EFFECTIVE ADMINISTRATION OF IRREVOCABLE LIFE INSURANCE TRUSTS (ILITS)

Best Practices, Crummey Notices, and Avoiding Pitfalls

trustate

About me

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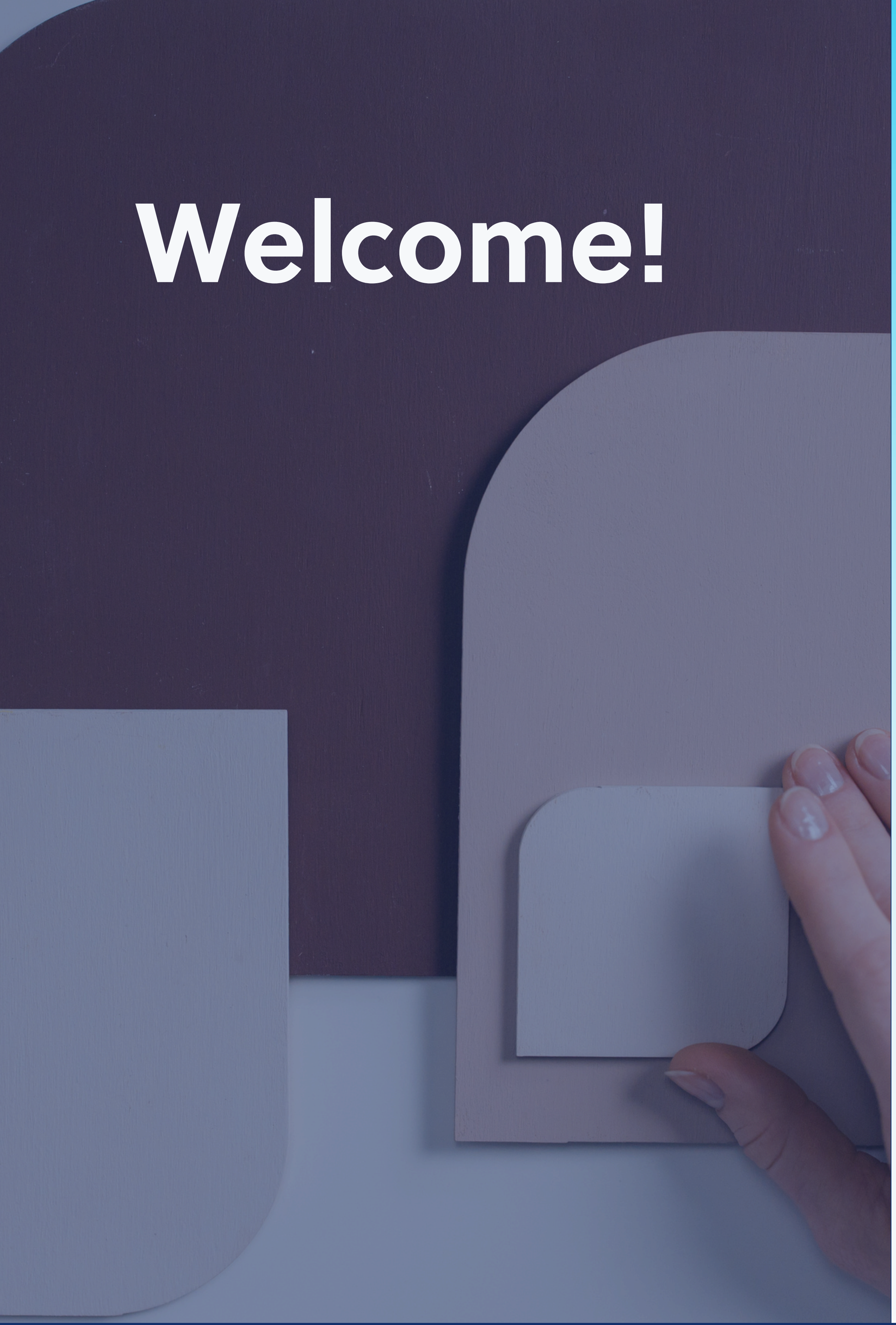
Founder and CEO, trustate

- Settled hundreds of estates, nationwide.
- Administered over $50B via estate administrations.
- 12+ years experience as estate attorney (JD & LLM) with multi-jurisdictional estate/trust admin practice.
- Learn more: trustate.com

Welcome!



