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The Not-so Irrevocable Trust

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Nearly 23 years ago, I published an article entitled "The Not-so Irrevocable Trust," in which I analyzed the estate and gift tax consequences of various trust arrangements in the context of the then-current Internal Revenue Code and case law. At the time, I recommended arrangements in irrevocable life insurance trusts to create flexibility for such trusts while retaining their advantages as estate planning tools. Since then, despite (or perhaps because of) the dramatic changes in the code, the irrevocable life insurance trust has become a standard in the repertoire of the estate planner. It is certainly as vital an estate planning tool as it has ever been. Yet because of the perceived inflexibility, many wealthy people who could benefit greatly from such trusts hesitate, procrastinate, and ultimately refuse to create them.

The essence of an irrevocable trust's value in estate planning is quite simple: Although a trust is considered a person under the Internal Revenue Code, it never dies, and is therefore not subject to federal estate tax. Upon receipt of insurance proceeds, it is generally not subject to income tax (IRC Section 101 (a)). And if it is properly drafted, insurance proceeds received by an irrevocable life insurance trust that owns the policy are excluded from the taxable estate of the insured (and his or her spouse).

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In a typical scenario, a wealthy individual is encouraged by his or her financial advisors to create a trust that will purchase, own, and become nominal beneficiary of a life insurance policy. Policy premiums are paid by the trust from gifts made by the grantor to the trust, subject to powers of withdrawal given to trust beneficiaries (the so-called Crummey powers). Gifts of up to $10,000 per year per donee ($20,000 for joint gifts with the grantor's spouse) may be contributed and excluded from federal gift tax through the granting of such Crummey powers. If the grantor-insured is married, the insurance proceeds typically remain in trust after his or her death, providing for the surviving spouse until the latter's death, at which time the trust corpus is distributed according to the dispository provisions of the trust. In most instances, the insurance policy or proceeds comprise the entire corpus of the trust.

Much of what cannot be known in advance may be provided for without compromising a trust's irrevocable status.

The problem: At the time the trust is created, the grantor is usually in good health and presumably many years from the event – death – which will trigger the dispositive provisions of the trust. Future changes in the grantor's and beneficiaries' life circumstances – and therefore in the grantor's wishes regarding the allocation and distribution of trust assets – cannot be known at the outset. Yet the trust must be irrevocable for the insurance proceeds to remain out of the grantor's taxable estate. Thus, the grantor is boxed into a plan which, years later, may not serve his or her best interests, or be in accord with his or her dispository intent at that time. Nor can future changes in tax laws that might impair the effectiveness of the trust's original strategy be predicted. For example, a future limitation by Congress upon the number of donees eligible for annual exclusion gifts could have severe gift tax consequences.

The purpose of this article is to take a fresh look at the irrevocable life insurance trust – to demonstrate that irrevocability is not synonymous with inflexibility, and to once again suggest, in terms of what the law is today, ways in which the estate holder can have his cake and eat it too.

Much of what cannot be known in advance may be provided for without compromising a trust's irrevocable status.

The trust may provide that the insured's spouse ceases to be a beneficiary or trustee in the event of divorce. Such a provision was permitted in a 1988 IRS Technical Advice Memorandum (TAM 88-19-001). In that ruling, the act of divorcing one's spouse was held to be an act of independent significance which would not constitute an incident of ownership. The trust may also limit the term "spouse" to only the person to whom the grantor is married at the date of execution of the instrument. Thus, if the original spouse dies, no subsequent spouse (or potential ex-spouse) will be a beneficiary.

The trust may provide that a beneficiary or the beneficiaries together may replace a trustee with an independent (non-grantor) trustee or a corporate trustee. If a beneficiary is to be a trustee, a provision must be included limiting the beneficiary's powers to distribute assets to himself to an ascertainable standard relating to education, health, maintenance, and support and another prohibiting the beneficiary from exercising the power in favor of anyone he or she has an obligation to support. The trust might also provide that a beneficiary could become a trustee or co-trustee upon the occurrence of an event, such as the death of a prior trustee or attainment of a certain age. The trustee may also be given the power to name a co-trustee.

If the grantor possesses an unrestricted power to remove the trustee and appoint anyone (including himself) successor trustee, he is considered as having the powers of the trustee.

