# DRAFTING SUGGESTIONS FOR IRREVOCABLE LIFE INSURANCE TRUSTS*

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## I. INTRODUCTION

This article presents practical and legal analyses of many provisions commonly used in irrevocable life insurance trusts, focusing on the consequences of dispositive provisions.[1] This article discusses income, estate, gift, and generation skipping transfer tax planning, as well as asset protection concerns, principally in the context of a trust holding insurance covering the life of an individual married person.

To set the context and facilitate the discussion, one must assume certain basic planning facts. First, assume the client is married and insurable.[2] Second, the decision to use a trust, as opposed to having individuals in the next generation, a partnership, or other entity hold the insurance, has been made and is not being reviewed. Third, the relationship between the insured and his or her spouse is not a matter of current concern, although no one can foretell the future. Fourth, the insurance is to cover the life of one individual. Fifth, although the surviving spouse will likely be the beneficiary of a significant testamentary marital deduction trust as well, it is desirable to allow the him or her to benefit from the life insurance proceeds. Sixth, one of the client's objectives is to prevent the imposition of income, estate, gift, and generation-skipping transfer taxation of the

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[1]A selective sampling of the excellent recent literature on this topic includes Jonathan G. Blattmachr & Georgiana J. Slade, *Life Insurance Trusts: How to Avoid Estate and GST Taxes*, 22 EST. PLAN. 259 (1995); Jon J. Gallo, *The Uses of Life Insurance In Estate Planning A Guide to Planning and Drafting - Part I*, 33 REAL PROP. PROB. & TR. J. 685 (1998); Jon J. Gallo, *The Uses of Life Insurance In Estate Planning: A Guide to Planning and Drafting - Part II*, 34 REAL PROP. PROB. & TR. J. 55 (1999); HOWARD M. ZARITSKY & STEPHAN R. LEIMBERG, TAX PLANNING WITH LIFE INSURANCE (2d ed. 1998) [hereinafter TPLI]; *see also* Christopher P. Cline, *Irrevocable Life Insurance Trusts: You Mean I Still Haven't Learned All the Rules and Now They Want to Change Them?*, 23 TAX MGM'T ESTATE, GIFTS & TRUST J. 245 (1998); Charles E. Early, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status*, 62 J. TAX'N 198 (April 1985).

[2]Insurability is important because trust provisions designed to avoid incidents of ownership might not otherwise be necessary. I.R.C. § 2042.

insurance death benefits.[3] Finally, another client objective is to prevent creditors from having access to the beneficiaries' death benefits, even though neither the beneficiaries nor the insured-settlor[4] has any current creditors out of the ordinary.[5]

In this context, the discussion is divided into the following analytical parts: (1) provisions effective prior to the trust division date, (2) provisions concerning the trust division date, and (3) provisions effective after the trust division date.

## II. PROVISIONS EFFECTIVE PRIOR TO THE TRUST DIVISION DATE

There are three principal types of provisions generally included in life insurance trusts and effective prior to the trust division date: (1) withdrawal powers, which are the most complicated,[6] (2) grantor trust provisions,[7] and (3) provisions that concern the distribution and application of income and principal prior to the trust division date.

### A. *Withdrawal Powers*

Withdrawal powers (also called "*Crummey* powers") are used to make gifts to the trust eligible for the annual exclusion from gift tax.[8] Such withdrawal powers are general powers of appointment for gift tax purposes.[9]

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[3]Current law reduces the estate tax by a combination of tax rate decreases and tax credit increases over the next eight years (2002-2009) and eliminates the tax in the year 2010. *See generally* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 501, 511, 521, 115 Stat. 38, 69-70, 150. However, the sunset provision in this Act nullifies those provisions in year 2011 and thereafter. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 41. At the time of this writing, it seems likely that the estate tax will be continued in some form, even after the phase-in period ending in 2009, and the author relies on this assumption in the remainder of this article.

[4]The term "settlor" refers to the person who has created the trust and who has transferred his or her property to the trust, as distinguished from the term "grantor," which refers to the person who is deemed to own the trust under section 671. A similar distinction was recognized in the recent amendments to the Regulations under section 671. *See* Reg § 1.671-2(e)(1)-2(e), Ex. (4); T.D. 8831, 1999-34 I.R.B. 303; T.D. 8890, 2000-30 I.R.B. 122.

[5]A discussion of the law regarding fraudulent transfers is beyond the scope of this article. *See generally* PETER SPERO, ASSET PROTECTION: LEGAL PLANNING & STRATEGIES ¶¶ 3.01-3.11 (2001).

[6]Indeed, there are articles that do little but describe in detail the complexity of withdrawal powers. One of the better recent analyses is Marc A. Chorney, *Transfer Tax Issues Raised by Crummey Powers*, 33 REAL PROP. PROB. & TR. J. 755 (1999)*; see also* Scott H. Malin, *Crummey Withdrawal Rights: Watch Your Step*, 10 PROB. & PROP. 52 (1996).

[7]Because of the interplay between the grantor trust provisions and the withdrawal power provisions, and since both are so common in life insurance trusts, grantor trust status is discussed in conjunction with the discussion of withdrawal powers below.

[8]Section 2503(b) excludes from annual taxable gifts the first $10,000 of such "gifts (other than gifts of future interests in property)" and is referred to as the present interest requirement for annual exclusion gifts. Generally, gifts to trusts do not qualify as gifts "other than gifts of future interests in property." To make gifts to trusts so qualify, trusts provide that beneficiaries may immediately withdraw additions to the trust, making the additions present interests for gifts tax purposes. *See generally* Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968) [hereinafter *Crummey*], *accepted in principle* in Rev. Rul. 1973-405, 1973-2 C.B. 321; *see also* Rev. Rul. 1985-88, 1985 C.B. 201; Bradley E. S. Fogel, *Billion Dollar Babies: Annual Exclusion Gifts to Minors*, 12 Prob. & Prop., No. 5 (Sept./Oct. 1998); 6.

[9]I.R.C. § 2514.

Oftentimes, power holders fail to exercise these powers since there are significant advantages to having the property remain in trust[10] and it is often clear that the settlor would prefer to have the funds administered inside the trust. After all, that is why the settlor created the trust in the first place.

But, is a withdrawal power given to the beneficiary inconsistent with the client's creditor protection goals with respect to the beneficiary's creditors? The question arises whether the trust will become "self-settled" when the beneficiary allows the power of withdrawal to lapse. If so, then the spendthrift provision may well not be effective.[11]

There are a number of answers to the question of inconsistency, but no case has held that a trust becomes self-settled because of the lapse of a withdrawal power.[12] The first and simplest approach is to locate the trust in a situs where spendthrift provisions are, by state law, applicable to self-settled trusts, such as in Alaska,[13] Delaware,[14] or Nevada.[15] Although some scholars have questioned whether locating the trust where the spendthrift provisions are is effective for beneficiaries who do not reside in those states,[16] their conclusion is currently the

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[10]Such advantages include protections from creditors and from further taxation. *See generally* Spero, *supra* note 5, at ¶¶ 3.01-3.11.

[11]One state has decided to overrule that result by statute under limited circumstances. *See* TEX. PROP. CODE ANN § 112.035(e): "A beneficiary of the trust may not be considered a settlor merely because of a lapse, waiver, or release of the beneficiary's right to withdraw a part of the trust property if the value of the property that could have been withdrawn by exercising the right of withdrawal in any calendar year does not exceed at the time of the lapse, waiver or release the greater of the amount specified in (1) [s]ection 2041(b)(2) or 2514(e), Internal Revenue Code of 1986, or (2) [s]ection 2503(b), Internal Revenue Code of 1986."

[12]The following cases are sometimes cited in support of the idea that such a trust created by one settlor becomes self-settled as to a beneficiary on lapse of the beneficiary's withdrawal power. First, In re Shurley, 115 F.3d 333 (5th Cir. 1997) [hereinafter *Shurley*]. *Shurley* involved actual transfers, not transfers by lapse of a withdrawal power, by daughters together with their parents to a single trust: "The trust agreement states that the property contributed by the parents 'represents 2/3 of the total value of all of said real property to be contributed and that the value of that portion of said real property to be contributed by [the two daughters] each represents 1/6 of the total value of all of said real property to be contributed'" (bracketed material as in original). *Id.* at 336; *see also* Bass v. Denney, 171 F.3d 1016, 1029 (5th Cir. 1999) ("In *Shurley*, we partially reversed the bankruptcy court to the extent it had declared portions of a spendthrift trust funded by the parents of the debtor to be property of his Chapter 7 estate" (citation omitted). Second, In Re Doris L. Morris, 151 B.R. 900 (C.D. Ill. 1993) (involving a trust established by a bank in settlement of a foreclosure action into a trust containing spendthrift provisions for the benefit of the suing party). Third, Hartsfield v. Lescher, 721 F.Supp. 1052 (E.D. Ark. 1989) (holding spendthrift provision ineffective during period of trust extension where trust under a will provided for termination and distribution unless the beneficiary chose to extend trust). None of these cases dealt with the circumstances arising from a purely passive failure of a beneficiary to exercise a general power of appointment that then lapsed.

[13]ALASKA STAT. § 34.40.110 (Michie 2000).

[14]DEL. CODE ANN. tit. 12 §§ 3571, 3572 (2000).

[15]NEV. REV. STAT. § 166.040 (Michie 1999).

[16]*See* Spero, *supra* note 5, at ¶ 6.08[5][a]; *see also* Peter Spero, *Using Life Insurance and Annuities for Assets Protection*, 28 EST. PLAN. 12, at n.22 and accompanying text (January 2001) ("[I]n addition, the problem can be avoided with respect to a Delaware- or Alaska-type trust (which is permitted to be a self-settled asset protection trust), at least with regard to a beneficiary who resides in one of those states.").

subject of dispute.[17]

On one hand, where a donee of a general power of appointment created by someone else fails to exercise that power, in most jurisdictions the donee's creditors cannot acquire the power, compel its exercise, or reach the property subject to the power, except to the extent otherwise provided by statute.[18] On the other hand, when the creator of a trust confers a general power of appointment on himself or herself, his or her creditors can reach the property in the trust even though the power is otherwise unexercised.[19] When a trust beneficiary permits a general power of appointment to lapse, that beneficiary is the "donee of the power" rather than the "creator of the trust" under the above rule. If instead the beneficiary were the "creator of the trust," then we would only have one rule: whenever a trust beneficiary permits a general power of appointment to lapse, property subject to the power is available to his or her creditors thereafter whether or not the beneficiary was the creator of the power. Therefore, courts in states recognizing that the donee of a general power who does not exercise that power may not be compelled to exercise the power for the benefit of his or her creditors should not conclude that a trust granting the beneficiary a withdrawal power is self-settled.[20] Thus, withdrawal powers can continue to be used to qualify for the annual exclusion from gift tax.

A second approach for dealing with the question of whether a withdrawal power given to a beneficiary is inconsistent with the client's protection goals with respect to the beneficiary is to use an intentionally unqualified disclaimer of the power.[21] Since the powerholder will probably retain an interest described in section 2518(b)(4)(B) and Regulation section 25.2518-2(e)(1)(ii), a non-quali-

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[17] *See*, *e.g*., Richard W. Nenno, *Delaware Law Offers Asset Protection and Estate Planning Benefits*, 26 EST. PLAN. 3 (January, 1999); David D. Shaftel, *Newest Developments in Alaska Law encourage Use of Alaska Trusts*, 26 EST. PLAN. 51 (1998); Jonathan G. Blattmachr & Howard M. Zaritsky, *North to Alaska—Estate Planning Under the New Alaska Trust Act*, 32 U. MIAMI INST. ON EST. PLAN., session 2.B.1-112 (1998); *see generally* Hanson v. Denckla, 357 U.S. 235, 256 (1958).

[18] AUSTIN SCOTT & WILLIAM FRETCHER, THE LAW OF TRUSTS, § 147.3 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS]. States that have changed this rule by statute include Alabama, California, Michigan, Minnesota, North Dakota, Oklahoma, South Dakota, Tennessee and Wisconsin as well as the District of Columbia. *Id.* at n.5. For the New York rule, see N.Y. EST. POW. & TRUST. LAW §§ 10-7.2-7.4 (McKinnley 1992).

[19] See SCOTT ON TRUSTS, *supra* note 19.

[20] *See id.* at n.3 (digesting Colorado, Illinois, Indiana and New Hampshire cases)*; see also Wood Trust*, 63 District and County 2d 737, 24 Fiduciary Reporter 16 (Montgomery County, Pa., 1973) (reciting the Pennsylvania rule).

[21] *See* Spero, *supra* note 16. It is important that the power be both effective under applicable state law and also not qualified for gift tax purposes, under section 2518. If the disclaimer is qualified for purposes of section 2518, the power holder may be treated as if he or she never had power for gift tax purposes, which results in no annual exclusion because qualified disclaimers relate back under section 2518(a), while unqualified disclaimers do not relate back. Therefore, the consequence of using a nonqualified disclaimer for gift tax purposes is that the donee of the power had the present interest for purposes of section 2503(b) but transferred that interest in a transfer effective under state law. In order to avoid gift tax on the lapse, that transfer can be made incomplete under the gift tax laws. *See infra* note 23 and accompanying text.

fied disclaimer should not be difficult to craft under the circumstances.[22] Moreover, if the beneficiary has a power of appointment, either *inter vivos* or testamentary, then the gift on lapse by the powerholder should be incomplete.[23]

The Service has attacked the failure to exercise withdrawal powers as reflective of a prior agreement between the beneficiary holding the withdrawal power and the settlor. However, following on the heels of three consistent Tax Court defeats,[24] the Service now seems to have abandoned that argument, at least in the absence of circumstances indicating that the "withdrawal rights in substance are not what they appear to be."[25]

1. *Types of Withdrawal Powers*

There are three basic versions of withdrawal powers: (1) five and five powers, (2) *Crummey* powers with retained control, and (3) hanging powers. The choice of which power to use impacts the structure of the trust and creates different advantages.

a. *The Five and Five Power.* A "five and five" power is a power to withdraw, limited to the amounts permitted as an exclusion from the lapse of a power of appointment under section 2514(e)(1) and (2). A "five and five" power is the simplest power to use and covers the smallest amount of gifts. Thus, from the client's perspective, using this power is dangerous if there is any likelihood that gifts to the trust will increase beyond the amounts covered by section 2514(e). The "five and five" power lapses at the end of the withdrawal period, and that lapse is excluded from taxable lapses or releases for gift and estate tax purposes under sections 2514(e) and 2041(b)(2).