Objectives

- Understand the purpose and mechanics of Irrevocable Life Insurance Trusts (ILITs).
- Learn the proper procedures for administering ILITs, including the Crummey notice/letter process.
- Explore best practices for funding an ILIT with life insurance policies.
- Identify common pitfalls in ILIT administration and strategies to avoid them.

Irrevocable Life Insurance Trusts (ILITs)

What is an ILIT?

- **Overview of ILIT structure and its role in estate planning:**
  - An Irrevocable Life Insurance Trust (ILIT) is a specialized estate planning trust designed to hold life insurance policies outside of an individual's taxable estate.
  - Benefits to Clients:
    - Estate tax savings,
    - Liquidity,
    - Asset protection, and
    - Controlled wealth transfer
- **What is a TRUST? See next pg.**

What is a Trust?

A trust is a legal arrangement, determined under state property laws, whereby

a person

settlor or grantor

transfers property

principal or corpus

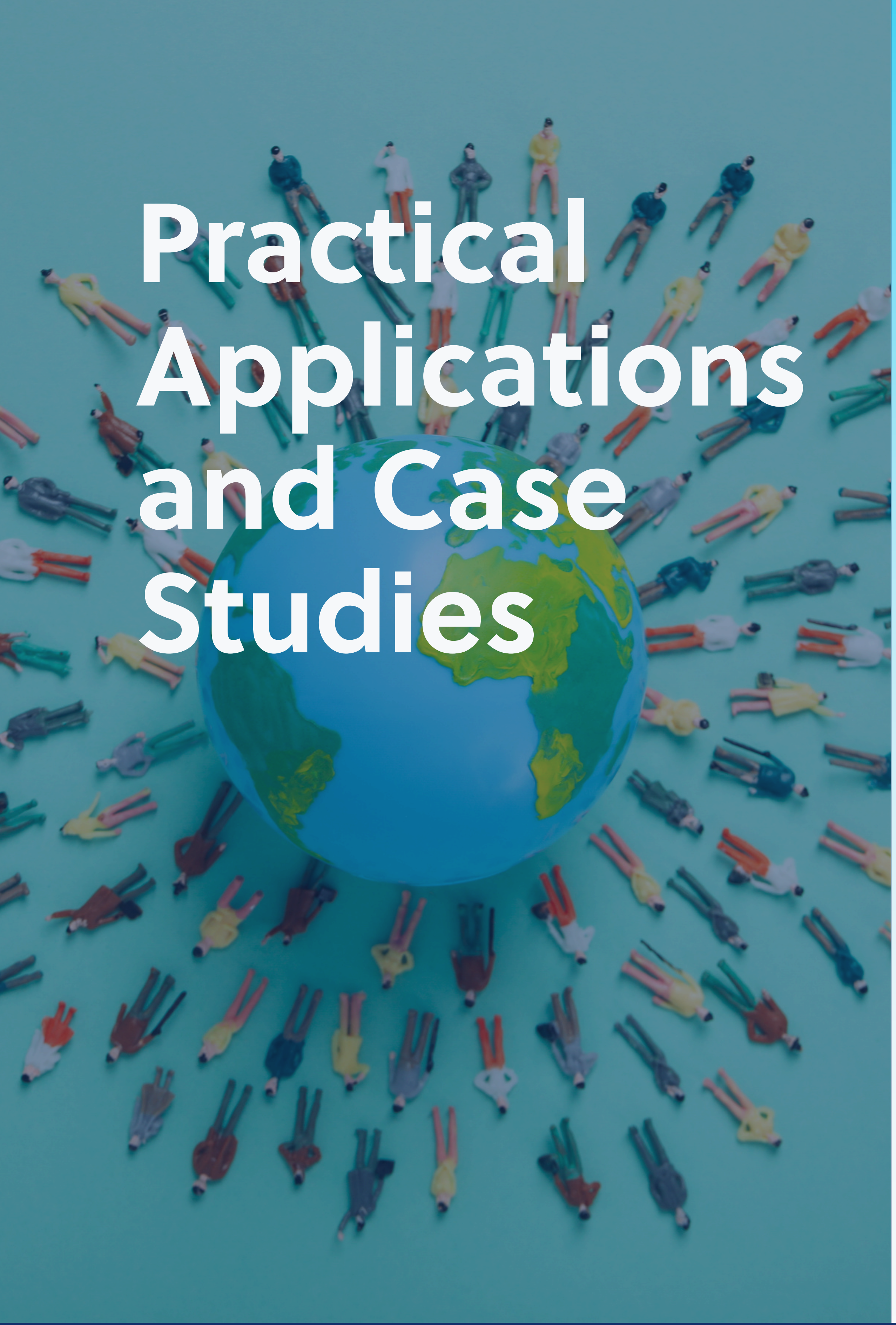
to another person

trustee

so the property can be administered for the benefit of a third person.

