

Life Without Crummey As We Know It? What To Do if Crummey Powers Are Restricted

There's nothing crummy about Crummey powers, also known as Crummey withdrawal rights. Commonly associated with irrevocable life insurance trusts (ILITs), Crummey powers essentially convert a gift of a future interest -- such as gifts to a trust -- that your beneficiary won't be able to enjoy until a later date to a gift of present interest that your beneficiary can enjoy immediately. Because the latter qualifies for the \$10,000 annual gift tax exclusion, while the former doesn't, Crummey powers essentially create a gift tax loophole.

The IRS does not take kindly to loopholes, and it has tried -- and likely will keep trying -- to restrict or eliminate Crummy powers. If you are the grantor (creator) of an ILIT or other trust with a Crummey provision, or if you plan to establish one, be prepared for the likelihood that the IRS will curtail Crummey powers. Let's take a closer look at why the IRS would like to do away with Crummey powers and what alternatives are available.

Play by the Rules

To understand how Crummey powers work and why the IRS dislikes them, you have to understand the rules covering gift tax exclusions. You know that giving outright up to \$10,000 in cash or assets per year is excluded from your gift tax liability -- as long as the gift is of a present interest.

But your gift is of a future interest if you give cash or assets to a conventional irrevocable trust with the same recipient as beneficiary, and the trust must hold the assets until a specified future date. In this case, the transfer of cash or assets to the trust does not qualify for the annual gift tax exclusion.

Court Ruling on Crummey

In *Crummey vs. Commissioner*, the court ruled in 1968 that if a beneficiary of an irrevocable trust is given the right to withdraw your gift to the trust, then the gift constitutes a present interest. After the ruling, estate planners began adding Crummey provisions to trust documents. These provisions offer the beneficiaries the right to withdraw the contribution made to the trust (up to \$10,000 for each beneficiary) within a specified time from the date of the gift -- usually 30 to 60 days.

Of course, you expect that your beneficiaries will not exercise the right to withdraw the gift. Doing so defeats your main objective in setting up the irrevocable trust -- for example, to hold life insurance outside your estate and use contributions to pay insurance premiums or to hold and manage assets for the beneficiaries. That's why in the IRS's eyes, you create the withdrawal right only to dodge the gift tax. Having failed in court to restrict Crummey powers, the IRS will likely try to persuade Congress to change the law.

Allow Room for Modifications and Revocations

Because the Crummey loophole may likely constrict if not close, disqualifying your future trust contributions for the annual gift tax exclusion, add to your trust documents language that allows

modifications or revocations for that contingency. If your irrevocable trust doesn't contain such language, your exit strategy will depend on your state's laws. (Some states, such as California, allow beneficiaries to modify the trust by agreement.)

What kind of language should you consider? Estate planners recently began using a provision allowing a trust committee of selected persons to decide independently to modify or revoke an otherwise irrevocable trust if Congress repeals or restricts Crummey powers. The legality of such a provision rests on the premise that such a trust was created for estate tax purposes, and those purposes are no longer being served owing to a change in the law.

Consider the Alternatives

Also consider exploring alternative ways to keep life insurance outside your estate, including family limited partnerships (FLPs) and limited liability companies (LLCs). FLPs and LLCs are effective tools for sheltering life insurance proceeds from estate tax. They are more flexible and give you greater control over the policy than ILITs. You can also combine a FLP with an ILIT. An advantage of both FLPs and LLCs is that they provide greater protection of assets from creditors.

The simplest way to keep your life insurance proceeds out of your estate is to let your beneficiary or other heir own it -- the do-it-yourself method. The downside of this method is you lose the tax and other advantages of more complex instruments such as FLPs and LLCs.

Be Prepared

Predicting when and how Crummey powers may be restricted is difficult, but make certain to consider your estate planning options in case the law changes. Smart estate planners are now developing trust documents that allow for modifications and revocations.