Because section 2514(e) refers to the "greater" of $5,000 or 5% of the principal out of which the power might be satisfied, the maximum amount will be $5,000 unless the client puts more than $100,000 into the trust. Such a trust is sometimes referred to as a "funded" trust.[26] The basic approach with a "funded trust" is that the income on the trust principal and the subsequent contributions will be used to pay the premiums on the policy.[27]

A funded trust may also permit the full annual exclusion gift to be covered by an annual "five and five" power. Consider the settlor who puts $440,000 into such a trust. He could then use *Crummey* powers to make gifts of $22,000

[22]To facilitate disclaimers by minor beneficiaries, the law trust could make their powers exercisable by a special guardian named under the trust instrument and give the special guardian the power to disclaim and the power to exercise or lapse the withdrawal power.

[23]*See* Reg. § 25.2511-2(b).

[24]Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 4; Estate of Holland v. Commissioner, 73 T.C.M. (CCH) 3236, 1997 T.C.M. (RIA) ¶ 97,302; Kohlsaat v. Commissioner, T.C.M. (CCH) 2732, 1997 T.C.M. (RIA) ¶ 97,212.

[25]*See* A.O.D. 1992-001 (June 30, 1992) *acq. in result only*, A.O.D. 1992-009 (Mar. 23, 1992), *acq. in result only; see also* A.O.D. 1996-010 (July 15, 1996) (stating that the Service will continue to deny where "withdrawal rights in substance are not what they appear to be in form").

[26]*See* Cline, *supra* note 1.

[27]There is no certainty that the indicated result will be achieved, since the amount of the premiums necessary to sustain the policy indefinitely cannot be determined ahead of time.

($440,000 times 5%) annually to each donee, and each donee would have the right to withdraw the full $22,000, and that amount could lapse at the end of a short, specified period, for instance 30 days, without the consequences attendant to a hanging power.[28]

The "five and five" amount is not indexed for inflation and is personal to each donee,[29] meaning a donee has only one such exclusion, unlike the gift tax annual exclusion, which can be multiplied by the number of donors. However, if we assume the trust will grow over time, then the 5% amount will also grow over time, thereby increasing the amount by which this power may lapse if the trust is funded with amounts in excess of $100,000. In turn, applying the 5% limitation to the larger trust principal will have the effect of mimicking the inflation adjustment applied to annual exclusions, thereby providing some limited amount of inflation protection. For example, on a trust funded with $440,000 that increases by 10% at the end of the first year, the withdrawal powers could lapse by $24,200, correlating to a 10% inflation adjustment for the annual exclusion. Thus, the withdrawal power's size due to the growth of trust assets could parallel or even surpass the inflation adjustment applied to the annual exclusion from gift tax.

"Five and five" powers are useful in many "unfunded" irrevocable life insurance trusts involving spouses. For example, spouses often make gifts to each other through trusts where the donee spouse is a beneficiary. This makes sense as long as the duration of the power is limited to the 60-day period permitted under the exclusion of such powers set forth in Regulation section 26.2632-1(c)(2)(ii)(B) with respect to estate tax inclusion periods under the generation skipping transfer tax, where the settlor intends to allocate a generation skipping transfer tax exemption to transfers to the trust. Effectively, the exclusion permits $5,000 of additional gifts to be made annually. Over a 42-year period and at 4% after tax annually, the additional gifts of $215,000 become $550,062.[30]

In an irrevocable life insurance trust, neither the spouse's other interests in the trust (if appropriately circumscribed) nor gift splitting will adversely affect the above planning.[31] If the spouse's withdrawal power is limited to the "five and five" amounts, then the withdrawal power will be disregarded for purposes of a retained interest analysis.[32] Further, gift splitting only applies for gift and generation skipping transfer tax purposes, not for estate tax purposes.[33] Therefore, the "five and five" withdrawal powers for spouses should only be used if the client funds the trust with $440,000.

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[28]See discussion *infra* pp. 191-192.

[29]Rev. Rul. 1985-88, 1985-2 C.B. 201 (concluding that each donee is treated as a donor by reason of the lapse of the power).

[30]Calculation done with NumberCruncher version 2000.01 ("NumberCruncher") by Stephan R. Leimberg & Robert T. LeClair, Leimberg & LeClair, Inc., P. O. Box 601, Bryn Mawr, PA 19010, 610-527-5216.

[31]*See* TPLI, *supra* note 1, ¶ 5.03[h] at 5-31-32.

[32]*Id.* at 5-49, Ex. (5-13).

[33]*Id.* at 5-50.

b. *The Crummey Power with Retained Control.* The Code treats the holder of a withdrawal power as making a gift of the property subject to the power on its lapse.[34] The gift may be incomplete if the power holder retains the power to change beneficiaries or if the power holder has a power of appointment under a trust provision other than the withdrawal powers. For trusts with a single beneficiary, the Service has ruled that the lapse of the "*Crummey* withdrawal power" does not create a taxable gift when the"*sole beneficiary"*of the trust has a general power to appoint a corpus.[35] The same logic should be extended to a power holder who retains only a special power of appointment.[36]

However, single beneficiary trusts do not provide as much protection from creditors as do trusts with more than one beneficiary. Even when a trust is otherwise wholly discretionary, a creditor can argue that because the sole beneficiary is the only beneficiary, the trustee must make a distribution to that beneficiary at some time.[37] The trustee has discretion over the time and method of the payments, but the trustee does not have discretion to decide between payment and non-payment.[38] Therefore, to optimize creditor protection, a trust should always have more than one beneficiary.[39] Thus, a trust with only a single power holder beneficiary who retains a power to change the beneficiaries who receive the benefit of the lapse of the power conflicts with the client's objective of protecting the assets in the trust from the beneficiary's creditors. The gift on lapse is just as incomplete where there is more than a single beneficiary and each beneficiary retains a power to appoint and creates the additional problem of chaos among the power holders.

One use for single beneficiary trusts, and the corresponding retained withdrawal powers, arises when a number of single beneficiary trusts are to be created and the single beneficiaries will all become partners in a partnership that owns the insurance. Here, each trust owns a single asset (its interest in the partnership), and the charging order rules provide the desired creditor protections.[40] Combining the single beneficiary trusts with the generation skipping annual exclusion under section 2642(c) in cases where the gift tax annual exclu-

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[34] I.R.C. § 2514; P.L.R. 1998-04-047 (Jan. 23, 1998).

[35] P.L.R. 1985-17-052 (Jan. 23, 1985); P.L.R. 198-29-097 (Apr. 22, 1982); P.L.R. 1981-42-061 (Jul. 12, 1981).

[36] Howard M. Zaritsky, Tax Planning For Family Wealth Transfers ¶ 4.07[5][c], at 4-42, 4-43, and 4-44 (Warren Gorham & Lamont, 3d ed. 1997) [hereinafter TPWT].

[37] *But see* Lang v. Commonwealth, 528 A.2d 1335 (Pa. 1987) (holding that the trustee could "spray" income and principal to beneficiaries other than the disabled beneficiary). The *Lang* court went on to refuse the state access to the trust as a creditor of the disabled beneficiary.

[38] *See* In Re Nicholson's Estate, 50 A.2d 283, 285-86 (Pa. 1946); *see also* 2 Robert J. Weinberg, Pennsylvania Estate Planning & Drafting, § 22.8, at 22-25; Restatement (Second) Trusts, § 187 (1957); Spero, *supra* note 5, at ¶ 6.03[1] and [4].

[39] To minimize conflicts among beneficiaries, consider using a provision authorizing the trustee to favor any beneficiary intended to be favored. Such a provision is often useful regarding spouses or parents vis-à-vis their children as the alternate beneficiaries.

[40] *See* Spero, *supra* note 5, at ¶ 8.01[2]. In this discussion with reference to limited partnerships, similar rules and results would apply to limited liability companies, which could also be used in this approach. *See id.* at ¶ 8.01[4].

sion and the generation skipping transfer tax annual exclusion are being applied to different transfers is very effective.

c. *Hanging Powers*. Hanging powers are the most advantageous and the most complicated type of withdrawal power.[41] Hanging powers subject the full amount of the gift (up to annual exclusion amounts) to withdrawal by the power holder but lapse only as to the amount permitted under section 2514, in the "five and five" amounts. For amounts in excess of the "five and five" amounts, the power holder's withdrawal power continues after the lapse period expires, although the withdrawal power may be subject to other restrictions after that initial period. One common restriction during the post-lapse period is to have the power then be exercisable only with the consent of a non-adverse party, such as an independent trustee or some other third party.[42] Each year the cumulative amount of the withdrawal powers continues to lapse, with the hope that with the 5% lapse becoming applicable as the trust grows, the power will eventually lapse altogether without a taxable gift at all. This most resembles the transfer tax treatment of annual exclusion gifts without regard to the lapse of withdrawal powers under section 2514, as they are excluded from taxable gifts.

Comparing a typical "five and five" power to a hanging power demonstrates their differences outside the context of the trust funded with more than $100,000. Typically the husband and wife make annual exclusion gifts to a child. For example, the husband and wife could give $20,000 annually in the year 2000 and this amount would be indexed for inflation. Assuming two 40-year-old spouses and one child, the gift tax annual exclusion would allow the spouses to give away $1,668,000 over their 42-year life expectancy (assuming only 3% inflation annually.)[43] However, if the gifts were only $5,000 annually, then only $640,507 could be given away under the same assumptions.[44] Further, assuming a 4% after-tax return, full annual exclusion gifts grow to $3.5 million, whereas the "five and five" gifts of $5,000 annually grow to only $1.1 million at the same rate and over the same period. In sum, "five and five" powers (not using a funded trust approach) forfeit over two-thirds of the available exclusions after growth, and each heir loses about $2.5 million out of $3.5 million under the above assumptions, leading to the question of whether the relative simplicity of "five and five" withdrawal powers justify their use.

Hanging powers can be transformed into "five and five" powers by funding only the amount within the "five and five" limitations. Further, a power to amend the withdrawal power provisions could still be given to the independent trustee to provide flexibility in case unforeseeable events occur.

[41] *See* Chorney, *supra* note 6.

[42] *See* Reg. § 25.2514-3(b), *see also* Jonathan G. Blattmachr & Georgiana J. Slade, *supra* note 1, at 259, n.12.

[43] Calculation done with NumberCruncher version 2000.01 ("NumberCruncher") by Stephan R. Leimberg & Robert T. LeClair, Leimberg & LeClair, Inc., P. O. Box 601, Bryn Mawr, PA 19010, 610-527-5216.

[44] *See* Appendix 2, table entitled "Crummey Powers Analysis."

### 2. *Drafting Suggestions*

When drafting a trust, the settlor should have a withdrawal power capable of covering as large an amount as possible under the annual exclusion from gift tax, and this goal can usually be achieved with hanging powers. Hanging powers are important to a drafter because they mean the trust's limitations will not effectively forbid larger gifts at a later time, even if larger gifts are not required at the time the trust is drafted.

Because different types of withdrawal powers entail different complexities, trusts should be drafted to permit the most comprehensive powers. This allows the determination of which power to use to be reserved for annual decision-making, rather than being dictated by drafting at the time the trust was created. Other drafting approaches that preserve annual decision making power include: (1) enabling a notice or deed of gift to accompany subsequent additions and alter the withdrawal powers as applied to such gifts,[45] or (2) allowing the trustees to amend the withdrawal power provisions at a later time.[46] Finally, a drafter should keep in mind that, for generation skipping transfer tax purposes, the lapse of a withdrawal power is a lapse of a general power of appointment and can have the effect of changing the transferor.[47]

### 3. *Income Tax Consequences of Withdrawal Powers*

The income of a trust is usually taxable either to the trust,[48] to the settlor,[49] or to the beneficiary.[50] A beneficiary who holds a power of withdrawal over trust principal is treated as the "owner" of that income[51] and is taxed as such for income tax purposes,[52] subject to the provisions of section 678(b). The income

[45]This is the approach favored by the law firm Wolf, Block, Schorr and Solis-Cohen based in Philadelphia, PA.

[46]Giving the independent trustee the power to amend the withdrawal power provisions on a prospective basis is the approach utilized by default in *Wealth Transfer Planning* (an estate planning software system) by Jonathan G. Blattmachr (The Technology Group, 2000). This approach and Wolf Block's approach are the simplest approaches, and, assuming simplicity is sufficient at the time the trust is drafted, allow flexibility in case more comprehensive and more complex powers become necessary in the future.

[47]Reg. § 26.2652-1(a)(5), Ex. (5). This can have desirable consequences. For example, a trust gives the settlor's children withdrawal powers which exceed "five and five" amounts. The trust further provides that when those powers lapse, the child's children will each have a withdrawal power over a pro rata portion of the sum lapsing in excess of' "five and five" limits. To the extent of the lapse in excess of "five and five" limits, the children become the transferors under the regulations. Therefore, the lapses (as transfers from the settlor's children) qualify for the gift tax annual exclusion. *See generally* Jonathan G. Blattmachr & Georgiana J. Slade, *supra* note 1, at n.12; Georgiana J. Slade, *Personal Life Insurance Trusts*, 807 TAX MGMT. PORTFOLIOS A-41 (1999).

[48]I.R.C. §§ 641-68.

[49]I.R.C. §§ 671-77, 678(b).

[50]I.R.C. § 678(a).