beneficiary

Practical Applications and Case Studies



Client Scenario: The Johnson Family ILIT

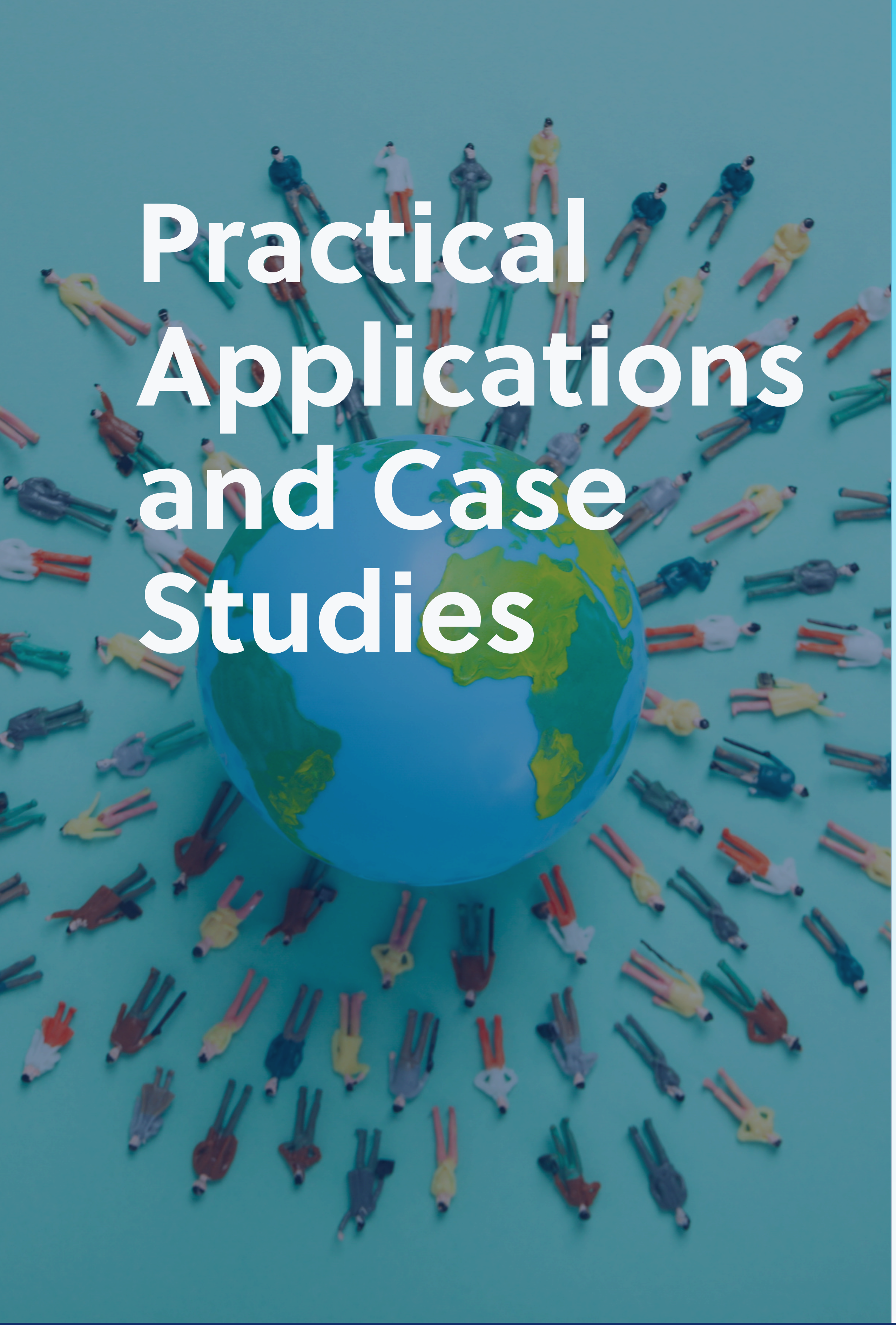
- Name: Robert and Susan Johnson, ages 62 and 60, residents of NY.
- Net Worth: $40m, including a $3m primary residence, $6m in investments and retirement accounts, $21m in business interests, and a $10m life insurance policy (term life).
- Family: Three adult children (ages 35, 32, and 30) and five grandchildren.
- Estate Tax Concern: The Johnsons' estate exceeds the federal estate tax exemption ($27.98m for a married couple). NY imposes a state estate tax with a lower exemption (approx. $7.3m per person in 2025). Without planning, their estate faces significant federal and state estate tax liabilities upon their deaths.

