Insight on Estate Planning

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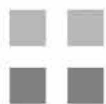

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The Crummey trust: Still relevant after all these years

Traditionally, trusts used in estate planning contain "Crummey" withdrawal powers to ensure that contributions qualify for the annual gift tax exclusion. Today, the exclusion allows you to give up to $14,000 per year ($28,000 for married couples) to any number of recipients.

Now that the gift and estate tax exemption has reached an inflation-adjusted $5.34 million, fewer people have to worry about gift and estate taxes. But, for many, the annual exclusion continues to be an important estate planning strategy. Thus, Crummey powers continue to be relevant.

Why make annual exclusion gifts?

Despite the record-high exemption, there are two important reasons to make annual exclusion gifts. First, if your wealth exceeds the exemption amount, an annual gifting program can reduce or even eliminate your liability for gift and estate taxes.

Second, even if your wealth is well within the exemption, annual gifting guarantees that the amounts you give are permanently removed from your taxable estate. If you rely on the exemption, there's no guarantee that Congress won't reduce the amount in the future, exposing your estate to tax liability.

What are Crummey powers?

The annual exclusion is available only for gifts of "present interests." But a contribution to a trust is, by definition, a gift of a *future* interest. To get around this obstacle, trusts typically provide beneficiaries with Crummey withdrawal powers. By giving them the right to withdraw

Beware the 5&5 rule

Building Crummey powers into a trust allows you to enjoy the benefits of the annual gift tax exclusion, but it's important to avoid granting withdrawal rights that are too large in relation to the size of the trust. Under the IRS's "5&5" rule, if a beneficiary's withdrawal rights exceed the greater of $5,000 or 5% of the trust principal, allowing those rights to lapse may cause the beneficiary to become a trust grantor, which can trigger a variety of unwanted gift and income tax consequences.

There are several strategies you can use to avoid violating the 5&5 rule. One is to limit withdrawals to the greater of $5,000 or 5% of the trust principal. Another is to contribute sufficient funds to the trust to ensure that no annual exclusion gifts will exceed the 5&5 limits.

Perhaps the most effective strategy is to increase your number of beneficiaries. For example, suppose you establish an irrevocable life insurance trust for the benefit of your two children and make annual exclusion gifts of $14,000 per beneficiary to cover the $28,000 premium. If the trust principal is only $200,000, those gifts will violate the 5&5 rule. But you can stay within the rule by adding a third beneficiary and limiting each beneficiary's withdrawal rights to no more than $10,000.

trust contributions for a limited period of time (usually 30 to 60 days), it's possible to convert a future interest into a present interest, even if the withdrawal rights are never exercised.

In order for Crummey powers to work, the trust must give beneficiaries *real* withdrawal rights. Generally, that means you can't have an agreement with your beneficiaries — express or implied — that they won't exercise their withdrawal rights (although it's permissible to discuss with them the advantages of keeping assets in the trust).

It also means that the trust should contain sufficient liquid assets so that beneficiaries can exercise their withdrawal rights if they choose to. Suppose, for example, that you set up an irrevocable life insurance trust and use annual exclusion gifts to cover the life insurance premiums. If contributions are used immediately to pay the premiums, any Crummey powers conferred by the trust are illusory: The trust has no liquid funds with which to satisfy a withdrawal request.

To avoid this problem, it's best to keep sufficient liquid assets in the trust to cover potential withdrawals or to time contributions so that life insurance premiums aren't paid until the Crummey withdrawal period has expired.

In designing a Crummey trust, keep in mind that excessive withdrawal rights can trigger adverse tax consequences for the beneficiaries. (See "Beware the 5&5 rule" on page 2.)

Must beneficiaries know withdrawal rights?

The IRS has long taken the position that a trust contribution isn't a present-interest gift — and, therefore, is ineligible for the annual exclusion — unless beneficiaries receive actual notice of their withdrawal rights and a "reasonable opportunity" to exercise those rights. In at least one case, the U.S. Tax Court ruled that the notice wasn't required. Nevertheless, to avoid an IRS challenge, it's prudent to provide beneficiaries with written notice of their withdrawal rights, preferably via certified mail.

There's no specific requirement regarding the amount of time that constitutes a "reasonable opportunity." The IRS has indicated in private rulings, however, that 30 days is sufficient, while three days is not. Common practice is to give beneficiaries between 30 and 60 days to exercise their withdrawal rights.