[51]I.R.C. § 678(a). Of course, there is no "five and five" exception under the income tax. *See, e.g.,* P.L.R 1990-34-004 (May 17, 1990).

[52]I.R.C. § 678(a); Rev. Rul. 1981-6, 1981-1 C.B. 385; Rev. Rul. 1967-241, 1967-2 C.B. 225; P.L.R. 1997-39-026 (Sept. 26, 1997); P.L.R. 1996-25-031 (June 21, 1996); P.L.R. 1995-41-029 (Oct. 13, 1995); P.L.R. 1994-48-018 (Dec. 2, 1994); P.L.R. 1992-26-037 (Mar. 27, 1992); P.L.R. 1990-34-004 (May 17, 1990); P.L.R. 1985-21-060 (Feb. 26, 1985).

tax consequences attendant to withdrawal powers generally apply to withdrawal powers used to make gifts eligible for the annual exclusion from gift tax.[53]

One difficulty in drafting irrevocable life insurance trusts is retaining enough flexibility in the trust so that the trustees can respond to unforeseeable circumstances. Structuring the trust as a grantor trust with respect to the settlor, meaning that for income tax purposes, the trust is treated as entirely owned by and income-taxed to the settlor, is one solution to this difficulty.

The substantive objectives of the clients often accomplish grantor status. First, assume it is desirable for the surviving spouse to benefit from the death benefits. Making the spouse a beneficiary will, during the spouse's lifetime, make the trust a grantor trust with respect to the settlor under section 677 (a) (1) and (2). But, the spouse can also be given access to the funds by being compensated for his or her services as a trustee. Thus, the extent of the desired access and the availability of other resources are important when choosing which options to provide for the surviving spouse.

The major advantages of being treated as a grantor trust owned by the settlor are thought to be: (1) adding to overall trust flexibility, (2) facilitating policy dealings, (3) allowing the income tax on trust income to be paid by the settlor as an additional non-taxable gift, and (4) escaping the compressed income tax rate structure applicable to trusts.[54]

If the trust is treated as a grantor trust with respect to the settlor, then transactions between the settlor and the trust are usually ignored for income tax purposes.[55] Structuring the trust as a grantor trust is not the only way to provide trust flexibility.[56]

When drafting a trust, the drafter can preserve flexibility in several ways. First, giving the trustees extensive discretionary powers provides significant flexibility. Avoiding mandatory payment provisions except as required by law[57]

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[53]*See, e.g.,* Rev. Rul. 1981-6, 1981-1 C.B. 385; Rev. Rul. 1967-241, 1967-2 C.B. 225; G.C.M. 33,451 (Mar. 7, 1967).

[54]Another objective grantor trust status serves as to the grantor is it qualifies the trust as a shareholder of an S corporation. This objective will be accomplished, however, by having either the grantor or the beneficiary treated as the owner of the entire trust so long as neither is treated as only a partial owner of the trust.

*See* I.R.C. § 1361(c)(2)(A)(i). However, eligibility as an S shareholder can be addressed separately in contingent trusts (either as a qualifying subchapter S trust or as an electing small business trust) under the trust document. This allows a trust that is a pot trust overall to take advantage of the advantages of separate shares and trusts with respect to S corporation shares without the disadvantages of a separate share trust overall. Such disadvantages include, among other things, the much smaller reductions of hanging power balances under the five percent rule, as to which see Part III of this article.

*Compare* Cline, *supra* note 1, at 246-51.

[55]Rev. Rul. 1985-13, 1985-1 C.B. 184.

[56]*See generally* W. Forsberg, *Special Powers of Appointment: The Key to Flexibility In Planning*, 27 EST. PLAN. 13 (2000); A. Klingan, *Adding Flexibility to Insurance Trusts Funded With Survivorship Life*, 26 EST. PLAN. 381 (1999).

[57]For example, in a contingent qualified terminable interest property trust designed to qualify for the marital deduction under section 2056(b)(7), all income must be payable to the surviving spouse, or the spouse must have the right to withdraw all income. Reg. §§ 20.2056(b)–7(d)(2).

provides additional flexibility. Often, the spouse can be given a limited power of appointment for "health, education, maintenance and support."[58] Such a power of appointment should be drafted to permit appointment in further trust and must be limited to prevent distributions discharging support obligations that the spouse, as power holder, may have.[59] Finally, the drafter could give a third party or an independent trustee a limited power to amend the trust.[60]

Grantor trust status is desirable because it allows getting the policy out of the trust and other policy dealings with a trust wholly owned by the insured. However, grantor trust status provides a very limited benefit in this regard because the policy goes to the trust, the policy does not come from the trust. If the policy does not come from the trust, then there will be an advantage under the transfer for value rules.[61] Grantor trust status with respect to the insured would be useful also because it allows the trust to be a recipient of a policy from another trust; however, this provides little certainty.[62] In short, grantor trust status[63] cannot be

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[58]I.R.C. § 2041(b)(1)(A). Indeed, Private Letter Ruling 1997-48-029 (Aug. 29, 1997) indicates that the spouse can be a beneficiary of a trust holding survivorship insurance even apart from such a power. *See* Kingan, *supra* note 25.

[59]Reg. § 20.2041-1(c)(1).

[60]Powers to amend the withdrawal provisions, for example, may be given to the independent trustee with respect to future gifts to the trust. Prudent limitations on a more general power to amend would include: (1) no retroactive effect, (2) no application to any contingent QTIP trust, (3) no application to any trust intended to qualify as a shareholder of an S corporation, (4) no application in favor of any beneficial interest to the grantor, nor in favor of any transferor to the trust, nor in favor of any insured under any policy held by the trust, and (5) no application so as to permit discharge of any support obligation of the settlor or of any trustee.

[61]I.R.C. § 101(a)(2)(B).

[62]See discussion *infra* note 63.

[63]Transfers of a policy for value are governed by section 101(a)(2), which provides that if a life insurance policy is transferred for "valuable consideration," then the death benefit in excess of transferor's basis is treated as ordinary income. Transfers to certain specified parties, such as the insured under the policy and to a partner of the insured under the policy, are excluded from the coverage of this section. I.R.C. § 101(a)(2)(B). In Swanson v. Commissioner, 33 T.C.M. (CCH) 296, T.C.M. (P-H) ¶ 74,061 (1974), the court held that a transfer of a life insurance policy to a trust that was wholly owned by the insured for federal income tax purposes under the grantor trust rules, sections 671-77, was a transfer "to the insured" under section 101(a)(2)(B). More broadly, the court held that all transfers of life insurance policies to all trusts treated as owned by the insured under the grantor trust rules are excluded from the transfer-for-value rules as such.

In Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975), the court affirmed the Tax Court's decision, but narrowed the holding by pointing out that the grantor trust was a revocable trust.

A broader source of authority today is Revenue Ruling 1985-13, 1985-1 C.B. 184, which was issued in response to Rothstein v. Commissioner, 735 F.2d 704 (2d Cir. 1984). The ruling holds that a grantor who is treated as the owner of a trust is treated as the owner of the trust's assets for federal income tax purposes and concludes "[S]ection 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner."

The Service rejects *Rothstein*'s holding "that a trust owned by the grantor must be regarded as a separate taxpayer." Thus, the Service is fundamentally unwilling to recognize any difference between the individual treated as the owner of the trust and the trust itself for income tax purposes. Consequently, a transfer of a policy to a grantor trust is a transfer "to the insured" for transfer-for-value purposes.

While the Service's position seems clear, the Service regards the determination of grantor trust status as "an area under extensive study" (*e.g.*, Revenue Procedure 1993-3, 1993-1 C.B. 370 at ¶ 5.16, and every year since) or an area involving factual determinations and consequently the Service

relied on to provide a significant benefit in this context.

Another reason for making the trust a grantor trust with respect to the settlor is to make non-taxable gifts by paying the income tax as a settlor obligation rather than out of trust assets. This benefit is entirely dependent on the settlor being treated as the owner of the trust assets, and its significance varies greatly.[64]

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will not rule on these matters. *See, e.g*., P.L.R. 1994-13-045 (Jan, 4, 1994). *But see, e.g*., P.L.R. 2000-11-054-8 (Mar. 17, 2000) (stating that "our examination reveals none of the circumstances that would cause the grantor to be treated as an owner under the provisions of subpart E"); P.L.R. 1985-45-076 (Aug. 14, 1985) (to the same effect).

Rulings in this area have so far relied on other exceptions than the "to the insured" exception discussed above. Also excluded from transfers-for-value are transfers""to a partner" of the insured (section 101(a)(2)(B)), and transfers when the transferee's basis carries over in whole or in part from the transferors. I.R.C. § 101(a)(2)(A). In a series of 1993 private letter rulings, the Service ruled that the'"to a partner" exception applied and therefore the transfer-for-value rules were inapplicable. P.L.R. 1993-28-010 (Apr. 16, 1993); P.L.R. 1993-28-012 (Apr. 16, 1993); P.L.R 1993-28-017 (Apr. 16, 1993); P.L.R 1993-28-019 (Apr. 16, 1993); P.L.R 1993-28-020 (Apr. 16, 1993). Similarly, in Revenue Ruling 1969-187, 1969-1 C.B. 45, and in Private Letter Ruling 1989-51-056 (Sept. 7, 1989), the Service ruled that a transfer was a part sale and part gift and resulted in a partial carryover of basis, thereby excluding the transfer from the transfer-for-value rules.

If there is a transfer of a policy relying on grantor trust status, whether or not a transfer of a policy was a transfer-for-value could cause significant amounts of insurance proceeds to be subjected to income taxation when those proceeds would otherwise have been exempt from income taxation.

[64]One should not rely on the power to use income to pay premiums, *see* § 677(a)(3), because of early decisions stating that the power to use income to pay premiums is not enough (despite seemingly contrary statutory language). *See* TPLI, *supra* note 1, at ¶ 5.03[13][b][i], 5-107, 5-108. But, the Service could argue that the statutory language as interpreted has been reenacted; therefore, the early determinations may be binding.

Drafters should not create a trust that is partly a grantor trust and partly not a grantor trust, nor partly a grantor trust with respect to the settlor and partly a grantor trust with respect to the beneficiary as power holder. The power to use income to pay premiums only gives certainty with respect to a portion of the trust equal to the portion of the income actually used to pay premiums into a grantor trust. Thus, one should use all trust income to pay premiums so that small amounts of income that are not used to pay premiums do not cause the trust to be partly a grantor trust and partly not a grantor trust.

A drafter may use the power to add beneficiaries other than after-born or after adopted children, for example, when the class of possible after-added beneficiaries is limited to spouses of beneficiaries or charities. I.R.C. § 674(d); *see generally* Madorin v. United States, 84 T.C. 667 (1985) (permissible to add charities). However, the settlor cannot retain such a power without section 2036 exposure. Such a power could be given to a non-adverse third party, but clients will probably only be comfortable giving this power to named individuals, causing the grantor trust status to become questionable if the grantor survives that person's death. The same mortality difficulty infects the power to accumulate income and principal for distribution to a grantor's spouse under section 677(a).

In Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), *acq*., 1977-1 C.B. 1, the court held that power to substitute assets of equivalent value under section 675(4)(C) is not an incident of ownership under section 2042. The Service has cited *Jordahl* for the proposition that such a power is not a reserved power. Nonetheless, *Jordahl*'s authority is questionable because it involved fiduciary powers and the Service raised the issues in an untimely fashion. Section 675(4)(C) speaks in terms of a power "exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity." Thus, a third party could probably hold such a power. Such an arrangement would mitigate any exposure to retained power arguments under section 2036. However, it is unclear how a third party could "reacquire" property that the third party never owned in the first place. Nonetheless, the Service has approved trusts using such powers in letter rulings. *See, e.g*., P.L.R. 1990-37-011 (June 14, 1990); P.L.R. 1990-26-036 (Mar. 28, 1990); P.L.R. 1990-11-052 (Mar. 16, 1990); P.L.R. 1989-36-063 (June 13, 1989).

If the trust holds only a life insurance policy, then the amount of the trust's taxable income will not reflect the policy's inside buildup.[65] Therefore, the trust's income may be small or even zero. Conversely, if the trust is going to engage in an installment purchase from the grantor, then grantor trust status with respect to the settlor will be of paramount importance because it shields the gains from recognition on the grantor's sale. Grantor trust status with respect to the settlor will also be important to flow through any further gains on any subsequent sale so that the settlor, rather than the trust or the beneficiary, pays the tax. While this can be a very significant advantage in trusts funded with assets other than life insurance, it is not usually significant in trusts funded only with life insurance. Indeed, one of the significant advantages of using life insurance as a funding vehicle in such trusts is the income-tax-deferred growth.

Escaping the compressed rate brackets applicable to trusts under section 1(e) is another advantage of grantor trusts. However, this benefit can be achieved by treating *any* individual as the owner of the trust; it is not required that the settlor be treated as the owner. For example, section 1(g), the kiddie tax, leads to nearly the same result as taxing the settlor when: (1) the beneficiary is taxed; (2) the beneficiary is a child of the grantor's; and (3) the beneficiary is under age 14 at the end of the taxable year.

In conclusion, treating the settlor as the owner of the trust under the grantor trust rules does have advantages, but these advantages are not overwhelming for a trust designed principally to hold life insurance.

### B. *Analysis and Interpretation of Section 678*

Should a beneficiary hold a withdrawal power, significant uncertainties attend the determination of income tax consequences if the trust would otherwise be treated as a grantor trust with respect to the settlor. This section attempts to shed some light on those uncertainties.