The $8.61m Problem:

- If Robert and Susan die in 2025 their entire $40m estate (including the policy's death benefit) is subject to estate taxes:
  - <u>Federal Estate Tax</u>: Exceeds exemption by $12.78m. At a 40% federal estate tax rate, this results in approximately <u>$5.11m in federal estate taxes</u>.
  - <u>New York Estate Tax</u>: With each spouse's estate valued at $20 million, the state tax applies to amounts above $7.3 million per spouse, resulting in approximately $3.5 million in combined state taxes (based on New York's graduated rates, up to 16%).

OUTCOME: Approximately $8.61 million in combined estate taxes.

- Without liquidity planning, their heirs might need to sell significant business interests (worth $21 million) or other assets to pay the $8.61 million tax bill, potentially disrupting the family's legacy and business operations.
- The $10 million life insurance policy, intended to provide financial security, significantly increases the taxable estate, exacerbating the tax burden.



Practical Applications and Case Studies

SOLUTION: The Johnson Family ILIT

The Johnsons' estate planning attorney recommends establishing an ILIT to hold the $10 million life insurance policy. Here's how it works and the savings it generates:

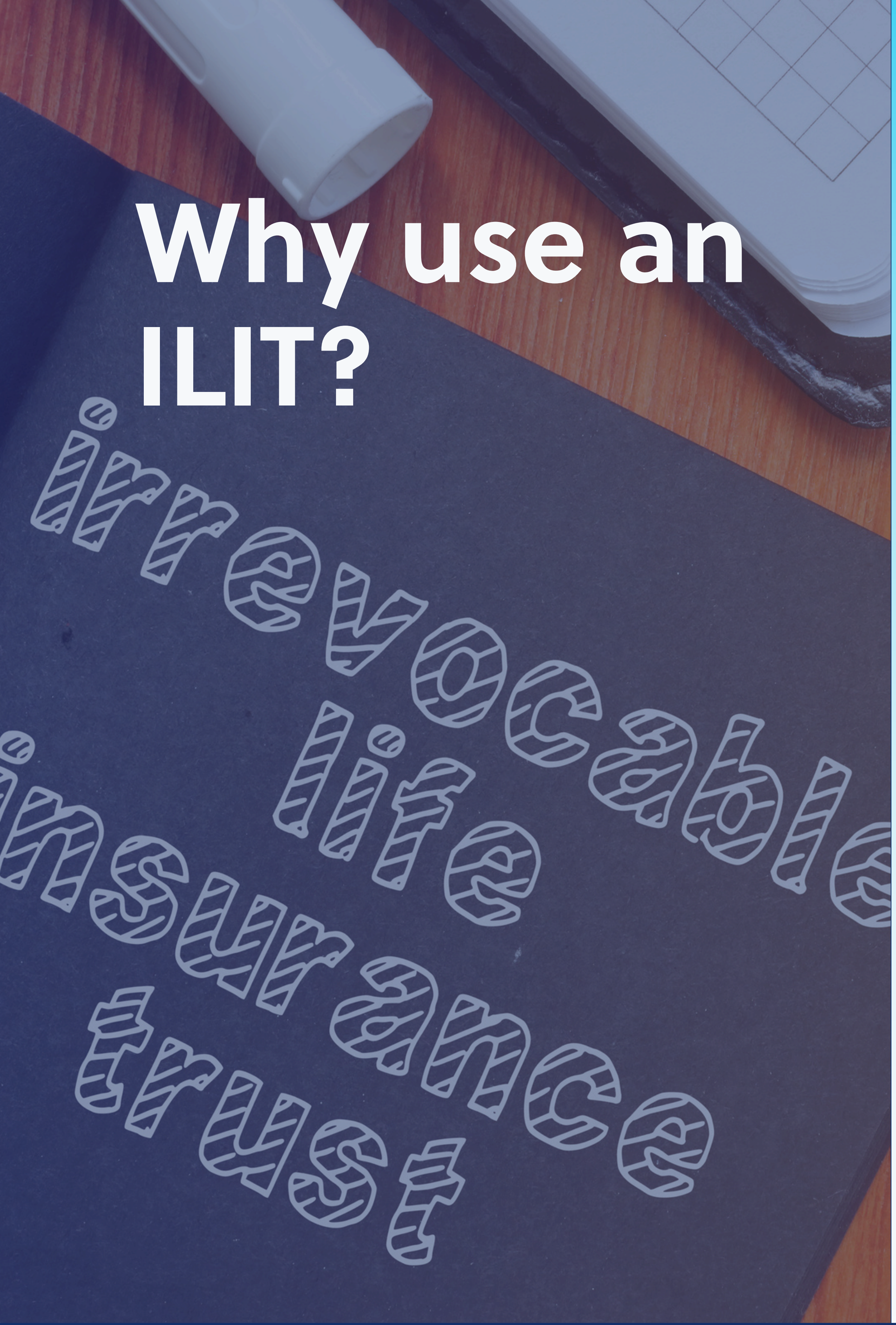
TAX OUTCOME: $5.3M SAVED

- By transferring the life insurance policy to the ILIT, the $10m death benefit is excluded from the taxable estate, reducing the estate to $30m ($3m residence + $6 million investments + $21m business).
