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ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

Implementing a *Crummey*-Style ILIT:
What Financial Professionals Need to Know

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Say you've met a married couple with a combined net worth of $35 million. They have implemented basic estate planning with wills that leave all assets to the surviving spouse at the first death and then to their kids at the second death.

You've described the federal estate tax problem for them. There's no issue at the first spouse's death, thanks to the unlimited marital deduction. At the second death, based on this year's exemptions and tax rates, their kids can expect about $3.1 million of wealth to be lost to federal estate taxes.

You also explain to your clients that in less than two years—if Congress and the president fail to act—the federal estate tax exposure is likely to be about $10 million.

The clients are disturbed and are interested in your answers to their problems.

The key part of the standard plan is to manage the taxes that can't be avoided. For most, that means purchasing an appropriate amount of life insurance in an irrevocable life insurance trust (ILIT).

While nearly all life insurance death benefits are income tax-free, the death proceeds from a personally owned policy are included in the insured's estate for estate tax purposes. For clients who have a federal estate tax issue, personal ownership of life insurance only exacerbates the problem.

Please keep reading to learn more and feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

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Implementing a *Crummey*-Style ILIT: What Financial Professionals Need to Know

Our hypothetical clients might have their adult children own coverage on the clients' lives to help manage estate taxes. That strategy doesn't work in every family, especially if one or more of the kids cannot be relied on to always do the right thing.

An ILIT is treated as if the insurance owned by it is owned by the kids for estate tax purposes. That is, if life insurance is owned by a properly created, funded, and administered ILIT, the death proceeds should be excluded from the insured's taxable estate.

While implementing an ILIT can make a great deal of sense for our high-net-worth clients, sometimes difficult details need to be addressed. In this article, we will discuss many of the obstacles that can arise when delivering life insurance into the most common type of irrevocable trusts.

ILIT Basics

The ILIT is one of the most conservative, reliable, tested, and versatile estate planning tools around. We usually think of it in its *Crummey*-style implementation.

If we have a married couple with estate tax issues, one of the spouses might create an irrevocable trust which is designed to own life insurance. The couple work with their estate planning attorney to have the right language included in the ILIT. The trust could provide that it is for the benefit of the grantor's spouse during her lifetime and for the benefit of the children thereafter.

The trustee of the trust makes the decision to apply for insurance on the life of the insured grantor. The insured makes gifts to the trustee of the ILIT to cover the premiums.

WHAT MAKES THINGS *CRUMMEY*?

Under normal gift tax rules, a donor can make federal gift tax-free transfers to a family member of up to $18,000 each year (in 2024). However, gifts of "future interests" (gifts where the donee does not have the immediate, unfettered, and ascertainable right to use, possess, or enjoy the gift) in trust generally do not qualify for the annual exclusion. See Internal Revenue Code Section 2503 (b). A gift must be one of "present interest" to qualify for the annual exclusion.

To overcome the fact that gifts into a trust would not otherwise qualify for the gift tax exclusion, the *Crummey*-style ILIT was developed. In the case of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the federal court ruled that gifts into a trust can qualify as present interest gifts if the beneficiary has the immediate right to take the gift out of the trust.

What if a beneficiary decides to take a gift out of the trust? Under those circumstances, the trustee must send them the money! The possibility of a beneficiary withdrawal might convince a high-net-worth client not to draft the ILIT with *Crummey* withdrawal provisions. However, in most cases, the grantor can coach beneficiaries at the trust's inception about the overall purpose and explain how exercising the withdrawal right might lead to a beneficiary ultimately getting less benefit from the trust.

Since *Crummey* was decided, a number of rulings, cases, and Service pronouncements have refined how its principles are applied to ILITs.