If a grantor of an irrevocable trust retains discretionary power as trustee to distribute trust assets, the trust property is includable in his estate under Code Sections 2036(a) and 2038(a). If the grantor possesses an unrestricted power to remove the trustee and appoint anyone (including himself) successor trustee, he is considered as having the powers of the trustee. In a 1979 Revenue Ruling (Rev. Rul. 79-353, 1979-2 C.B. 325), the IRS stated that the grantor's retention of the power to remove a corporate trustee and substitute another corporate trustee is equivalent to the retention of discretionary power over trust assets.

Important recent developments in the law, however, now give the grantor broad power to remove and replace a trustee without incurring adverse estate tax consequences. In the case of *Estate of Wall* (1993), it was held that the grantor's reservation of the right to replace the corporate trustee with another corporate trustee did not constitute a retained power causing inclusion of the trust assets in the grantor's estate. In the *Estate of Vak* (1992), the court held that where the grantor reserved the right to remove and replace the trustees with successor individual trustees *who were not related or subordinate to him*, the grantor had not retained dominion and control over the transferred property.

In a recent Revenue Ruling (Rev. Rul. 95-58, 1995-36 I.R.B. 16), the IRS, conceding defeat, revoked the 1979 Revenue Ruling. It also held, with respect to the (grantor) decedent, as follows: "...even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of Section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income." This important new ruling further enhances flexibility with respect to irrevocable trusts.

The grantor may be given the right to remove a Crummey power holder or exclude a designated beneficiary from exercising such a withdrawal power. This protects against a situation where a beneficiary becomes financially irresponsible.

It is important to ensure that there is always a sufficient number of persons holding Crummey withdrawal powers to qualify transfers to a trust for the annual gift tax exclusion. This can be accomplished by naming alternate power holders in the event one or more power holders dies. Such alternate power holders must also have a beneficial interest in the trust or the IRS may not recognize his or her power.

The trustee may be given the power to reduce the amount of each donee's Crummey withdrawal power. This may be useful if federal legislation alters the Crummey powers. The trustee would be able to limit the aggregate amount of withdrawal granted under the trust so that it does not exceed the amount that could be transferred to the trust tax free. The trustee could also be given the power to change the administrative provisions of the trust, such as powers of management, investment, custody of assets, and the power to allocate receipts between principal and income.

A *non-beneficiary* trustee may be given the power to distribute the property to the beneficiaries based upon their best interests. Trust assets may be distributed, for example, to buy a vacation home, if the trustee determines it is in the best interest of a beneficiary.

The trustee may be given the power to lend funds to any person, including the grantor or his or her estate, for adequate consideration.

The trustee may be given the power to terminate the trust and distribute the policy to the grantor's spouse or other beneficiaries, such as adult children. However, the trustee should not be given the power to distribute to the grantor, because the existence of such a power, even if never exercised, risks inclusion of the insurance proceeds in the grantor's estate. To avoid a successful IRS argument that broad discretionary trustee powers make the Crummey powers illusory, the trust should contain language which provides that the trustee's termination right cannot eliminate a beneficiary's withdrawal right.

A power of appointment is the power to direct the disposition of property that belongs to someone other than the power holder. The grantor of an insurance trust may convey such a power to any trust beneficiary, who may then direct the use of – or appoint – property remaining in trust after the grantor's death. Such a power is considered a general power of appointment when the donee (i.e., the person given the power) may convey an interest in the property to whomever he or she pleases, including himself or herself. A power is considered a limited (or special) power of appointment when the donee is authorized to appoint interests in the property only to specified objects or classes of objects, other than the donee, the donee's estate, or creditors of the donee or his or her estate. An object of a power is the person, corporation, or charity to whom or to which the property may be appointed. A general power of appointment causes the subject property to be included in the estate of the power holder, whereas a limited power does not. In neither case, however, is the irrevocability of the trust – and thus the exclusion of its corpus from the grantor's estate – jeopardized by granting powers of appointment to trust beneficiaries.