    - Federal Estate Tax Savings: $4m in federal estate taxes.
        - Without ILIT: Taxable estate = $40 million. Tax on $12.78 million (above $27.22 million exemption) = $5.11 million.
            - With ILIT: Taxable estate = $30 million. Tax on $2.78 million = $1.11 million.
        - New York Estate Tax Savings: $1.3m in state estate taxes
            - Without ILIT: State tax on $40 million estate ≈ $3.5 million.
            - With ILIT: State tax on $30 million estate ≈ $2.2 million.

Additional Benefits:

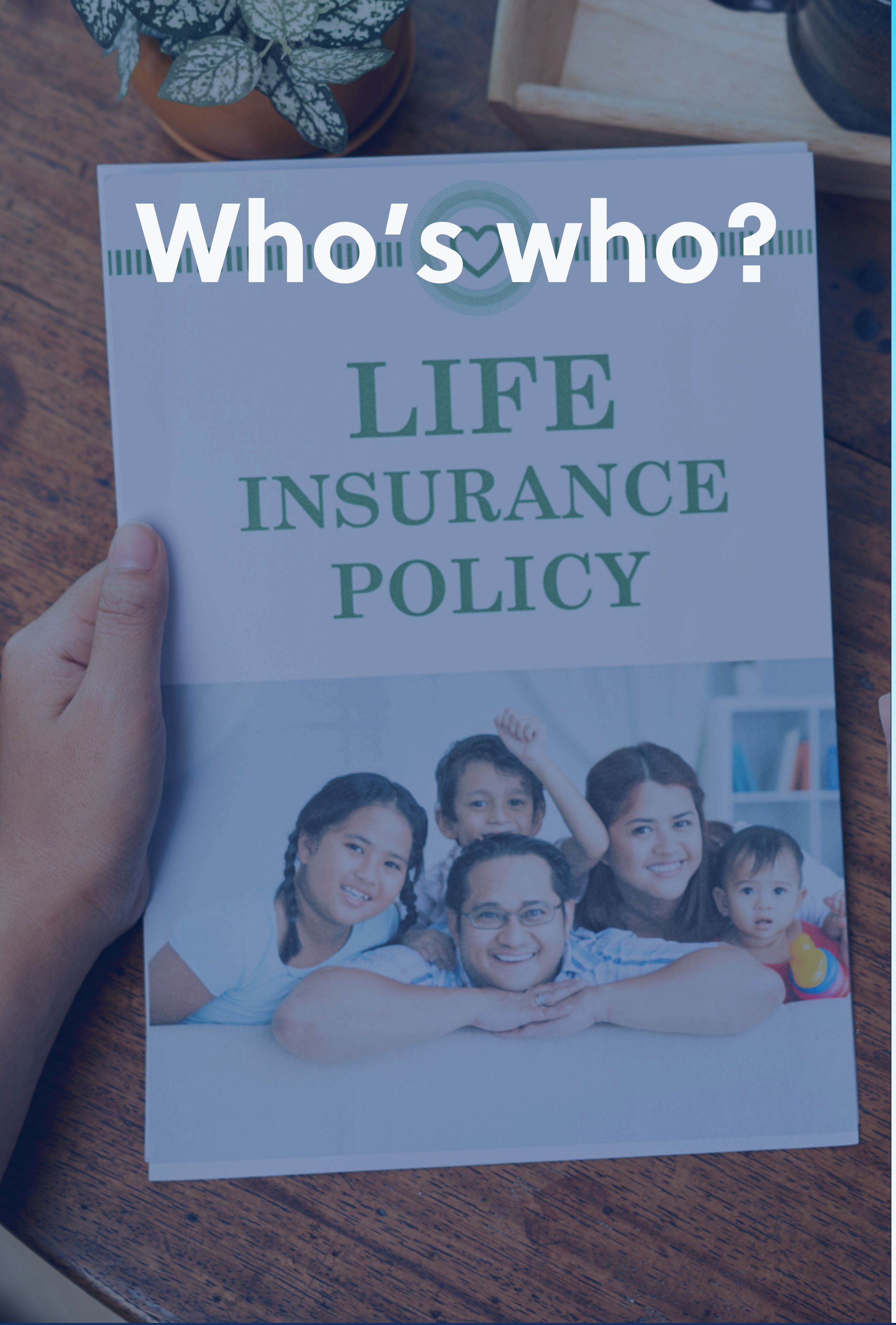
- Liquidity: The $10 million death benefit is paid tax-free to the ILIT, providing liquidity to cover the remaining $3.31 million in estate taxes without selling business assets or the residence.
- Asset Protection: The ILIT shields the $10 million death benefit from creditors, lawsuits, or divorce settlements, safeguarding funds for the Johnsons' children and grandchildren.
- Controlled Distributions: The ILIT specifies distributions (e.g., at ages 30, 35, and 40, or for education/healthcare), ensuring responsible use of funds.
- Business Preservation: The $10 million death benefit provides liquidity to pay the $3.31 million tax bill, preserving the $21 million business for the heirs.
- Wealth Transfer: After taxes, the remaining $6.69 million of the death benefit supports future generations, aligning with the Johnsons' legacy goals.