Actual Notice

In Revenue Ruling 81-7, 1981-1 CB 474, the Service considered this situation:

> On December 29, 1979, G created and funded an irrevocable trust for the benefit of A, a legally competent adult, for A's life with remainder to B. The trust instrument gives the independent trustee absolute discretion to distribute trust income and principal to A for life. Income not distributed is added to corpus. At A's death any remaining, undistributed corpus and income are payable to B free of trust.
>
> In addition, the trust instrument provides as follows:
>
> > The beneficiary may demand immediate distribution at any time (up to December 31 of the year in which an addition, including the original corpus, is made to the trust) of the sum of $3,000 per donor or the amount of the addition from each donor whichever is less. The demand right is not cumulative.
>
> Neither G nor the trustee informed A of the demand right with regard to the initial contribution to the trust before the demand right had lapsed.

The IRS concluded that a trust beneficiary must actually know that a gift has been made to the trust, and that the beneficiary has the right to withdraw it, before the gift qualifies as a present interest.

While Revenue Ruling 81-7 has never been revoked, courts have been reluctant to require actual notice to beneficiaries as a prerequisite for annual exclusion availability.
For example, in *Turner v. Commissioner*, TC Memo 2011-209, the Tax Court said that where the beneficiaries of the trust may not have known they had the power to withdraw, it did not affect their legal right to do so, and so the withdrawal power (and exclusion claim) were valid.

Is actual notice of the withdrawal right required, then? Many attorneys take the conservative position that it's a best practice to include actual notice to the beneficiaries by the trustee.

Duration of Withdrawal Right

When implementing a *Crummey* ILIT, a beneficiary's right to withdraw a contribution may be limited in time. It makes practical sense for a withdrawal window to close, as the trustee gains flexibility to use donated cash to purchase assets more consistent with the trust's overall purpose. In the case of an ILIT, the alternative asset would be life insurance.

Crummey withdrawal windows open for at least thirty days in the year the gift is made have been recognized as valid by the Service. See Private Letter Ruling 8004172.

Although the source of the 30-day waiting period is a private letter ruling—and it cannot be relied upon as precedent—most estate planning attorneys have become comfortable with using it as the minimum standard.

Number of Annual Exclusion Gifts

For many of our high-net-worth clients seeking to buy life insurance in an ILIT, the premium can be substantial. Under such circumstances, it might be a challenge to find enough annual exclusions to cover the gift.

> Example: John and Mary are married with four children. They have a combined net worth of $50 million. They decide to buy $10 million of survivorship insurance coverage to be owned by an ILIT. The annual premium for the plan is $180,000.
>
> John and Mary join together to make gifts to the trust in the amount of $36,000 per child—using up their annual exclusion amounts for 2024. With four children, they can make annual exclusion gifts of $144,000, which is $36,000 less than the annual premium needed for the policy.

How might the couple in this example provide the rest of the money needed for the life insurance premium? There are a number of possibilities—more about that later—but one strategy would be to add more *Crummey* beneficiaries to the ILIT.

In *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (29 July 1991), the ILIT provided that remote contingent beneficiaries could be given Crummey withdrawal rights. The Service argued that only the withdrawal rights of current trust beneficiaries should be recognized for gift tax purposes. The Tax Court ruled that all the beneficiaries' rights of withdrawal would be recognized.

In *Estate of Kohlsaat*, No. 22465-94 (U.S.T.C. 1997), the IRS continued to argue that only the withdrawal rights of current beneficiaries should be honored for annual exclusion purposes. However, the taxpayer was able to successfully claim the annual gift tax exclusion with respect to each of 16 contingent beneficiaries of the trust.

A Less Obvious Gift Tax Issue

The IRS has decided that Section 2514(e) creates a possible trap for the beneficiaries of an ILIT. If a beneficiary has a right to take a withdrawal from ILIT, and the beneficiary fails to do so, that beneficiary is considered to be making a gift to the other trust beneficiaries. The gift is taxable—to the extent the unexercised right is worth more than $5,000 or 5 percent of what's in the trust—whichever is greater. This is the so-called "five and five" limitation.

If the trust language does not make special provision for the five and five limitation, the beneficiaries may be making unexpected gifts. Furthermore, because the gifts are not gifts of present interests, they do not qualify for the annual exclusion. The trust beneficiaries would be expected to file gift tax returns under such circumstances, using up part of their own lifetime estate and gift tax exemptions.