Until recent amendments to section 671, the two principal avenues to this uncertainty were the "withdrawn and recontributed" theory and section 678.[66] The withdrawn and recontributed theory states that, upon lapse of a withdrawal power, the beneficiary effectively removes the property subject to the beneficiary's withdrawal power and then recontributes the property to the trust. The theory treats the beneficiary as the grantor with respect to the property, subject to the

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A recent letter ruling held that a power to remove and replace the trustee did not cause estate tax inclusion under Revenue Ruling 1995-58, 1995-2 C.B. 191, but did cause the settlor to be treated as the owner under section 674(a) as a power effecting beneficial enjoyment. P.L.R. 2000-30-018 (July 31, 2000). This efficiently makes the trust a grantor trust with respect to the settlor without causing estate tax inclusion. *See* Estate of Vak, 973 F.2d 1409 (8th Cir. 1992); Estate of Wall v. Commissioner, 101 T.C. 300 (1993); Rev. Rul. 1995-58, 1995-2 C.B. 191. But see P.L.R. 2001-23-034 (June 11, 2001) (holding that estate tax inclusion is determined by reference to the character of the power of the trustee—a power limited by an ascertainable standard relating to health, educators, maintenance, and support—rather than by reference to the limitations of Revenue Ruling, 1995-58, 1995-2, C.B.191).

[65] I.R.C. § 72(e)(5).

[66] *See, e.g.*, Early, *supra* note 1; John B. Huffaker, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing their Current Status*, 62 J. TAX'N 198 (1985).

withdrawal power, and the beneficiary is taxed under sections 671 to 677 as applied to the beneficiary holding the withdrawal power. The withdrawn and recontributed theory, which all but reduced the provisions of section 678(b) to a dead letter, has been repudiated in recent amendments to the regulations under section 671.[67]

Next, we turn to section 678 as a source of confusion. While section 678(a) provides that the power holder is treated as the owner for income tax purposes, section 678(b) provides that a non-grantor power holder is not treated as the owner of the trust if the settlor is treated as the owner under the grantor trust rules.[68] However, section 678(b) only expressly applies "with respect to a power *over income*."[69] The current state of uncertain income tax treatment stems principally from the failure of section 678(b) to expressly cover powers "over principal," such as *Crummey* powers.

Some practitioners believe this failure is simply a "legislative error"[70] and that powers over principal, like *Crummey* withdrawal powers, only make a beneficiary the owner of the trust if the settlor is not otherwise treated as the owner under the grantor trust rules.[71] Indeed, Revenue Ruling 1981-6 speaks broadly to that effect.[72]

Other commentators, such as Howard Zaritsky, believe:

> [T]here is a good argument that the grantor and the beneficiary *share the ownership of the trust* when they each have a power over trust principal. Therefore, if the grantor's ownership of the capital gains and losses of an intentionally defective trust is important, no "*Crummey* powers" should be granted to beneficiaries, even if this means forfeiting the gift tax annual exclusion.[73]

Any arrangement where ownership is shared would be completely undesirable because it makes the transaction more complex, and because of its impact on any applicable S election and making income tax payments as tax-free gifts. An analysis of the relevant statutory provisions highlights this effect.[74]

Section 678(a) provides:

> A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

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[67]Reg. § 1.671-2(e) (1, 2 and 6, Ex. (4)); T.D. 8831, 64 F.R. 43667-01; T.D. 8890, 65 F.R. 4133-01.

[68]*See* Rev. Rul. 1981-6, 1981-1 C.B. 385 ("Section 678(b) provides that section 678(a) shall not apply if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of subpart E of Part I of subchapter J, other than section 678.").

[69]I.R.C. § 678(b) (emphasis added).

[70]*See* Cline, *supra* note 1, at 249, para. 1 (reciting that helpful legislative history exists, but without citation thereto); Richard A. Oshins & Stevens J. Oshins, *Protecting and Preserving Wealth Into the Next Millennium*, 137 Trusts & Estates 52 (Sept. 1998).

[71]Oshins & Oshins, *supra* note 70.

[72]*See supra* note 68 at quoted portion of ruling.

[73]TPWT at ¶ 4.10[4] (emphasis added).

[74]For extensive analysis of the legislative history, see Jonathan G. Blattmachr & Fred Sembler, *Crummey Powers and Income Taxation*, The Chase Review (July 1995).

> (1) Such person has a power exercisable *solely by himself* to vest the corpus or the income there from in himself, or *such person has previously partially released or otherwise modified* such a power and after the release or modification *retains such control* as would, within the principles of sections 671 to 677 inclusive, subject a grantor of a trust to treatment as the owner thereof. (Emphasis added).

Thus, the statute should be analyzed at three moments in time: (1) when the power is outstanding, (2) when the power is no longer outstanding, and (3), with respect to hanging powers, when the power is hanging and still exercisable, but may be subject to additional restrictions.

1. *While the Power is Outstanding*

While the power is outstanding, one would expect that section 678(a)(1) would clearly apply by its terms. The power holder then has a power exercisable "solely by himself" and the power is a power "to vest the corpus or the income therefrom in himself."[75] The power holder would therefore be treated as the owner for income tax purposes unless the exception under section 678(b) applies.

Section 678(b) provides:

> Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

A trust otherwise a grantor trust with respect to the settlor but over which the beneficiary has a withdrawal power over principal presents the question whether section 678(b) applies to powers over principal as well as to powers over income. The legislative history of section 678 helps answer this question.

The legislature enacted section 678 in 1954[76] as a codification of Regulation 29.22(a)-22.[77] The legislature amended section 678 in 1976,[78] and again in 1983.[79] The 1976 and 1983 legislative history is silent on the meaning or intent of the phrase "over income" as it appears in the statute, and the only regulation applicable to section 678(b) does no more than recite the statutory provisions.[80]

The 1954 legislative history supports the argument that the legislature did not intend to limit the powers over income, despite the language of section 678(b). The House Report accompanying the Code of 1954 that addresses section 678 states:

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[75]P.L.R. 1987-01-007 (Sept. 30, 1986); P.L.R. 1983-26-074 (Mar. 29, 1983).

[76]Internal Revenue Code of 1954, Pub. L. No. 591, § 678, 68A Stat. 231 (1954).

[77]T.D. 5488, 1946-2 C.B. 2; G.C.M. 33,451 (Mar. 7, 1967).

[78]Pub. L. No. 94-955, § 1013(b), 90 Stat. 1615 (1976).

[79]Pub. L. No. 97-448, 96 Stat. 2373 (1983) (adding subsection (e), a cross-reference to section 1361(d)).

[80]Reg. § 1.678(b)-1.

> A person other than the grantor may be treated as the substantial owner of a trust if he has an unrestricted power to take the trust *principal* or income, or if he has modified this power (by release or otherwise) but has retained powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable because of such a power.[81]

This passage indicates that the legislature did not contemplate a distinction between powers over income and powers over principal.

Furthermore, a series of private letter rulings treats *Crummey* withdrawal powers (powers over principal) as if they resulted in ownership by the power holder only to the extent that the settlor was not treated as the owner under other provisions of the grantor trust rules.[82] None of these rulings gives any consideration to the exclusion of powers over principal from the statutory language of section 678(b).[83] In sum, even when the beneficiary's withdrawal power is outstanding, the scope and application of section 678(a) and (b) are uncertain in the common circumstance where the settlor's spouse is a permissive beneficiary, because section 678(a) and (b) would make the settlor the owner of the trust's income under section 677(a)(1) and (a)(2), and the withdrawal power would make the beneficiary the owner of the trust under section 678(a)(1).

Fortunately, this uncertainty is typically short-lived because the withdrawal power usually ceases to be "exercisable solely by himself" after the initial withdrawal period of 30 or so days. After the initial withdrawal period, section 678(a)(1) does not apply.

Analysis of section 678(a)(1) has several drafting implications. First, one should not allow the withdrawal power to continue until the end of the year.

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[81]H.R. 1337, 83d Cong., 2d Sess. 1, reprinted 1954 Code, *Cong. and Admin News* 4025, 4089-4090 (Part XX(E), Mar. 19, 1954) (emphasis added); *see also* Senate Report, S.R. 1622, 83d Cong., 2d Sess. 1, reprinted 1954 Code, *Cong. and Admin News* 4629, 4719 (Part XXI(F), 1954) containing identical language.

[82]P.L.R. 1992-32-013 (May 4, 1992) (ruling that a beneficiary holding a withdrawal power over the principal was the owner of the trust except to the extent that the settlor is treated as the owner under section 675); P.L.R. 1992-26-037 (Mar. 27, 1992) (same); P.L.R. 1987-01-007 (Sept. 30, 1986) (applying same rule to section 677); P.L.R. 1985-45-076 (Aug. 14, 1985) (same); P.L.R. 1985-21-060 (Feb. 26, 1985) (same); P.L.R. 1985-17-052 (Jan. 29, 1985) (same, but only under section 675); P.L.R. 1983-26-074 (Mar. 29, 1983) (same under sections 675 and 677); P.L.R. 1983-08-033 (Nov. 23, 1982) (same).

[83]Other scholars have cited the following rulings, but they are not helpful for the reasons indicated: Revenue Ruling 1981-6, 1981-1 C.B. 18, does not contain any facts indicating the settlor would have been treated as the owner under any other provision of the trust. Revenue Ruling 1967-241, 1967-2 C.B. 225, concerns a provision under a will. Private Letter Ruling 2000-22-035 (June 5, 2000) takes place after the death of the settlor. Private Letter Rulings 2000-11-054-58 (Mar. 20, 2000), Private Letter Ruling 1998-12-039 (Mar. 20, 1998), Private Letter Ruling 1997-45-010 (Nov. 7, 1997), and Private Letter Ruling 1992-32-041 (May 4, 1992) all recite that "our examination reveals none of the circumstances that would cause the grantor to be treated as an owner under the provisions of subpart E." In Private Letter Ruling 1998-12-006 (Mar. 20, 1998), Private Letter Ruling 1997-45-010 (Nov. 7, 1997), and Private Letter Ruling 1997-39-026 (Sept. 26, 1997), the spouse was not a beneficiary of the trust and no fact recited indicates that the settlor would be treated as the owner in any event. Private Letter Ruling 1990-34-004 (May 17, 1990) also involves a deceased grantor." *See also* P.L.R. 1996-25-031 (June 21, 1996). Private Letter Ruling 1978-52-042 (Sept. 27, 1978) concerns a trust under a will.

Instead, one should terminate the withdrawal power as soon as qualification for the annual exclusion permits. The Tax Court in *Cristofani* approved a power as short as 15 days and the Service has approved powers lasting only 30 days in letter rulings.[84] Second, if the power must continue after the end of the year (*e.g.*, it must hang), then one should consider terminating the power on January first of the year following the year in which the power is created, rather than terminating at the end of that year. Also, one should consider making the withdrawal power exercisable (after the initial, gift-tax annual exclusion withdrawal period) only with the consent of the independent trustee then serving. Under such circumstances, section 678(a)(1) would not continue to apply after the initial period because the power would not be "exercisable solely by himself" as required under section 678(a)(1). Third, additional complicated drafting will be required to coordinate lapses under more than one trust, and one must recognize that there may be more than one trust at sometime whether or not there was more than one trust when the trust was drafted.[85]

2. *After the Beneficiary's Power Lapses*

Once the withdrawal power lapses, further uncertainties occur. The first uncertainty is the unclear language of section 678(a)(2). That section, subject to the same uncertain application of the section 678(b) exception, provides that the beneficiary, to be taxable at that point, must have "previously partially released or otherwise modified such a power" and, after the release or modification, must retain "such control as would, within the principles of sections 671 to 677 inclusive, subject a grantor of a trust to treatment as the owner thereof."[86]

While the meaning of "previously" seems clear in this context, the clarity of section 678(a)(2) stops there. A *Crummey* power that is allowed to lapse has not been "partially released" at all. Rather, it has been entirely allowed to lapse.[87] Congress must know the difference between partial and entire, and that difference should be given effect as a matter of settled principles of statutory interpretation.[88]

Next, Congress must know the difference between a *release* of a power of appointment and the *lapse* of a power of appointment. This distinction was the

[84]Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 4; *see also* rulings collected in TPLI, *supra* note 1, at ¶ 5.03[3][b], n.76.

[85]*See generally* Sean P. Kearney, *Preventive Maintenance: Avoiding Multiple Crummey Power Lapses*, 12 PRO. & PROP. 54 (1998).

[86]I.R.C. § 678(a)(2).

[87]*See* Cline, *supra* note 1, at n.21; Early, *supra* note 1, at 62.

[88]*See, e.g.*, Federal Power Comm'n v. Memphis Light, Gas & Water Div., 411 U.S. 458 (1973); United States v. American Trucking Ass'n, 310 U.S. 534, 543 (1940); United States v. Klinger, 199 F.2d 645, 648 (2d Cir. 1952), *aff'd per curiam*, 345 U.S. 979 (1953); Focht v. Commissioner, 68 T.C. 223, 244 (1977) ("Judges in tax cases tend to consult the statute only when the legislative history is ambiguous.") (Hall, J., dissenting); Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 528 (1947). *But see* Northern States Power Co. v. United States, 73 F.3d 764 (8th Cir. 1996); King Ranch, Inc. v. United States, 946 F.2d 35 (5th Cir. 1991) ("[A]bsent ambiguity…this court will not rewrite a federal statute, no matter how inartfully drafted.").

central moving factor in the enactment of the Powers of Appointment Act in 1951, three years before the enactment of the 1954 Internal Revenue Code. This distinction should apply in this context because a *Crummey* power "lapses" by non-exercise and is not released. The 1951 Powers of Appointment Act made *Crummey* powers equivalent only in the estate and gift tax context, not in the income tax context. Since there is no income tax provision making lapses and releases equivalent, the distinction between release and lapse is just as real today as it was 50 years ago in the income tax context.[89] Thus, applying section 678(a)(2) to *Crummey* powers is even more problematic and uncertain once the initial withdrawal power period has lapsed.