Why use an ILIT?



Why use an ILIT?

- **How an ILIT fits into overall tax and estate planning strategies.**
  - When placing an insurance policy into an ILIT, the policy's death benefit is removed from the grantor's taxable estate, reducing estate taxes.
  - The ILIT ensures tax-free policy proceeds (cash) passes to the trust beneficiaries.
- **What's the point? What are the benefits of removing life insurance proceeds from the grantor's estate for estate tax purposes.**
- **Key Players: Role of the grantor, trustee, and beneficiaries.**
- **Understanding fiduciary responsibilities in ILIT administration.**



Who's who?

Elements of a policy

Life Insurance Policy: Every policy has the following

Owner	Insured	Beneficiary

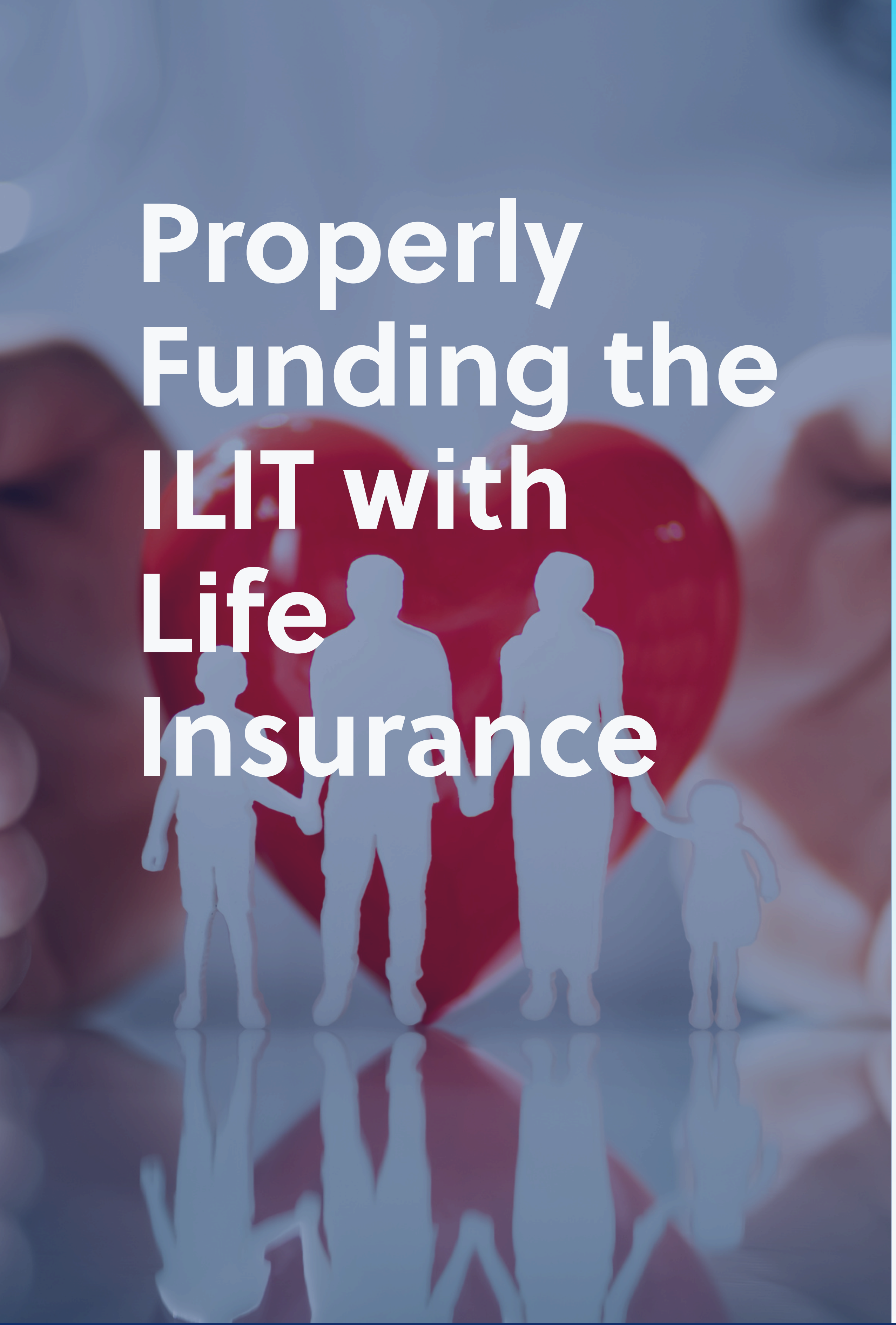
Non ILIT **Policy INCLUDED in the taxable estate:**