OTHER RELEVANT TAX ISSUES

In addition to the string of cases refining our understanding of withdrawal powers, a number of cases may test the estate tax objectives of ILITs. For example:

1. The reciprocal trust doctrine may cause two complementary ILITs implemented for the benefit of each of the spouses and children to be includible in the estate of the decedent. See Private Letter Ruling 9235025.
2. The grantor's right to remove the trustee and appoint a replacement trustee who is *subordinate* to the grantor may cause trust-owned life insurance to be included in the grantor's taxable estate. See Revenue Ruling 95-58.
3. Transfers of existing life insurance to an ILIT are subject to inclusion in the insured's estate if the transfer occurred within three years of death. See Internal Revenue Code Section 2036. If the details of implementation are incorrectly done, the "three-year rule" may be unexpectedly applied, even if new coverage is purchased to be owned by the ILIT.

***Crummey*-Style ILIT Implementation**

In a perfect world, most *Crummey*-style ILITs would be implemented this way:

1. The ILIT is drafted by the lawyer.
2. The ILIT trustee opens a trust bank account.
3. The grantor sends a check to the trustee.
4. The trustee of the ILIT sends 30-day *Crummey* notices to the beneficiaries.
5. The beneficiaries decide not to withdraw the money.
6. The trustee decides to apply for insurance on the life of the grantor.
7. The insurance is approved.
8. The trustee pays the premium.

The reason for these theoretical steps is to most closely conform to the requirements of the *Crummey* case and its subsequent set of rules, regulations, and cases.

In the real world, it's rare for a client to create and fund an ILIT before the client knows whether life insurance is available for a reasonable price. A real-world implementation might go like this:

1. The life insurance application is taken.
2. The coverage is approved for delivery within a short period of time.
3. The client tries to persuade his attorney to draft an ILIT within the delivery window.
4. For various reasons, the ILIT cannot be drafted—much less funded—within that window.
5. The client pays for the coverage personally because he's afraid his insurability might be adversely affected by waiting for the ILIT.
6. The coverage is actually placed into the trust after the insurance is put into effect.

With an imperfect real-world implementation of the type described, the insured would be running a three-year risk of estate tax inclusion of the death benefit.

DEALING WITH SOME OF THE IMPERFECTIONS

There are plenty of competing interests at work during the implementation of insurance owned by an ILIT. The client, insurance professional, insurance company, attorney, and client's tax professional are all likely to be stakeholders in the outcome. The insurance professional is likely to have to take the lead in coordinating efforts to bring off a successful conclusion.

As we discussed in the implementation section of this article immediately preceding, the application for the insurance is likely to be the first step taken in a real-world situation. That fact can create problems and add pressures to the process.

Some of the pressures center around the availability of *Crummey*-generated gift tax exclusions. *Crummey* issues generally have potential gift tax consequences.

Other pressures center around the three-year possibility of estate tax inclusion of the policy's death benefit.

Starting the Underwriting Process

The biggest fear in starting the underwriting process before the ILIT in in place is the possibility of the three-year estate tax inclusion of the death benefit. If the contract is owned by the insured during the issue process, then the danger of inclusion is real.

On the other hand, if the underwriting process is delayed, it creates other nontax risks:

- The client may not get the best offer due to the fact that the ability to shop around is limited.
- The client may experience a health event rendering her or him uninsurable.

The IRS has conceded that until a premium is paid, the life insurance policy does not exist. Most attorneys, then, will find it acceptable for the insured to be the initial applicant for life insurance coverage with the idea that a trust will be named as the real permanent owner before any money is sent to the insurance company.

Thirty Days Is Not Enough

Assume the application for insurance has been approved and the ILIT has been drafted. The underwriter has given the agent a 15-day window within which the policy must be delivered, or else the underwriting offer will be withdrawn.

The client can make a cash gift to the trust, but the first premium payment deadline will expire prior to the *Crummey*-withdrawal window closing. What to do? Some might suggest having the trust beneficiaries affirmatively waive their *Crummey* rights with regard to the first trust contribution.