Moreover, the second clause of section 678(a)(2) requires that the power holder "after the release or modification retains such control as would, within the principles of sections 671 to 677 inclusive, subject a grantor of a trust to treatment as the owner thereof." But the powerholder beneficiary generally has no "control" at all. The power holder beneficiary has a beneficial interest, but surely not all beneficial interests constitute "control" of any type, and certainly not the particular subset of control that is "within the principles of sections 671-677." Such "control" might include control under the various forbidden administrative provisions of those sections, but is quite clearly not equivalent to "any beneficial interest at all." Nonetheless, Service rulings[90] hold that the control requirement is satisfied by virtually any beneficial interest that the beneficiary power holder does not give up.[91] Even where a beneficiary has a testamentary power of appointment, he or she does not satisfy the control requirement, at least not when the beneficiary is alive

Additionally, the statutory term "retains," as opposed to words indicating that control granted under the trust is also covered, has not been defined.

### 3. *Hanging Powers and Section 678(a)*

A "hanging power" falls within the "retains control" provision more than a "five and five" power. Under a hanging power, the "five and five" portion lapses entirely in the first year, but the power holder continues to have the right to exercise the "hung" power. Thus, a hanging power seems to fall more within the intendment of the "partial release" and "retains control" language. However,

[89]A more complete discussion of this legislative history can be found in Gallo, *supra* note 1, at text accompanying notes 53-60 and 90-98.

[90]*See* P.L.R. 2000-11-058 (Mar. 20, 2000); P.L.R. 2000-11-054-56 (Mar. 20, 2000); P.L.R. 1998-12-039 (Mar. 20, 1998); P.L.R. 1997-45-010 (Nov. 7, 1997); P.L.R. 1997-3026 (Sept. 26, 1997); P.L.R. 1996-25-031 (June 21, 1996); P.L.R. 1995-41-029 (Oct. 13, 1995); P.L.R. 1994-48-018 (Dec. 2, 1994); P.L.R. 1992-32-041 (May 4, 1992); P.L.R. 1992-32-013 (May 4, 1992) (ruling that a beneficiary holding withdrawal power over the principal was the owner of the trust except to the extent that the settlor is treated as the owner under section 675); P.L.R. 1992-26-037 (Mar. 27, 1992); P.L.R. 1990-34-004 (May 17, 1990); P.L.R. 1987-01-007 (Sept. 30, 1986); P.L.R. 1985-45-076 (Aug. 14, 1985); P.L.R. 1985-21-060 (Feb. 26, 1985); P.L.R. 1985-17-052 (Jan. 29, 1985); P.L.R. 1983-26-074 (Mar. 29, 1983); P.L.R. 1883-08-033 (Nov. 23, 1982).

[91]Curiously, this analysis seems to suggest that only "naked" powers would escape the coverage of section 678(a)(2).

there are often additional restrictions that apply to "hung" powers that do not apply to powers before the hang occurs. For example, a hung power might be exercisable only with the consent of a non-adverse third party or trustee. Here, the "retains control" requirement is not satisfied. No ruling explicitly considers these requirements.

Thus, section 678(a)(2) should not be applied to the lapse of a *Crummey* power for the following reasons:

> (1) a lapse is "entire," not "partial," and entire lapses are not described in section 678(a)(2);
>
> (2) a lapse is not a release, partial or otherwise, and therefore is not described in section 678(a)(2);
>
> (3) the power holder usually does not "retain" any sort of "control" at all, no less the particular subset of control required as "within the principles of sections 671-677" and with respect to hanging powers, the other applicable restrictions need to be analyzed; and
>
> (4) Congress has determined in the enactment of section 678(b) that if the settlor is taxable as the owner of the trust under the principles of sections 671-677, then the beneficiary should not be taxed.

Nonetheless, the Service is now applying section 678(a)(2) to trusts using *Crummey* powers with increasing regularity and with less regard to the statutory requirements.[92] To avoid those difficulties when using *Crummey* powers in the context of S corporations, one should consider having the trustee make the electing small business trust election under section 1361(e)(1). Under the Proposed Regulations, a trust that is partly treated as owned by the grantor or owned by another is eligible to be treated as an electing small business trust.[93] While the Service has not ruled on the extent of the exception under section 678(b), the rulings on the application of section 678(a)(2) leave a great deal of uncertainty. Nonetheless, the rulings make grantor trust status with respect to the settlor even more problematic whenever *Crummey* powers are used.

This creates several implications for drafting. First, if income is taxed to the power holders in proportion to their cumulative powers, then income may be taxed at lower rates than would otherwise be applicable, subject, to the kiddie tax under section 1(g). If a spousal power is used, then the income subject to that power might end up on a joint return with the settlor-spouse. However, the rate differential, if any, will probably be insignificant if there is little or no income, a common situation in many trusts holding only insurance policies.

Second, subsequent policy dealings will probably be slightly impacted by hanging powers. Many practitioners believe one should make the new trust and the insured partners in a partnership or arrange for partial carryover of basis to avoid possible application of the transfer for value rules under section 101(a)(2).

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[92]*See supra* note 90.

These practitioners believe the level of certainty grantor trust status provides for the settlor-insured is inadequate to permit a client to act on that basis alone.

Third, paying the income tax as an additional non-taxable gift seems uncertain when withdrawal powers are used, even when the trust is otherwise a grantor trust with respect to the settlor.[94] The tax may not be the settlor's tax to pay; rather, the tax may be the liability of the power holders in proportion to their cumulative powers. However, this may not matter when there is little or no income because there will be little or no income tax.

Fourth, if one could make the gifts "present interests" for gift tax purposes using some other approach besides withdrawal powers, section 2503(c) trusts or section 2503(b) trusts, for example—such trusts—could become grantor trusts with respect to the settlor and could pay those income taxes as additional, gift tax-free gifts.[95] Fifth, one could make any hanging power exercisable only with the consent of a non-adverse third party or trustee after the initial, gift-tax annual exclusion withdrawal period has expired.

Finally, a trust can only be an eligible S shareholder after it divides into shares, and a contingent trust provision will usually accomplish the division. Dividing the trust means the hanging power will be reduced by 5% of the divided shares rather than by 5% of the entire trust.[96] A provision stating the entire trust should be considered as a whole, an "in solido" provision, would allow the taxpayer to have his or her cake (separate shares for S corporation tax purposes) and eat it too (by reducing the hanging powers by reference to the larger trust totality) but may not be effective.

In conclusion, if one wishes to use *Crummey* withdrawal powers and make the trust's settlor the owner of the trust for income tax purposes, then the best approach to making the trust a grantor trust with respect to the settlor is to use a series of overlapping provisions.

C. *Dispositive Provisions Prior to the Trust Division Date*

The final analysis relevant to a trust prior to the trust division date involves the escape hatch. The escape hatch is a provision allowing discretionary payments of income and principal among the beneficiaries. The purpose of escape hatches is to provide flexibility, and more specifically,[97] to allow the trustees the flexibility to get the policy out of the trust. If there is no independent trustee serving prior to the trust division date, then the power to distribute should be confined to "health, education, maintenance and support" so that the interested

[93]Regulation § 1.1361-1(j)(8) and –1(k), Ex (3); *see also* Regulation § 1.641(c)-1(c) (to the same effect).

[94]This is why there are so many ruling requests in the subchapter S context where income tax treatment is so important.

[95]*See generally* Robert S. Balter, *Drafting Suggestions for Sec. 2503(c) Trusts*, 24 RIA Est. Planner's Alert, No. 10, at 5 (October 1999).

[96]*See infra* Part III, Provisions Concerning Trust Division Date, at p. 206.

[97]In practice, the effect of such a provision is likely to be minimal, because the trust will only own the life insurance policy and all income will consist of dividends credited to the policy.

trustee will not have a general power of appointment.[98] If an independent trustee is serving from the outset, then the independent trustee should be given the power to make distributions of income and principal to and among the beneficiaries as a group or individually for any purpose. The ability to make distributions is a significant advantage and one of the main reasons for having an independent trustee.

## III. PROVISIONS CONCERNING THE TRUST DIVISION DATE

The trust division date, the date when the trust is divided into shares for beneficiaries, impacts the amount of the lapse of withdrawal powers when hanging powers are used to create present interests for gift tax purposes. Once the death benefit becomes a trust asset, the cumulative withdrawal powers are usually reduced not by $5,000 annually under section 2514(e)(1), but by the far larger 5% limitation under section 2514(e)(2). For example, assume the trust owns a policy providing a $1 million death benefit with an interpolated terminal reserve value of $75,000. Prior to the death of the insured, the lapse that occurs under a hanging power is limited to $5,000 per beneficiary per year.[99] However, once the death benefit has been paid, the annual lapse amount will increase to $50,000 per beneficiary, which is 5% of $1 million and, there will be no more contributions to the trust to pay premiums. Lapsing the accumulated hanging power two or three times will probably wipe out whatever remains of the then-unexercised withdrawal powers.

Often a trust's only asset is its insurance policy, and the value of its insurance policy is its replacement value. Replacement value is defined as the cost of a similar policy on an insured of similar age and health on the pertinent valuation date.[100] The value of an existing cash value policy is normally its "interpolated terminal reserve value,"[101] which is the value against which the 5% limitation of section 2514 is measured, assuming a cash value policy and a normally healthy insured.[102]

Once it is more likely than not that the insured will die within one year,[103] the proper value is the policy's replacement value, the proceeds for "five and five" valuation purposes.[104] When the insured's death within one year is more likely

[98] I.R.C. § 2041(b)(1)(A).

[99] Rev. Rul. 1985-88, 1985-1 C.B. 201.

[100] Reg. § 25.2512-6(a); Reg. § 20.2031-8(a). The replacement cost of a newly issued policy is equal to the first premium paid. The replacement cost of a term policy equals the paid but unearned premium. A single premium policy is valued at the amount the same insurer would charge for a similar policy. *See generally* TPLI, *supra* note 1, ¶ 3.02[2][a].

[101] Reg. § 25.2512-6(a), Ex. (4).

[102] If the policy is subject to a split-dollar agreement, then the normal valuation must be reduced to reflect the claim to be paid off to the premium payor. Premium payments give rise to additional gifts. *See generally* TPLI, *supra* note 1, at ¶ 3.02[2][a][v].

[103] Reg. § 1.7520-3(b)(3); Reg. § 20.7520-3(b)(3); Reg. § 25.7520-3(b)(3); *see also* Rev. Rul. 1980-80, 1980-1 C.B. 194.

[104] *See* P.L.R. 1994-13-045 (Jan. 4, 1994).

than not, the 5% arm of the "five and five" limitation may reduce the hanging powers even during the insured's lifetime.

These provisions concerning the trust division date have several drafting implications. Dividing the trust into shares at the time of the insured's death effectively lapses the withdrawal powers under the 5% arm of section 2514(e) on only a proportionate share of the life insurance proceeds one time. In the example above, assume the insured has four children who are the only power holders, each with identical cumulative unexercised withdrawal powers. If the $1 million trust is divided into four shares and the withdrawal powers are continued, then the annual lapse amounts under the 5% limitation will be $12,500 per child per year ($1 million divided by 4, multiplied by 5%) for a total of $50,000 ($12,500 per child times four children) annually. If the trust is not divided into shares until afterwards, the annual lapse amount per child will be $50,000 per child ($1,000,000 times 5%) for a total of $200,000 per year. Therefore, some practitioners do not divide the trust for a period of time after the insured's death and continue the withdrawal powers until all the rights to withdraw all accumulated balances under the hanging powers have lapsed. Thus, the trust division date should be set so that the withdrawal powers will be reduced by the application of the 5% limitation during each calendar year in which the trust is kept together and wiped out altogether at the expiration of that period.

One formulation of the trust division date states that the trust division date will be the day "following the first day of the first year following the year of" the insured's death.[105] This formulation assures that the 5% limitation will be applied at least twice, once at the beginning of the year in which the insured dies and once at the beginning of the year following the insured's death. Nothing prevents even more conservative formulations, such as "the day following the first day of the third (or fourth, or fifth, etc.) year following the year of the insured's death."

Note that dividing the trust into shares when the settlor dies, runs a greater risk of inadequate reductions of the withdrawal powers under the 5% limitation, which could completely terminate the hanging withdrawal powers. If this happens, the only alternative to carrying the powers forward and applying them after the trust is divided into shares will be paying the beneficiaries who hold unexercised powers an amount equal to those amounts outright and free of trust. However, this alternative forfeits the creditor protection benefits generally afforded by trusts.[106]

A formula[107] could be devised to delay division into shares until the hanging powers have either been fully exercised or have lapsed entirely. One should consider using language defining the trust division date as the day following the first day of the first year following the year after the death of the settlor in which

[105]Courtesy of Francis J. Mirabello, Esq., of Morgan, Lewis & Bockius, Philadelphia, PA.

[106]*See generally* Spero, *supra* note 5, at ¶¶ 6.01-6.14.

[107]For a discussion of the use of formulas in estate planning generally, *see* Carlyn S. McCaffrey, *Tax Tuning the Estate Plan by Formula*, 1999 UNIV. OF MIAMI HECKERLING INSTITUTE 400 (1999).

no amount is subject to withdrawal under any of the powers created under the section creating the *Crummey* withdrawal powers. This language obviates the need for a provision directing payment of the balance subject to withdrawal in case the order of deaths is unexpected. However, a provision directing payment of the balance subject to withdrawal will still be required in case the beneficiary dies holding an unexercised and unlapsed power to withdraw.

## IV. PROVISIONS EFFECTIVE AFTER THE TRUST DIVISION DATE

### A. *Each Trust Should Have More Than One Beneficiary*

The creditor protection afforded under spendthrift provisions varies from jurisdiction to jurisdiction.[108] If there is only one beneficiary, the courts look at the distribution discretion of the trustees as going principally to when distributions will be made.[109] That discretion is not protected as much as the fiduciary discretion is when more than a single trust beneficiary is involved.[110] Therefore, there should always be more than one trust beneficiary. Often, practitioners should divide the trust into shares for each beneficiary and fund separate trusts for each beneficiary. To have more than one trust beneficiary when a separate trust is set up with respect to each beneficiary, one should consider adding the beneficiary's own descendants as potential beneficiaries. Even a trust with a single beneficiary with no descendants is entitled to accumulate assets for a later time when he or she may have descendants.[111] Another way to have more than one beneficiary is to add a person's spouse or a charity as a potential beneficiary.[112]

### B. *Trustee Selection and Change*

Who should be the trustee is one of the most important design issues in creating a trust. Even if the insured has no beneficial interest in the trust, the insured settlor should never be the trustee because the insured as trustee will have incidents of ownership under section 2042, causing the death benefit to be included in the insured's taxable estate and defeating one of the purposes for having the trust in the first place.[113]

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[108]*See supra* text accompanying notes 37-38.