Owner	Insured	Beneficiary
Grantor	Grantor	Spouse, Kids, Trust

ILIT **Policy EXCLUDED from the taxable estate:**

Owner	Insured	Beneficiary
Trust	Grantor	Trust

RAISES IMPORTANT QUESTION: If the Grantor doesn't "own" the policy for estate tax purposes, how do premiums get paid?



Properly Funding the ILIT with Life Insurance

Thus, to fund an ILIT properly, you need to change the OWNER and the BENEFICIARY to the TRUST.

- Why the trust must be both the owner and the beneficiary of the policy to achieve estate tax benefits.
- The potential consequences of having incorrect beneficiary designations or ownership structures.

The Crummey Power

Purpose of Crummey Powers

- Grantor created trust and funded it with the policy and then needs to "walk away" from EVERYTHING else with respect to the policy.
- However, SOMEONE needs to pay the premiums!
- Trustee doesn't have money to pay the policy as there is nothing in the trust other than the policy… So, how can Trustee pay?
    - Option 1: Grantor pays the premium to the insurance company directly to keep the policy in good standing. DOESNT WORK - INCLUDIBLE IN GRANTOR'S ESTATE
        - They need to be paid from the trust, which means by the Trustee on behalf of the trust.
    - Option 2: Grantor funds trust with a bunch of cash in addition to policy upon initial funding. DOESNT WORK - USES LIFETIME GIFT TAX EXEMPTION AS GIFTS ARE OVER ANNUAL EXCLUSION AMOUNT AND NO PRESENT INTEREST.
    - Option 3: Grantor funds trust with a bunch of cash in addition to policy upon initial funding and gives withdrawal right. DOESNT WORK - USES LIFETIME GIFT TAX EXEMPTION FOR AMT OVER EXCLUSION