Some warn about the potential downside of a *Crummey* waiver:

> Typically, a *Crummey* trust provides that the beneficiaries' withdrawal powers lapse after a specified period of time. However, some practitioners have beneficiaries affirmatively waive their powers. Such a waiver of withdrawal powers constitutes a release, not a lapse —and is thus fully (gift) taxable without regard to the "5 and 5" exception. The distinction is clear: allowing powers to "die a natural death" can be safe; "killing" powers is not.

Cash Is Not Available in the Trust

Let's assume the policy has been approved for delivery and the trust has been created. Also assume the insured got impatient and deposited the premium into the trust-owned policy instead of allowing a 30-day seasoning in a trust-owned bank account before the trustee paid the premium.

Finally, let's assume the trustee sent out *Crummey* withdrawal notices to the beneficiaries and one of them asked for their share.

The trust itself has no money; it just owns a life insurance policy. How can the trustee honor the beneficiary's request for a *Crummey* withdrawal?

One possibility might be for the trustee to free-look the insurance policy and ask the carrier to return the initial premium to the trust. Once the money comes back to the trust, the trustee could send the beneficiary the requested funds. Of course, that process would completely undermine the grantor's intentions with regard to estate tax management.

In the alternative, the trustee might decide to send the beneficiary part of the trust's property in satisfaction of the request. In the situation where the trust's sole asset is a life insurance policy, the trustee might distribute a fractional ownership interest in the contract.

Some case law supports the idea that an ILIT trustee can distribute trust property instead of cash in satisfaction of a *Crummey* withdrawal demand.

The Lawyer Cannot Be Rushed

Lawyers can be slower than clients would like in drafting needed documents, including irrevocable trusts. What if the policy is ready to be issued, but the trust is not finished?

One solution might be to act as if the ILIT exists, relying on state law permitting oral trusts. An oral trust might allow a trustee to sign as policyowner even though a written document does not yet exist. It's not a perfect idea, though:

1. Not every state permits the creation of an oral trust.
2. If the insured dies before the written version of the trust is finished, it will likely be a scramble to figure out the trust's terms.
3. The insurance company may have trust verification requirements that will, as a practical matter, preclude the use of the oral trust technique.

Another more practical approach might be to remind the attorney of his or her potential professional liability if the trust is not finished in a timely manner—and the client's heirs have a tax liability as a result.

With regard to all the potential time-crunch issues described, a client's own attorney may have a preferred method of dealing with them. The life insurance professional should welcome the ability to talk things over with client's counsel in an effort to work through the practical issues that arise.

Crummey Is Not Enough

What are the choices available to an insured ILIT grantor if there are not enough *Crummey* beneficiaries to cover the whole premium? Here is a list of the most common solutions we see:

Use private split dollar. Implemented in a business context, split dollar is a way for an employer to help finance personal life insurance coverage for an employee. In a private, family situation, split dollar can be used to provide life insurance coverage to cover estate tax liabilities on a gift tax-favorable basis. Under the 2003 regulations, private split dollar will fall into either the loan regime of taxation or the economic benefit regime. In general, particularly in early years, using private split dollar to help finance the premium for ILIT-owned coverage will lower the gift tax value of the coverage.

Use premium financing. As with private split dollar, premium financing could be a valid way to reduce the annual gift tax consequences of implementing a *Crummey*-style ILIT.

Use the unified exemption. With a unified estate and gift tax exemption of $13.61 million in 2024, a person seeking to fund an ILIT in excess of the reach of annual exclusion amount could instead file a gift-tax return reporting the use of a portion of the taxpayer's exemption.

All of these choices have significant potential drawbacks, which is why we consider them to be "Plan B" alternatives to *Crummey*-style ILITs.

CONCLUSION

For many married couples with estate tax issues, the conventional planning wisdom—to implement life insurance owned by an ILIT—still works. With the looming increase in estate taxes scheduled for 2026, the strategy is going to be more important than it is today.

Successfully implementing a *Crummey*-style ILIT can be challenging, even for seasoned financial professionals. By working methodically with the client, insurance company, and the client's other experienced professional advisors, chances are maximized for the best possible result.

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Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.