[109]Spero, *supra* note 5, at ¶ 6.03[1][b].

[110]*See supra* text accompanying notes 37-38.

[111]Scott on Trusts § 112.1; Spero, *supra* note 5, at ¶ 6.02[5].

[112]Counsel and client should consider substantial restrictions on permissive spousal interests, particularly a provision stating no distribution can be made to a beneficiary who is a spouse of a descendant except in kind or in further trust. Distributions in kind would be by application for benefit like the permissive use of a residence made available to a descendant while the descendant and the descendant's spouse are living together as husband and wife. Distributions to a trust for the benefit of the spouse could be further limited. Such a trust interest could be limited in duration (*e.g.*, nothing beyond the lifetime of the spouse) and only to trusts forbidding distributions of principal or forbidding distributions of principal other than for health, or other than for health in the discretion of an independent trustee.

[113]*See* TPLI, *supra* note 2, at ¶ 5.03[6][a], at n.157. If you need to get out of this problem, see Private Letter Ruling 1994-13-045 (Jan. 4, 1994).

Next, the insured's spouse may be a trustee without adverse estate tax effects if the spouse is not an insured.[114] It is important to draft the trust so that the spouse as trustee will not have a general power of appointment. This can be accomplished by disabling the spouse as trustee from exercising any power that would cause the spouse to have a general power and requiring an independent trustee to exercise such tax sensitive powers.

A friend should not be a trustee for several reasons. First, it would expose the friend to confidential financial facts and circumstances that a client might not wish to divulge. Second, friendships come and go.

Professionals like accountants and lawyers who may be knowledgeable with regard to those facts and circumstances should usually not be trustees for various reasons. They can be expensive, and the involvement as a trustee might make the client less objective regarding the desirability of a professional, a situation that may be difficult to remedy at that point. Furthermore, the personal involvement with the family can be a significant imposition, for example, when there is a disabled beneficiary or a business to run. Moreover, it seems that few entrepreneurial clients think that either their accountant or their lawyer could run their business in those situations in which the trust will end up owning the business.

Some commentators have suggested that "a corporate trustee is often the most efficient and best choice" even though a corporate fiduciary may also seem expensive and inflexible.[115] However, a mediocre trustee can also be expensive if competent advisors are not used. And as for being "inflexible," inter-personal difficulties seem just as likely with family and personal friends.

When drafting a trust, two different types of trustees are needed—first, a trustee who will be involved with the family, in whom beneficiaries can confide, and who will know if personal problems and needs exist. Second, a trustee who can manage money (or, at least a person who can manage those who will be managing the money) and who is comfortable and willing to be involved in monetary matters is essential.

The beneficiary is the person who will best know the beneficiary's needs. The beneficiary for whom the trust has been set aside has by far the greatest stake in the administration of the trust for his or her benefit. Thus, one should consider making the beneficiary a trustee of the trust set aside for him or her.[116] The

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[114]The spouse can be a trustee of a trust holding only insurance covering the non-trustee-spouse's life, but the spouse should not be a trustee of a trust holding insurance covering both spouses' lives. Hence, separate trusts for each type of coverage are appropriate.

[115]DOUGLAS K. FREEMAN & STEPHAN G. RAPKIN, PLANNING FOR LARGE ESTATES, § 5.28[1], 5-179 (Matthew Bender & Co. 1998).

[116]There are exceptions to this general approach for physically or mentally disabled beneficiaries, and for beneficiaries with creditor or marital problems. However, beneficiaries who do not have either the experience or the inclination to be their own trustees should be permitted by the trust instrument to hire advisors or appoint corporate fiduciaries, either of whom will have both the experience and the inclination to help, while permitting even those beneficiaries to retain control and direction over the funds that otherwise would have been distributed to them outright. It will also permit them to enjoy a level of protection from their own creditors otherwise attainable only through complex partnership or limited liability structures.

second trustee should be a very carefully selected independent trustee.[117] The beneficiary should have the power to remove and replace any independent trustee with another independent trustee.[118] The beneficiary should also have the power to hire and fire advisors and to appoint and discharge a corporate fiduciary. Where a closely held business is involved that actually requires significant personal involvement, a special business trustee should be provided for, either by appointment at the outset or by enabling such an appointment at a later time.

While having the beneficiary serve as his or her own trustee raises issues, those issues can be solved by drafting.[119] The investment responsibility of nonprofessional trustees may very well require increased sensitivity.[120] The extent to which drafting can resolve such issues varies from state to state.[121] In some states, this approach may not be feasible under applicable state law.

### C. *Provisions Regarding Distribution of Income*

Many trusts provide for the mandatory payment of income annually or quarterly, but this is unwise because payment of the income will be discoverable by creditors and, at least once paid, will be attachable and may become subject to equitable distribution in a marital dispute as well.[122] Additionally, the payment of income transforms the payments into amounts subject to estate taxes (*i.e.*, in the trust they were exempt from estate taxes).

Moreover, when payments of income are forced out of the trust, it is uncertain who will enjoy the distributed money: it could be the beneficiary, as likely intended, or a judgment creditor, a divorcing or separating spouse, or the tax collector. Certainty of beneficiary enjoyment seems to be enhanced by discretionary, not mandatory payments.

In a typical insurance trust where the policy is the trust's only asset, it will probably be less significant whether the payments are discretionary or mandatory. The income will consist of dividends (mainly dividends not paid in cash) that are posted to the policy and, assuming the policy is not a "modified endow-

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[117]See ROBERT ESPERTI & ROBERT PETERSON, IRREVOCABLE TRUSTS ANALYSIS WITH FORMS, ¶ 12.03 and Form 12.1 (RIA Group-Warren Gorham & Lamont 1998) (discussing the practical process for choosing trustees and providing checklists for various tax consequences).

[118]*See generally* Rev. Rul. 1995-58, 1995-2 C.B. 191 (revoking Rev. Rul. 1979-353, 1979-2 C.B. 325). While the transfer tax consequences of a power to remove and replace the trustee now seem settled, the impact on creditor protections seems less certain and may vary from jurisdiction to jurisdiction.

[119]Georgiana S. Slade, *The Beneficiary as Trustee: A Pandora's Box*, 19 TAX MGM'T EST. GIFTS & TR. J. 197 (1994).

[120]Alfred M. Falk, *Pity the Poor Trustee: Dealing with the Hazards of Trusteeship for Nonprofessional Trustees*, 14 PROB. & PROP. 6 (2000) (containing many helpful drafting suggestions).

[121]*See, e.g.,* N.Y. EST. POWERS & TRUSTS LAW §§ 2-1.14, 3-3.3, 3-3.5(b), 5-1.4, and 7-1.1 (McKinney 2001) (concerning trusts where beneficiary is the trustee).

[122]Some states exclude inherited assets from equitable distribution in a marital settlement and some do not. Moreover, the burden of proving one's entitlement to an exclusion from equitable distribution is on the person asserting the benefit of the exclusion, and this burden is difficult to prove. Practically, the exclusion might be of questionable value.

ment contract, these dividends will not be accounting income."[123] Therefore, even if income payments are mandatory, little if anything will be distributed. However, the amount distributed will reduce the ultimate growth of the trust assets. Due to compounding for any substantial time period, this may be a significant reduction.[124]

Where the beneficiary is his or her own trustee, a mandatory income payment provision forces payment by the same person who otherwise may well have discretion to make the payment when needed, and often in the exact amount needed, and in such a manner so as to minimize creditor exposure.

This problem is significant because the mandatory payment of income can reduce the amount of money heirs receive by 31%. For example, assume a life insurance trust holding a $10 million policy where the other assets in the insured's estate are $15 million, $2 million in exemptions, and $3 million in settlement costs for the first estate, leaving a marital deduction trust holding another $10 million. The attached spreadsheets compare the results to the next generation, assuming a 3.2% annual rate of return (60% equity, 40% income asset allocation, 2% dividend yield on the equities, and 5% income yield on the bonds for a composite rate of return of 3.2%). The result is a 31% ($5.5 million out of $17.9 million) increase in net dollars to heirs when the income is not paid out from the insurance trust or the unified credit trust. All income is subjected to a 40% income tax rate, and $175,000 annual after tax expenses are assumed and increased for inflation at 3%. When income is not paid out, as the expenses exceed the income, the marital trust is depleted (instead of increasing as it does when the income is paid out from the other trusts). The result is that the surviving spouse is only spending 50 cents on the dollar when the income is not being distributed from all of the trusts to her, instead of accumulating dollars that could have been free of tax and subjecting them to tax in the surviving spouse's estate.[125]

Some experts have suggested that investing the insurance trust in low-income, growth assets may alleviate the problem of mandatory payments. To illustrate the effect of such a strategy, constant rates of income between the marital and the insurance trust would have to be abandoned because the 31% differential actually remains 31% whenever a constant rate of income is applied to both the marital and the non-marital trusts. Therefore, one would have to assume that the marital trust generates little or no income while the non-marital trusts generate approximately normal investment returns.

[123] I.R.C. § 7702A.

[124] $1 million earning 10% for 99 years matures to $12.527 billion. $1 million earning just 9% for the same 99 years matures to $5 billion (40%), and $1 million earning 8% matures to $2 billion (about 16%). Thus, one should minimize withdrawals to maximize compounding.

[125] *See* Appendix 1, tables entitled "Spouse's Income-Paying All Income To Spouse Annually," "Spouse's Income-Without Insurance and UC Trust Payouts," and "Trust Accumulations – Not Paying Income To Spouse."

Merely stating that part of the problem emphasizes how much of an influence provisions unnecessarily requiring that all income be paid out annually have on the overall investment policy and administration of the trusts.[126] If this situation exists, then realigning investments is a reasonable approach to dealing with the problem. However, realigning the investments is not a perfect solution. It complicates the investment selection process (as seen above) and at the very worst it holds the investment selection process hostage to an artificial non-income requirement when appropriate asset allocation or hedging might indicate a different approach.

The mandatory payment provisions have several implications regarding income and principal distributions. The mandatory payment of income from an irrevocable insurance trust or unified credit trust will often prescribe the removal of assets from an estate tax free, creditor-protected environment and subject it to both of those risks. Forcing funds into those risks would be a mistake, especially when the ultimate decision-maker is the same person into whose hands the funds are being forced.

Except as otherwise required by law,[127] the distribution of income and principal to the beneficiary should be under the trustee's discretion. If the beneficiary is only one of the trustees and an independent trustee is serving, then one should give the power to distribute income to an independent trustee so he or she can make distributions to the beneficiaries for any purpose or accumulate the income in his or her absolute discretion. The drafter should protect the trustee's right to accumulate the income in the face of a broad standard of distribution, such as "for any purpose." A drafter should also consider giving the trustee the right to accumulate the income first, and secondly give the trustee the discretion to distribute the income.[128] This drafting technique grants the trustee significant flexibility and also affords the beneficiary significant creditor protection.

If the beneficiary is the only trustee, then the drafter should limit the trustee's discretion to distribute income to "health, education, support or maintenance."[129]

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[126]In a marital trust, paying all of the income, rather than subjecting it to a power of withdrawal, also forfeits significant generation skipping tax advantages. *See* David A Handler & Deborah Dunn, *Accumulation QTIP Trust: The Overlooked Provisions of the Marital Deduction Regulations*, 25 RIA Estate Planner's Alert No. 3 (2000).

[127]*See, e.g.,* I.R.C. § 2056(b)(7) (qualifying for the marital deduction in a contingent marital deduction trust under); I.R.C. 1361(d) (qualifying as a contingent qualified subchapter S Trust).

[128]Such a provision might read, "the net income shall in the discretion of the trustee either be accumulated, in whole or in part, and added to principal at the end of the annual accounting period, or paid in such amounts as the trustee may deem appropriate for any purpose."

[129]I.R.C. § 2041(b)(1)(A). However, using an ascertainable standard is a compromise because it does not provide as complete a shield against the beneficiary's creditors as would a wholly discretionary trust with an independent trustee (as described in note 133). Using an independent trustee and a wholly discretionary trust forfeits permitting the beneficiary to become his or her own trustee. Such a beneficiary could, however, have the power to remove and replace independent trustees at any time under Revenue Ruling 1995-58, 1995-2 C.B. 191 (providing greater protection for the beneficiary with less involvement of the beneficiary in overall trust operations).

D. *Provisions Regarding Distributions of Principal*

Provisions regarding distribution of principle are governed by the same concerns as provisions regarding distribution of income. Usually, drafters should avoid mandatory distributions of principal and should not give powers to withdraw for any purpose to beneficiaries who may be compelled to exercise them in favor of creditors (which could cause unnecessary estate tax inclusion).

Many trusts give each beneficiary a separate "five and five" power even where the trust is not seeking gift tax annual exclusion. However, if the beneficiary is the trustee, then it is not necessary to give the beneficiary rights to demand action by the trustee. Creditors can sometimes compel the exercise of general powers of appointment by their debtors, and estate tax inclusion is often compelled if the power is outstanding on the date of death.[130]

The spouse as trustee and beneficiary can have the power to make distributions of principal to himself or herself for "health, education, maintenance and support." The spouse can also have the power to make distributions to others "for any purpose" so long as such power is not exercisable in such a manner as to discharge any support obligation that the spouse may have towards a beneficiary.