Handle with care

If you wish to make annual exclusion gifts to a trust, be sure the trust provides the beneficiaries with Crummey withdrawal powers. Crummey trusts present several potential traps for the unwary, so be sure your trust is drafted by an experienced professional. ■

Now's the time for a charitable lead trust

Affluent families who wish to give to charity while minimizing gift and estate taxes should consider a charitable lead trust (CLT). These trusts are most effective in a low-interest-rate environment, so conditions for taking advantage of a CLT currently are favorable. Although interest rates have crept up a bit in recent years, they remain extremely low.

How a CLT works

A CLT provides a regular income stream to one or more charities during the trust term, after which the remaining assets pass to your children or other noncharitable beneficiaries. Essentially, it's the opposite of a charitable remainder trust (CRT), which provides income to your noncharitable beneficiaries during the trust term and leaves the remainder to one or more charities.

If your beneficiaries are in a position to wait for several years (or even decades) before receiving their inheritance, a CLT may be an attractive planning tool. That's because the charity's upfront interest in the trust dramatically reduces the value of your beneficiaries' interest for gift or estate tax purposes.

2 types of CLTs

There are two types of CLTs: 1) a charitable lead annuity trust (CLAT), which makes annual payments to charity equal to a fixed dollar amount or a fixed percentage of the trust assets' initial value, and 2) a charitable lead unitrust (CLUT), which pays out a set percentage of the trust assets' value, recalculated annually. Most people prefer CLATs because they provide a better opportunity to maximize the amount received by one's noncharitable beneficiaries.

Typically, people establish CLATs during their lives (a strategy known as an "inter vivos" CLAT) because it allows them to lock in a favorable interest rate. Another option is a testamentary CLAT, or "T-CLAT," which is established at death by one's will or living trust.

T-CLATs offer some important advantages: They allow you to retain control over the assets during your life and, because the assets are transferred at death, their basis is "stepped-up" to the date-of-death value, minimizing or eliminating income taxes in the event they're sold. The main drawback to a T-CLAT is uncertainty about interest rates. If rates are substantially higher when the trust is funded at your death, its ability to reduce estate taxes will be diminished.

Another issue to consider is whether to design a CLAT as a grantor or nongrantor trust. Nongrantor CLATs are more common, primarily because the grantor avoids paying income taxes on the trust's earnings. However, grantor CLATs also have advantages. For example, by paying income taxes, the grantor allows the trust to grow tax-free, enhancing the beneficiaries' remainder interest. Also, the grantor receives a charitable income tax deduction based on the present value of the charitable payment stream (as opposed to a nongrantor CLAT, for which the *trust* deducts amounts paid out to charity).

Interest matters

Here's why CLATs are so effective when interest rates are low: When you fund a CLAT, you make a taxable gift equal to the initial value of the assets you contribute to the trust, less the value of all charitable interests. A charity's interest is equal to the total payments it will receive over the trust term, discounted to present value using the Section 7520 rate, a conservative interest rate set monthly by the IRS. As of this writing, the Sec. 7520 rate has fluctuated between 2.2% and 2.4% this year.

If trust assets outperform the applicable Sec. 7520 rate (that is, the rate published in the month the trust is established), the trust will produce wealth transfer benefits. For example, if the applicable Sec. 7520 rate is 2.5% and the trust assets actually grow at a 7% rate, your non-charitable beneficiaries will receive assets well in excess of the taxable gift you report when the trust is established.

If your beneficiaries are in a position to wait for several years (or even decades) before receiving their inheritance, a CLT may be an attractive planning tool.

Act now

If a CLAT appeals to you, the sooner you act, the better. In a low-interest-rate environment, outperforming the Sec. 7520 rate is relatively easy, so the prospects of transferring a significant amount of wealth tax-free are good. ▮

Good intentions

Don't let asset transfers run afoul of the law

With the current estate tax regime of a high gift and estate tax exemption amount and low estate tax rates, transferring wealth is becoming the focus of estate planning rather than reducing estate tax liability. And with asset values still relatively low, it's an ideal time to transfer your wealth to loved ones.

Before taking action, however, it's important to be familiar with fraudulent transfer laws. Simply put, your creditor can challenge your gifts, trusts and retitled property as fraudulent transfers.

