, have the Trust pay the insured beneficiary's LTC expenses, then collect the LTC benefits under the policy and distribute them to the insured beneficiary, and that this would work with either a reimbursement rider or an indemnity rider

Concluding Comments

Everyone should do at least some basic estate planning, but many people feel it is too complicated. Perhaps by breaking it down into its component parts - the **A-B-C-Ds** - you will be able to help your clients focus on what's most important to them at their stage of life, and perhaps even get them to move on to the **E** of estate planning: **Enjoying life!**

For those clients who have accumulated considerable wealth, it becomes necessary to employ more sophisticated estate planning techniques. It is hoped that the material presented today on ILITs will help you help your clients in this regard and, at the same time, create opportunities for you to sharpen your skills and enhance your practices

Final thought: Most people do not "like" life insurance ... they only like the many things that life insurance can accomplish

Thank you for your attention!

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Education:

Bachelor of Science in Economics from Yale University; Bachelor of Laws from Columbia University Law School.

Business History:

Bob practiced law in New York City for nine years, specializing in estate, trust, and corporate work. He joined New York Life in 1964 and transferred to San Francisco in 1966. As Senior Advanced Underwriting Consultant for New York Life, he was a leader in all phases of the Company's Advanced Underwriting program and authored numerous Bulletins. He retired early from New York Life and, from 1986 through 1989, was Vice President of Management Compensation Group/SF, specializing in the design and funding of supplemental executive benefit programs for major corporations. He re-affiliated with New York Life in 1990 and later became a principal of The Silver Group, which joined Provada Insurance Services in 2006.

Speaking Engagements and Published Articles:

Faculty member at CLU Symposium and nine CLU Institutes; repeat speaker at meetings of both the Association for Advanced Life Underwriting and the Million Dollar Round Table; speaker at Nevada Estate Planning Conferences and Federal Tax Institute; faculty member at seminars sponsored by the Community Property Journal, Farnsworth Publishing Company, and California CPA Foundation for Education and Research; lectured on Deferred Compensation at the Twelfth Annual Federal Estate Planning Symposium in Kansas City, co-sponsored by UMKC Law School; faculty member at the Practising Law Institute's 37th Annual Estate Planning Institute in San Francisco; frequent speaker at meetings of Estate Planning and Planned Giving Councils, Chapters of the Society of Financial Service Professionals and the National Association of Insurance and Financial Advisors, and other industry groups, mainly on Estate Planning, Planned Philanthropy, Deferred Compensation, and Life and Long-Term Care Insurance.

Article on using Philanthropy in Estate Planning was published in the July 1996 issue of the *Daily Journal*; article in the July 1997 issue of *Trusts & Estates* magazine co-authored with Alan Silver won their EPIC Award as "Best Article" of the year; article on Life Settlements was published in the August 2004 issue of *California Broker*.

Professional Affiliations:

San Francisco Estate Planning Council (Former President)
East Bay Estate Planning Council (Former Director; Past Chairperson, Technical Update Committee)
Marin County Estate Planning Council
National Association of Estate Planners & Councils (Speakers' Bureau, Immediate Past Board Member)
State Bars of New York and California (Inactive Status)
Association for Advanced Life Underwriting
San Francisco Chapter, Society of Financial Service Professionals (Former President)
Local, State, and National Associations of Insurance and Financial Advisors (NAIFA)

Community Activities:

Former Member and Chairperson, Mill Valley Planning Commission
Former City Councilmember and two-term Mayor of Mill Valley
Former Member, Marin County Transit District and Marin County Transit Commission (former Chairperson)
Current Long-Time Member and Chairperson, Marin County Flood Control District Zone 3 Advisory Board
Current Member, Citizens Oversight Committee of the Transportation Authority of Marin