Tax Court Goes Easy On Lax Crummey Protocols

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Irrevocable life insurance trusts are a mainstay of transfer tax planning with the object of avoiding estate tax on life insurance policy payouts. Such trusts often provide a Crummey withdrawal feature to one or more trust beneficiaries, so that premium payments by the grantor are eligible for exclusion from taxable gifts as present interest annual exclusion gifts.

Clients are instructed that the grantor should transfer premium payments to the trust, and that the trust should remit the proceeds to the insurance company. Further, the trustee should provide notice to the beneficiaries of their withdrawal rights at or about the time of the contributions of premium amounts to the trust. These protocols are intended to minimize the risks of IRS challenge to present interest status of the contributions.

Oftentimes, clients disregard these instructions, and the grantor makes direct payments of premiums to the insurance company. This is what occurred in the recent Tax Court case of Estate of Turner v. Commissioner. As one might expect, the IRS challenged the present interest exclusion status of the premium payments. However, in a boon to other taxpayers who have similarly funded their premium payments, the Tax Court still allowed the present interest exclusion treatment.

The IRS first argued that the trust beneficiaries had no meaningful rights to withdraw the premium payments since they were not first paid to the trust. The Tax Court noted that the key factor in a present interest gift such as this is whether the beneficiary had the "legal right to demand" the withdrawal. Under the terms of the trust, the beneficiaries have the absolute right and power to demand withdrawals from the trust after each direct or indirect transferred to the trust. That the funding occurred indirectly was thus irrelevant to the right to demand.

The IRS also argued that there was no meaningful withdrawal rights because some, or even all, of the beneficiaries may not have known they had the right to demand withdrawals per the absence of notice to them. Again, the Tax Court indicated such lack of notice did not affect the "legal right to demand" withdrawals and thus lack of notice was not determined to be an impediment to present interest status. The court appropriately noted that lack of notice was not an impediment in the Crummey case, either.

Does this mean that taxpayers can now make direct premium payments that bypass the trusts, and avoid delivering withdrawal notices to beneficiaries? For taxpayers that end up in the Tax Court, and that are willing to front the litigation costs to get there, the answer is probably yes. However, since the IRS has not conceded this issue, and since other courts may not agree with this interpretation, proper contribution and withdrawal notice protocols should still be observed (but with the comfort that favorable Tax Court treatment will backstop the protocols if they are not fully observed). Also, practitioners should confirm that their life insurance trust forms allow for withdrawals for both direct *and indirect* contributions.

Estate of Turner v. Comm'r, T.C. Memo. 2011-209 (Aug. 30, 2011)

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