A limited power of appointment is a powerful tool in building flexibility into an irrevocable insurance trust, giving a non-trustee the ability to override the typical *per stirpes* distribution on the death of the insured (or upon the death of the survivor of the insured and his or her spouse) and to redirect the distribution of trust assets in the event of changed circumstances to specific parties. It allows the deferral of decision until the most appropriate time for making the decision.

A few examples will illustrate how limited powers increase irrevocable trust flexibility. Assume that by the time of the death of the insured or the insured's spouse, one child turns out to be financially secure and does not need a full share of the trust corpus. The power holder may hold the right to allocate a lesser share – or even no share – to that child or to his or her descendants. Even where it is desired that such child receive his or her full share, it may not be to that child's advantage to receive his or her share outright. Instead, it might be desirable from an estate tax planning standpoint to leave that child's share to a lifetime trust for his or her benefit, so that the property would not be included in the child's estate. Thus, the limited power can be a powerful tool in planning to take advantage of the $1 million per grantor exemption from tax on generation-skipping transfers (GST).

In planning for trusts not sheltered by the GST exemption, powers may be structured to cause general powers of appointment to be attributed to children (non-skip persons), causing their interests to be included in their estates, on the assumption that regular estate tax rates are preferable to the generation-skipping tax. Such powers may be technically general for GST purposes, but still afford the power holder limited discretion. For example, the authority in the successor generation to appoint could be limited to creditors of the power holder's estate, supplemented with a limited power to appoint to certain classes of beneficiaries, descendants, or charities.

Rather than growing wealthy, a child may have gotten into serious financial difficulties. If the child receives his or her share outright, the entire share may be attached by the child's creditors. In such case, the power holder may establish an "asset protection trust" and leave such assets for the child's benefit, so that the trust assets are protected from creditors.

Such a power given to the surviving spouse of the grantor might enable that spouse to favor one child over another in the distribution of trust assets, thus providing the children with an incentive to treat the surviving parent appropriately during his or her old age. On the other hand, the existence of such a power runs the risk that one child or other descendant may exercise undue influence over an elderly – and perhaps mentally diminished – power holder.

The drafter of the trust must nevertheless be careful, in granting a power of appointment, to avoid creating a general power of appointment. A general power results in inclusion of the property subject to the power in the estate of the power holder at his or her death. An additional concern is that the exercise, lapse, or release of such general power during a power holder's life is treated as a gift. Powers need not be completely unrestricted to be considered general. For example, the power to appoint to one's self, one's creditors, one's estate, or the creditors of one's estate constitutes a general power of appointment.

A beneficiary may, however, be given the power to appoint trust assets to himself or his descendants, subject to an ascertainable standard, without having the assets included in the beneficiary's estate. Under the regulations, this limited power could include providing for health, maintenance, education, support, support in reasonable comfort, maintenance in health and reasonable comfort, support in the accustomed manner of living, education, including college and professional education, and medical, dental, hospital and nursing costs, and the expenses of invalidism.

This power need not require the holder to consider the wealth of a beneficiary, or require the beneficiary to exhaust his or her financial resources before property may be appointed by the holder of the power to himself or herself or another beneficiary. Thus, in a first-to-die policy where the wife is the trustee-beneficiary, she may be able to appoint the policy to herself pursuant to an ascertainable standard and thereby disgorge all the assets of the trust.

Although an irrevocable trust appears to be an inflexible instrument, it can be structured to be surprisingly flexible.

In addition to amounts permissible for self-appointment subject to an ascertainable standard, the power holder may also be given the right to withdraw an amount equal to the greater of $5,000 or 5 percent of the trust corpus annually, without being treated as the holder of a general power. But if the power holder dies, the amount subject to the power in excess of that $5,000 or 5 percent is includable in his or her estate.

Although an irrevocable insurance trust appears by its nature to be an inflexible instrument, it can be structured to be surprisingly flexible. By drafting the trust to anticipate future changes in the law or family circumstances, allowing replacement of the trustee, giving the grantor the power to exclude a particular originally named Crummey power holder, providing for alternate power holders, giving the trustee the power to change the non-dispositive provisions of the trust, providing for a broad best-interest standard of distribution, giving the trustee the power to make loans, including a bail-out provision, and judiciously using limited powers of appointment, the trust may be able to deal effectively with future changes within the confines of the trust instrument. ■

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