Understanding UFTA

Most states have adopted the Uniform Fraudulent Transfer Act (UFTA). The act allows creditors

to challenge transfers involving two types of fraud that you should be mindful of as you weigh your estate planning options.

Actual fraud occurs when making a transfer or incurring an obligation "with actual intent to hinder, delay or defraud any creditor," including current creditors and probable future creditors. That doesn't mean the fraudulent transfer laws protect anyone who could conceivably become a creditor some day. If that were the case, asset protection planning would be futile.

But suppose a real estate investor discovers that one of his properties is contaminated with hazardous waste and immediately transfers all of his assets to an offshore trust. Clearly, that would be a fraudulent transfer even though no one has actually filed a lawsuit against the investor yet.

Just because you harbor no intent to defraud creditors doesn't mean you're safe from an actual fraud challenge. Because a court can't read your mind, it will consider the surrounding facts and circumstances to determine whether a transfer involves fraudulent intent. So before you make gifts or place assets in a trust, consider how a court might view the transfer.

Constructive fraud is a more significant risk for most people because it doesn't involve intent to defraud. Under UFTA, a transfer or obligation is constructively fraudulent if you made it without receiving a reasonably equivalent value in exchange for the transfer or obligation *and* you either were insolvent at the time or became insolvent as a result of the transfer or obligation.

Just because you harbor no intent to defraud creditors doesn't mean you're safe from an actual fraud challenge.

"Insolvent" means that the sum of your debts is greater than all of your assets, at a fair valuation. You're presumed to be insolvent if you're not paying your debts as they become due.

Generally, the constructive fraud rules protect only *present* creditors — that is, creditors whose claims arose before the transfer was made or the obligation was incurred. In some cases, however, a future creditor may challenge a transaction if it leaves you with assets that are unreasonably small or if you intend or believe (or reasonably should believe) that you'll be unable to pay your debts as they become due.

Factoring in insolvency and net worth

Most estate planning strategies have an asset protection component. You may make gifts to your children or set up trusts to minimize taxes or to control how and when your beneficiaries receive your wealth. But, as an added benefit, the assets are removed from your estate and protected from your creditors.

By definition, when you make a gift — either outright or in trust — you don't receive reasonably equivalent value in exchange. So if you're insolvent at the time, or the gift renders you

insolvent, you've made a constructively fraudulent transfer, which means a creditor could potentially undo the transfer.

To avoid this risk, analyze your net worth before making substantial gifts. Even if you're not having trouble paying your debts, it's possible to meet the technical definition of insolvency.

Consult your advisor

Before taking action to transfer your wealth, discuss fraudulent transfer laws with your estate planning advisor. The laws vary from state to state, so it's important to understand how they may affect your estate plan.

Estate Planning Pitfall

Watch out for IRA traps

An IRA can be a valuable estate planning tool, offering tax-deferred growth (tax-free in the case of a Roth IRA) and asset protection. But two recent developments create traps for the unwary.

The first involves the "one-rollover-per-year" rule, which allows you to withdraw IRA funds tax- and penalty-free — as often as once a year — provided you reinvest the funds in the same or another IRA within 60 days. Until recently, it was generally accepted that this limit applied separately to each of a taxpayer's IRAs. In other words, if you had three separate IRAs, you could do as many as three 60-day rollovers per year. Even the IRS's proposed regulations and publications say that the one-rollover-per-year rule applies on an IRA-by-IRA basis. But, in a recent decision, the U.S. Tax Court ruled that taxpayers are limited to one rollover per year in the aggregate, regardless of how many IRAs they have.

The IRS plans to follow the Tax Court's decision and, accordingly, has withdrawn the relevant language from the proposed regs. The IRS will begin to enforce the new limit for rollovers made after Dec. 31, 2014. Keep in mind that the rule applies only to rollovers in which the taxpayer obtains control of the funds. As before, there's no limit on trustee-to-trustee transfers between IRAs.

The second development involves inherited IRAs. Recently, the U.S. Supreme Court held that these IRAs aren't protected from creditors in bankruptcy. Generally, this is a concern only for nonspousal beneficiaries, because spouses can obtain creditor protection by rolling over inherited IRAs into their own IRAs. But if you leave an IRA to a nonspousal beneficiary — and you're concerned about the risk of bankruptcy — it may be preferable to establish an asset protection trust for that beneficiary and name the trust as beneficiary of the IRA.

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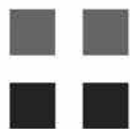

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