The independent trustee can have the power to make distributions to any beneficiary for any purpose at all, and this is particularly useful if charitable planning is a possibility. It is unlikely that "health, education, support and maintenance" is broad enough to encompass distributions to a beneficiary to establish or maintain a charity, although the low varies from state to state. The independent trustee's power to make distributions "for any purpose" will permit the beneficiaries to establish a charitable lead trust, supporting organization, or private foundation.

The trust should not contain provisions terminating the trust when a beneficiary reaches a certain age. The trust should only terminate as required by the rule against perpetuities or, if the rule does not apply, then on the date when no descendant of the settlor is alive.[131]

E. *Trust Termination*

A drafter should never terminate the trust until the law requires termination because assets in the trust enjoy significant protections from domestic and commercial creditors. A perpetual trust can be accomplished by establishing the trust in one of the 14 jurisdictions that has abolished the rule against perpetuities.[132] If

[130]If that were the only concern, drafting could defeat it by making the power only exercisable on one day each year. Death on any other of the 365 calendar days would occasion no estate tax inclusion. But powers that are only exercisable once a year are peculiarly subject to attachment since creditors will know the exact date when such powers will be exercised.

[131]*See, e.g.,* DEL. CODE ANN. tit. 25, § 503.

[132]The 14 states are Alaska, Arizona, Delaware, Florida, Idaho, Illinois, Maine, Maryland, New Jersey, Ohio, Rhode Island, South Dakota, and Wisconsin. *See* Steven J. Oshins & Jonathan G. Blattmachr, *Megatrusts and Mega Insurance Trusts*, 46 J. AM. SOC'Y CLU & CHFC 30 (1991).

the trust must be established in another state, the drafter should not cut off the compounding and creditor protections by terminating the trust when the beneficiaries reach a specific age. While terminating when the beneficiary is too young, funds will probably be squandered. Terminating when the beneficiary is older will probably subject the assets to an immediate inheritance or estate tax.

## V. CONCLUSION

Drafters should keep several strategies in mind when structuring trusts. In a suggested trust holding a policy insuring one individual, there would be two trustees: the insured's spouse and an independent trustee.[133] The independent trustee would hold only those tax-sensitive powers expressly confided to an independent trustee and might be appointed for a limited time period and for limited purposes. All other powers might be exercisable by the spouse alone as trustee. In case of divorce or separation, the spouse could be deemed to have resigned as trustee and be treated as deceased for purposes of any beneficial interest the spouse might have in the trust.

The trust could provide the beneficiary with the right to make distributions to himself or herself for "health, education, maintenance and support" and could give the independent trustee the power to make distributions to any beneficiary for any purpose. The spouse as trustee might have the power to make distributions to the settlor's descendants for any purpose, provided the distributions were not used to discharge support obligations. The trust would have a provision explaining the intended income tax effects and another using hanging powers to create present interests for all beneficiaries, except where the settlor intends to allocate generation skipping transfer tax exemption to the trust. The spouse could have a "five and five" withdrawal power. The trust would give the trustee extensive powers and try to anticipate trustee disability, minor, and disabled beneficiaries, subchapter S shares as part of the trust corpus and various other items. Overall, the trust would be quite flexible while providing significant creditor protections and very significant income, estate, gift, and generation skipping transfer tax advantages.

[133]The term "independent trustee" refers to a person (1) who is not and never will be a beneficiary under the trust, and (2) a person who is not likely to be a transferor to the trust. The independent trustee's successors, in addition to those qualities, will also be people who are not described in section 672(c) with respect to the trust's settlor or the trustee appointing him or her. The rule that the independent trustee's successor not be a person described in section 672(c) is from Revenue Ruling 95-58, 1995-2 C.B. 191, revoking Revenue Ruling 1979-353, 1979-2 C.B. 325. The rule is illogical because section 672(c) is an income tax provision and has no logical relationship to any of the gift, generation skipping, or estate tax provisions, and certainly not to the retained interest provisions of sections 2036-2038. Revenue Ruling 1995-58, 1995-2 C.B. 191, only applies to the retained power to remove and replace trustees. It is not applicable to original trustee appointments. As such, it would be permissible to use an otherwise independent person falling within one of the section 672(c) classifications at the outset.

# APPENDIX ONE
# SPOUSE'S INCOME
## PAYING ALL INCOME TO SPOUSE ANNUALLY

*ASSUMPTIONS*

| | |
|---|---|
| INSURANCE TRUST STARTING PRINCIPAL | $10,000,000 |
| QTIP MARITAL DEDUCTION TRUST STARTING PRINCIPAL | $10,000,000 |
| UNIFIED CREDIT STARTING PRINCIPAL- ASSUMED | $1,000,000 |
| INCOME TAX RATE | 40.00% |
| INFLATION RATE | 3.00% |
| RATE OF INCOME CALCULATED AS INDICATED BELOW | 3.20% |

| | *ALLOCATION* | *INCOME* | *COMP % INCOME* |
|---|---|---|---|
| EQUITY PORTION | 60.00% | 2.00% | 1.20% |
| INCOME PORTION | 40.00% | 5.00% | 2.00% |

| *YEAR* | *INCOME FROM QTIP* | *INCOME FROM U/C* | *INCOME FROM INS* | *INCOME FROM CUMULATIONS* | *SPOUSE'S TOTAL INC* | *INCOME TAX* | *INCOME NET OF INCOME TAX* | *AFTER TAX EXPENSES* | *SPOUSE'S ESTATE* |
|---|---|---|---|---|---|---|---|---|---|
| 1 | $320,000 | $32,000 | $320,000 | $0 | $672,000 | $268,800 | $403,200 | $175,000 | $10,228,200 |
| 2 | $320,000 | $32,000 | $320,000 | $7,302 | $679,302 | $271,721 | $407,581 | $180,250 | $10,455,531 |
| 3 | $320,000 | $32,000 | $320,000 | $14,577 | $686,577 | $274,631 | $411,946 | $185,658 | $10,681,820 |
| 4 | $320,000 | $32,000 | $320,000 | $21,818 | $693,818 | $277,527 | $416,291 | $191,227 | $10,906,884 |
| 5 | $320,000 | $32,000 | $320,000 | $29,020 | $701,020 | $280,408 | $420,612 | $196,964 | $11,130,532 |
| 6 | $320,000 | $32,000 | $320,000 | $36,177 | $708,177 | $283,271 | $424,906 | $202,873 | $11,352,565 |
| 7 | $320,000 | $32,000 | $320,000 | $43,282 | $715,282 | $286,113 | $429,169 | $208,959 | $11,572,775 |
| 8 | $320,000 | $32,000 | $320,000 | $50,329 | $722,329 | $288,932 | $433,397 | $215,228 | $11,790,945 |
| 9 | $320,000 | $32,000 | $320,000 | $57,310 | $729,310 | $291,724 | $437,586 | $221,685 | $12,006,846 |
| 10 | $320,000 | $32,000 | $320,000 | $64,219 | $736,219 | $294,488 | $441,731 | $228,335 | $12,220,242 |
| 11 | $320,000 | $32,000 | $320,000 | $71,048 | $743,048 | $297,219 | $445,829 | $235,185 | $12,430,886 |
| 12 | $320,000 | $32,000 | $320,000 | $77,788 | $749,788 | $299,915 | $449,873 | $242,241 | $12,638,518 |
| 13 | $320,000 | $32,000 | $320,000 | $84,433 | $756,433 | $302,573 | $453,860 | $249,508 | $12,842,869 |
| 14 | $320,000 | $32,000 | $320,000 | $90,972 | $762,972 | $305,189 | $457,783 | $256,993 | $13,043,659 |
| 15 | $320,000 | $32,000 | $320,000 | $97,397 | $769,397 | $307,759 | $461,638 | $264,703 | $13,240,594 |
| 16 | $320,000 | $32,000 | $320,000 | $103,699 | $775,699 | $310,280 | $465,419 | $272,644 | $13,433,369 |
| 17 | $320,000 | $32,000 | $320,000 | $109,868 | $781,868 | $312,747 | $469,121 | $280,824 | $13,621,666 |
| 18 | $320,000 | $32,000 | $320,000 | $115,893 | $787,893 | $315,157 | $472,736 | $289,248 | $13,805,154 |
| 19 | $320,000 | $32,000 | $320,000 | $121,765 | $793,765 | $317,506 | $476,259 | $297,926 | $13,983,487 |
| 20 | $320,000 | $32,000 | $320,000 | $127,472 | $799,472 | $319,789 | $479,683 | $306,864 | $14,156,306 |
| 21 | $320,000 | $32,000 | $320,000 | $133,002 | $805,002 | $322,001 | $483,001 | $316,070 | $14,323,238 |
| 22 | $320,000 | $32,000 | $320,000 | $138,344 | $810,344 | $324,137 | $486,206 | $325,552 | $14,483,892 |
| 23 | $320,000 | $32,000 | $320,000 | $143,485 | $815,485 | $326,194 | $489,291 | $335,318 | $14,637,865 |
| 24 | $320,000 | $32,000 | $320,000 | $148,412 | $820,412 | $328,165 | $492,247 | $345,378 | $14,784,734 |
| 25 | $320,000 | $32,000 | $320,000 | $153,112 | $825,112 | $330,045 | $495,067 | $355,739 | $14,924,062 |
| 26 | $320,000 | $32,000 | $320,000 | $157,570 | $829,570 | $331,828 | $497,742 | $366,411 | $15,055,393 |
| 27 | $320,000 | $32,000 | $320,000 | $161,773 | $833,773 | $333,509 | $500,264 | $377,404 | $15,178,253 |
| 28 | $320,000 | $32,000 | $320,000 | $165,704 | $837,704 | $335,082 | $502,623 | $388,726 | $15,292,150 |
| 29 | $320,000 | $32,000 | $320,000 | $169,349 | $841,349 | $336,540 | $504,809 | $400,387 | $15,396,572 |
| 30 | $320,000 | $32,000 | $320,000 | $172,690 | $844,690 | $337,876 | $506,814 | $412,399 | $15,490,987 |

***SPOUSE DIES***

| | |
|---|---|
| **SPOUSE'S ESTATE** | $ 15,490,987 |
| **SPOUSE'S ESTATE TAX @ 55%** | $ 8,520,043 |
| **NET TO HEIRS FROM ESTATE** | $ 6,970,944 |
| PLUS INSURANCE TRUST PRINCIPAL | $ 10,000,000 |
| PLUS UNFIED CREDIT TRUST PRINCIPAL | $ 1,000,000 |
| **TOTAL NET TO HEIRS—ALL INCOME PAID TO SPOUSE ANNUALLY** | **$17,970,944** |

# SPOUSE'S INCOME

WITHOUT INSURANCE TRUST AND UC TRUST PAYOUTS

*ASSUMPTIONS*

| | |
|---|---|
| INSURANCE TRUST STARTING PRINCIPAL | $10,000,000 |
| QTIP MARITAL DEDUCTION TRUST STARTING PRINCIPAL | $10,000,000 |
| UNIFIED CREDIT STARTING PRINCIPAL- ASSUMED | $1,000,000 |
| INCOME TAX RATE | 40.00% |
| INFLATION RATE | 3.00% |
| RATE OF INCOME CALCULATED AS INDICATED BELOW | 3.20% |

| | *ALLOCATION* | *INCOME* | *COMP % INCOME* |
|---|---|---|---|
| EQUITY PORTION | 60.00% | 2.00% | 1.20% |
| INCOME PORTION | 40.00% | 5.00% | 2.00% |

| *YEAR* | *INCOME FROM QTIP* | *INCOME FROM U/C* | *INCOME FROM INS* | *INCOME FROM CUMULATIONS* | *SPOUSE'S TOTAL INC* | *INCOME TAX* | *INCOME NET OF INCOME TAX* | *AFTER TAX EXPENSES* | *SPOUSE'S ESTATE* |
|---|---|---|---|---|---|---|---|---|---|
| 1 | $320,000 | $0 | $0 | $0 | $320,000 | $128,000 | $192,000 | $175,000 | $10,017,000 |
| 2 | $320,000 | $0 | $0 | $544 | $320,544 | $128,218 | $192,326 | $180,250 | $10,029,076 |
| 3 | $320,000 | $0 | $0 | $930 | $320,930 | $128,372 | $192,558 | $185,658 | $10,035,977 |
| 4 | $320,000 | $0 | $0 | $1,151 | $321,151 | $128,461 | $192,691 | $191,227 | $10,037,441 |
| 5 | $320,000 | $0 | $0 | $1,198 | $321,198 | $128,479 | $192,719 | $196,964 | $10,033,196 |
| 6 | $320,000 | $0 | $0 | $1,062 | $321,062 | $128,425 | $192,637 | $202,873 | $10,022,960 |
| 7 | $320,000 | $0 | $0 | $735 | $320,735 | $128,294 | $192,441 | $208,959 | $10,006,442 |
| 8 | $320,000 | $0 | $0 | $206 | $320,206 | $128,083 | $192,124 | $215,228 | $9,983,337 |
| 9 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $221,685 | $9,953,653 |
| 10 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $228,335 | $9,917,317 |
| 11 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $235,185 | $9,874,132 |
| 12 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $242,241 | $9,823,891 |
| 13 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $249,508 | $9,766,383 |
| 14 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $256,993 | $9,701,389 |
| 15 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $264,703 | $9,628,686 |
| 16 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $272,644 | $9,548,042 |
| 17 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $280,824 | $9,459,218 |
| 18 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $289,248 | $9,361,970 |
| 19 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $297,926 | $9,256,044 |
| 20 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $306,864 | $9,141,181 |
| 21 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $316,070 | $9,017,111 |
| 22 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $325,552 | $8,883,560 |
| 23 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $335,318 | $8,740,242 |
| 24 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $345,378 | $8,586,864 |
| 25 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $355,739 | $8,423,125 |
| 26 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $366,411 | $8,248,714 |
| 27 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $377,404 | $8,063,310 |
| 28 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $388,726 | $7,866,585 |
| 29 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $400,387 | $7,658,197 |
| 30 | $320,000 | $0 | $0 | | $320,000 | $128,000 | $192,000 | $412,399 | $7,437,798 |

***SPOUSE DIES***

| | |
|---|---|
| **SPOUSE'S ESTATE** | $7,437,798 |
| **SPOUSE'S ESTATE TAX @ 55%** | $4,090,789 |
| **NET TO HEIRS** | **$3,347,009** |

# TRUST ACCUMULATIONS
## NOT PAYING INCOME TO SPOUSE

| *ASSUMPTIONS* | |
|---|---|
| INSURANCE TRUST STARTING PRINCIPAL | $10,000,000 |
| QTIP MARITAL DEDUCTION TRUST STARTING PRINCIPAL | $10,000,000 |
| UNIFIED CREDIT STARTING PRINCIPAL—ASSUMED | $1,000,000 |
| INCOME TAX RATE | 40.00% |
| INFLATION RATE | 3.00% |
| RATE OF INCOME CALCULATED AS INDICATED BELOW | 3.20% |

| | *ALLOCATION* | *INCOME* | *COMP % INCOME* |
|---|---|---|---|
| EQUITY PORTION | 60.00% | 2.00% | 1.20% |
| INCOME PORTION | 40.00% | 5.00% | 2.00% |

| *YEAR* | *INCOME FROM QTIP* | *INCOME FROM U/C* | *INCOME FROM INS* | *INCOME FROM CUMULATIONS* | *TRUSTS' TOTAL INC* | *INCOME TAX* | *INCOME NET OF INCOME TAX* | *AFTER TAX EXPENSES* | *CUM TRUST ESTATE* |
|---|---|---|---|---|---|---|---|---|---|
| 1 | $0 | $32,000 | $320,000 | $0 | $352,000 | $140,800 | $211,200 | $0 | $11,211,200 |
| 2 | $0 | $32,000 | $320,000 | $38,758 | $390,758 | $156,303 | $234,455 | $0 | $11,445,655 |
| 3 | $0 | $32,000 | $320,000 | $46,261 | $398,261 | $159,304 | $238,957 | $0 | $11,684,612 |
| 4 | $0 | $32,000 | $320,000 | $53,908 | $405,908 | $162,363 | $243,545 | $0 | $11,928,156 |
| 5 | $0 | $32,000 | $320,000 | $61,701 | $413,701 | $165,480 | $248,221 | $0 | $12,176,377 |
| 6 | $0 | $32,000 | $320,000 | $69,644 | $421,644 | $168,658 | $252,986 | $0 | $12,429,363 |
| 7 | $0 | $32,000 | $320,000 | $77,740 | $429,740 | $171,896 | $257,844 | $0 | $12,687,207 |
| 8 | $0 | $32,000 | $320,000 | $85,991 | $437,991 | $175,196 | $262,794 | $0 | $12,950,001 |
| 9 | $0 | $32,000 | $320,000 | $94,400 | $446,400 | $178,560 | $267,840 | $0 | $13,217,841 |
| 10 | $0 | $32,000 | $320,000 | $102,971 | $454,971 | $181,988 | $272,983 | $0 | $13,490,824 |
| 11 | $0 | $32,000 | $320,000 | $111,706 | $463,706 | $185,483 | $278,224 | $0 | $13,769,048 |
| 12 | $0 | $32,000 | $320,000 | $120,610 | $472,610 | $189,044 | $283,566 | $0 | $14,052,614 |
| 13 | $0 | $32,000 | $320,000 | $129,684 | $481,684 | $192,674 | $289,010 | $0 | $14,341,624 |
| 14 | $0 | $32,000 | $320,000 | $138,932 | $490,932 | $196,373 | $294,559 | $0 | $14,636,183 |
| 15 | $0 | $32,000 | $320,000 | $148,358 | $500,358 | $200,143 | $300,215 | $0 | $14,936,398 |
| 16 | $0 | $32,000 | $320,000 | $157,965 | $509,965 | $203,986 | $305,979 | $0 | $15,242,376 |
| 17 | $0 | $32,000 | $320,000 | $167,756 | $519,756 | $207,902 | $311,854 | $0 | $15,554,230 |
| 18 | $0 | $32,000 | $320,000 | $177,735 | $529,735 | $211,894 | $317,841 | $0 | $15,872,071 |
| 19 | $0 | $32,000 | $320,000 | $187,906 | $539,906 | $215,963 | $323,944 | $0 | $16,196,015 |
| 20 | $0 | $32,000 | $320,000 | $198,273 | $550,273 | $220,109 | $330,164 | $0 | $16,526,178 |
| 21 | $0 | $32,000 | $320,000 | $208,838 | $560,838 | $224,335 | $336,503 | $0 | $16,862,681 |
| 22 | $0 | $32,000 | $320,000 | $219,606 | $571,606 | $228,642 | $342,964 | $0 | $17,205,645 |
| 23 | $0 | $32,000 | $320,000 | $230,581 | $582,581 | $233,032 | $349,548 | $0 | $17,555,193 |
| 24 | $0 | $32,000 | $320,000 | $241,766 | $593,766 | $237,507 | $356,260 | $0 | $17,911,453 |
| 25 | $0 | $32,000 | $320,000 | $253,167 | $605,167 | $242,067 | $363,100 | $0 | $18,274,553 |
| 26 | $0 | $32,000 | $320,000 | $264,786 | $616,786 | $246,714 | $370,071 | $0 | $18,644,624 |
| 27 | $0 | $32,000 | $320,000 | $276,628 | $628,628 | $251,451 | $377,177 | $0 | $19,021,801 |
| 28 | $0 | $32,000 | $320,000 | $288,698 | $640,698 | $256,279 | $384,419 | $0 | $19,406,219 |
| 29 | $0 | $32,000 | $320,000 | $300,999 | $652,999 | $261,200 | $391,799 | $0 | $19,798,019 |
| 30 | $0 | $32,000 | $320,000 | $313,537 | $665,537 | $266,215 | $399,322 | $0 | $20,197,341 |

***SPOUSE DIES***

| | | |
|---|---|---|
| **CUM TRUST ESTATE** $20,197,341 | | |
| **PLUS NET TO HEIRS FROM SURVIVING SPOUSE'S ESTATE WITHOUT NON-QTIP TRUST INCOME** | | $ 3,347,009 |
| **PLUS UNIFIED CREDIT TRUST PRINCIPAL** | ***ALREADY INCLUDED IN TRUST ESTATE*** | $ 0 |
| **TOTAL NET TO HEIRS—INCOME OTHER THAN QTIP ACCUMULATED** | | **$23,544,350** |
| NET TO HEIRS FROM ESTATE IF INCOME IS PAID FROM ALL TRUSTS | | $ 6,970,944 |
| PLUS PRINCIPAL OF UNIFIED CREDIT TRUST | | $ 1,000,000 |
| PLUS PRINCIPAL FROM INSURANCE TRUST | | $10,000,000 |
| TOTAL NET TO HEIRS- ALL INCOME PAID TO SPOUSE ANNUALLY | | $17,970,944 |
| **INCREASE IN NET TO HEIRS** | | **$ 5,573,406** |
| **INCREASE IN NET TO HEIRS AS A PERCENTAGE OF NET TO HEIRS IF ALL INCOME IS PAID OUT** | | **31%** |

# APPENDIX TWO
# CRUMMEY POWERS ANALYSIS

FIVE AND FIVE GIFTS versus FULL ANNUAL EXCLUSION GIFTS

| | "FIVE AND FIVE GIFTS" | | | FULL ANNUAL EXCLUSION GIFTS | | |
|---|---|---|---|---|---|---|
| *YEAR* | *ANNUAL GIFT* | *GROWTH 4%* | *ENDING BALANCE* | *ANNUAL GIFT* | *GROWTH 4%* | *ENDING BALANCE* |
| 2000 | $5,000.00 | $0.00 | $5,000.00 | $20,000.00 | $0.00 | $20,000.00 |
| 2001 | $5,000.00 | $200.00 | $10,200.00 | $20,000.00 | $800.00 | $40,800.00 |
| 2002 | $5,000.00 | $408.00 | $15,608.00 | $20,000.00 | $1,632.00 | $62,432.00 |
| 2003 | $5,000.00 | $624.32 | $21,232.32 | $20,000.00 | $2,497.28 | $84,929.28 |
| 2004 | $5,000.00 | $849.29 | $27,081.61 | $22,000.00 | $3,397.17 | $110,326.45 |
| 2005 | $5,000.00 | $1,083.26 | $33,164.88 | $22,000.00 | $4,413.06 | $136,739.51 |
| 2006 | $5,000.00 | $1,326.60 | $39,491.47 | $22,000.00 | $5,469.58 | $164,209.09 |
| 2007 | $5,000.00 | $1,579.66 | $46,071.13 | $24,000.00 | $6,568.36 | $194,777.45 |
| 2008 | $5,000.00 | $1,842.85 | $52,913.98 | $24,000.00 | $7,791.01 | $226,568.55 |
| 2009 | $5,000.00 | $2,116.56 | $60,030.54 | $26,000.00 | $9,062.74 | $261,631.29 |
| 2010 | $5,000.00 | $2,401.22 | $67,431.76 | $26,000.00 | $10,465.25 | $298,096.55 |
| 2011 | $5,000.00 | $2,697.27 | $75,129.03 | $26,000.00 | $11,923.86 | $336,020.41 |
| 2012 | $5,000.00 | $3,005.16 | $83,134.19 | $28,000.00 | $13,440.82 | $377,461.22 |
| 2013 | $5,000.00 | $3,325.37 | $91,459.56 | $28,000.00 | $15,098.45 | $420,559.67 |
| 2014 | $5,000.00 | $3,658.38 | $100,117.94 | $30,000.00 | $16,822.39 | $467,382.06 |
| 2015 | $5,005.90 | $4,004.72 | $109,128.55 | $30,000.00 | $18,695.28 | $516,077.34 |
| 2016 | $5,456.43 | $4,365.14 | $118,950.12 | $32,000.00 | $20,643.09 | $568,720.44 |
| 2017 | $5,947.51 | $4,758.01 | $129,655.63 | $32,000.00 | $22,748.82 | $623,469.25 |
| 2018 | $6,482.78 | $5,186.23 | $141,324.64 | $34,000.00 | $24,938.77 | $682,408.02 |
| 2019 | $7,066.23 | $5,652.99 | $154,043.86 | $34,000.00 | $27,296.32 | $743,704.34 |
| 2020 | $7,702.19 | $6,161.75 | $167,907.81 | $36,000.00 | $29,748.17 | $809,452.52 |
| 2021 | $8,395.39 | $6,716.31 | $183,019.51 | $36,000.00 | $32,378.10 | $877,830.62 |
| 2022 | $9,150.98 | $7,320.78 | $199,491.26 | $38,000.00 | $35,113.22 | $950,943.84 |
| 2023 | $9,974.56 | $7,979.65 | $217,445.48 | $38,000.00 | $38,037.75 | $1,026,981.60 |
| 2024 | $10,872.27 | $8,697.82 | $237,015.57 | $40,000.00 | $41,079.26 | $1,108,060.86 |
| 2025 | $11,850.78 | $9,480.62 | $258,346.97 | $40,000.00 | $44,322.43 | $1,192,383.29 |
| 2026 | $12,917.35 | $10,333.88 | $281,598.20 | $42,000.00 | $47,695.33 | $1,282,078.63 |
| 2027 | $14,079.91 | $11,263.93 | $306,942.04 | $44,000.00 | $51,283.15 | $1,377,361.77 |
| 2028 | $15,347.10 | $12,277.68 | $334,566.82 | $44,000.00 | $55,094.47 | $1,476,456.24 |
| 2029 | $16,728.34 | $13,382.67 | $364,677.83 | $46,000.00 | $59,058.25 | $1,581,514.49 |
| 2030 | $18,233.89 | $14,587.11 | $397,498.84 | $48,000.00 | $63,260.58 | $1,692,775.07 |
| 2031 | $19,874.94 | $15,899.95 | $433,273.73 | $50,000.00 | $67,711.00 | $1,810,486.07 |
| 2032 | $21,663.69 | $17,330.95 | $472,268.37 | $50,000.00 | $72,419.44 | $1,932,905.52 |
| 2033 | $23,613.42 | $18,890.73 | $514,772.52 | $52,000.00 | $77,316.22 | $2,062,221.74 |
| 2034 | $25,738.63 | $20,590.90 | $561,102.05 | $54,000.00 | $82,488.87 | $2,198,710.61 |
| 2035 | $28,055.10 | $22,444.08 | $611,601.24 | $56,000.00 | $87,948.42 | $2,342,659.03 |
| 2036 | $30,580.06 | $24,464.05 | $666,645.35 | $56,000.00 | $93,706.36 | $2,492,365.39 |
| 2037 | $33,332.27 | $26,665.81 | $726,643.43 | $58,000.00 | $99,694.62 | $2,650,060.01 |
| 2038 | $36,332.17 | $29,065.74 | $792,041.34 | $60,000.00 | $106,002.40 | $2,816,062.41 |
| 2039 | $39,602.07 | $31,681.65 | $863,325.06 | $62,000.00 | $112,642.50 | $2,990,704.91 |
| 2040 | $43,166.25 | $34,533.00 | $941,024.31 | $64,000.00 | $119,628.20 | $3,174,333.10 |
| 2041 | $47,051.22 | $37,640.97 | $1,025,716.50 | $66,000.00 | $126,973.32 | $3,367,306.43 |
| 2042 | $51,285.82 | $41,028.66 | $1,118,030.98 | $68,000.00 | $134,692.26 | $3,569,998.68 |
| ***TOTALS*** | $640,507.25 | $477,523.74 | **$1,118,030.98** | $1,668,000.00 | $1,901,998.68 | **$3,569,998.68** |

**ADVANTAGE OF FULL GIFTING** **$2,451,967.70**
**PERCENTAGE FORGONE BY FIVE AND FIVE GIFTING** **68.68%**