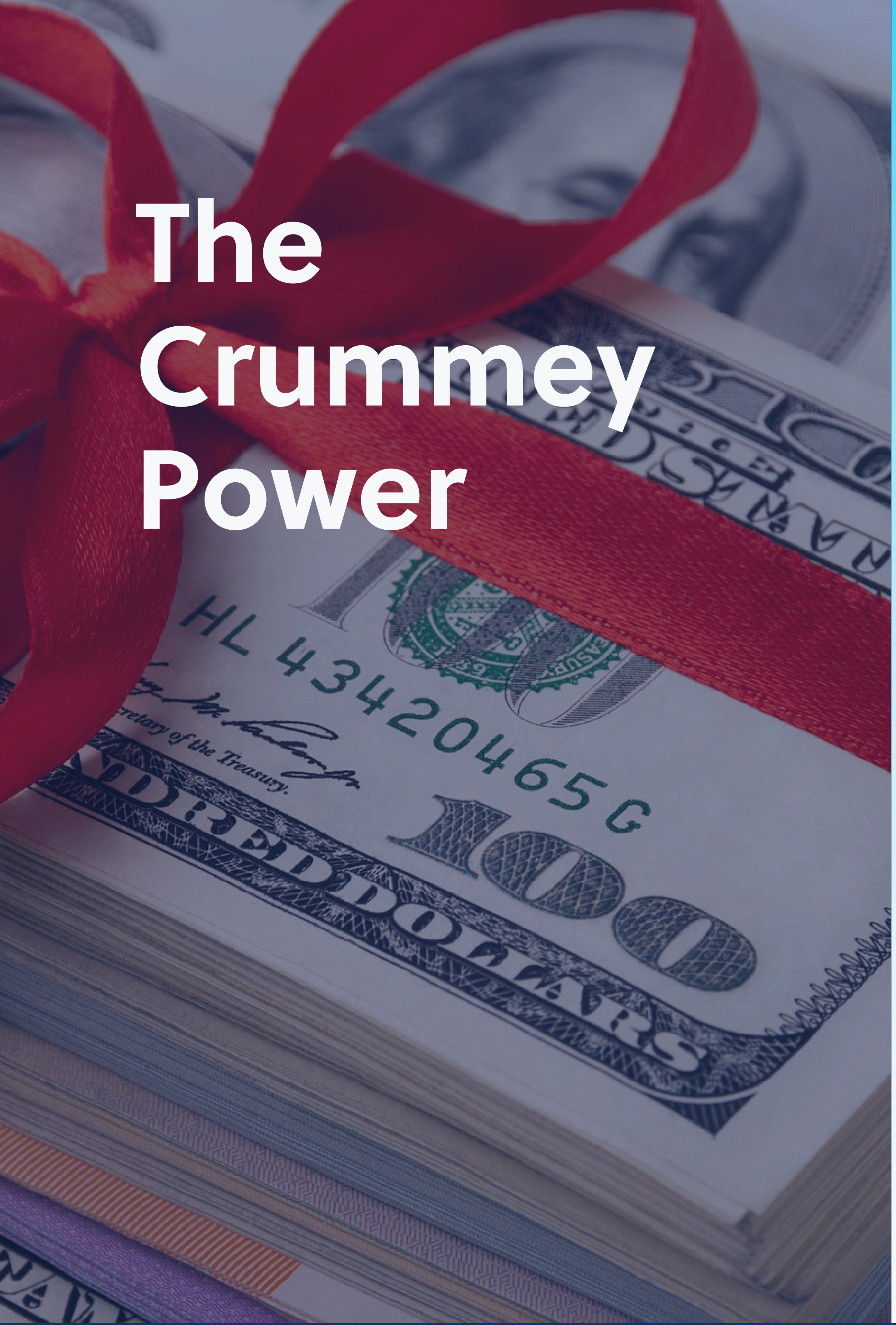
Gifts

Exemptions vs. Exclusions

	Lifetime Exemption	Annual Exclusion
Amount of Threshold	• $13,990,000 (single) • $27,980,000 (married - can gift split)	• $19,000 per year per single person • $38,000 per year per married couple (can gift split)
How many?	One: Finite • Each person gets ONE big lifetime gift tax exemption amount.	<u>INFINITE</u>. **Renews Annually without cutting into the exemption amount. • Each person gets an INFINITE number of gift tax exclusion per person EVERY YEAR.
	U.S. Citizens	U.S. Citizens
Applies to	• FUTURE interest gifts • PRESENT interest gifts over the exclusion threshold	• Present interest gifts ONLY • 1 gift per person
709 required?	YES	No, but sometimes it makes sense to do so
	Linked to estate tax exemption/estate taxes	<u>Gone at death – you don't use 'em, you lose 'em.</u>

How it works - Elements of a Crummey Cycle

STEP 1	STEP 2	STEP 3	STEP 4	STEP 5
Grantor puts $$ in trust bank account or writes check to the trust of the premium amount.	Grantor issues a "Notice of Contribution" to the Trustee.	Trustee issues notice(s) of right to withdraw distributive share to each of the beneficiary(ies). THIS IS WHAT MAKES GIFT A PRESENT INTEREST AND NOT A FUTURE INTEREST	Beneficiaries waive their right or simply do nothing.	Trustee takes $$ from trust and PAYS THE PREMIUM for the insurance policy.
	Notice 1	**Notice 2 - BENE CAN WITHDRAW, HERE AND NOW**	**"Withdrawal Window" recommended: 30 days**	

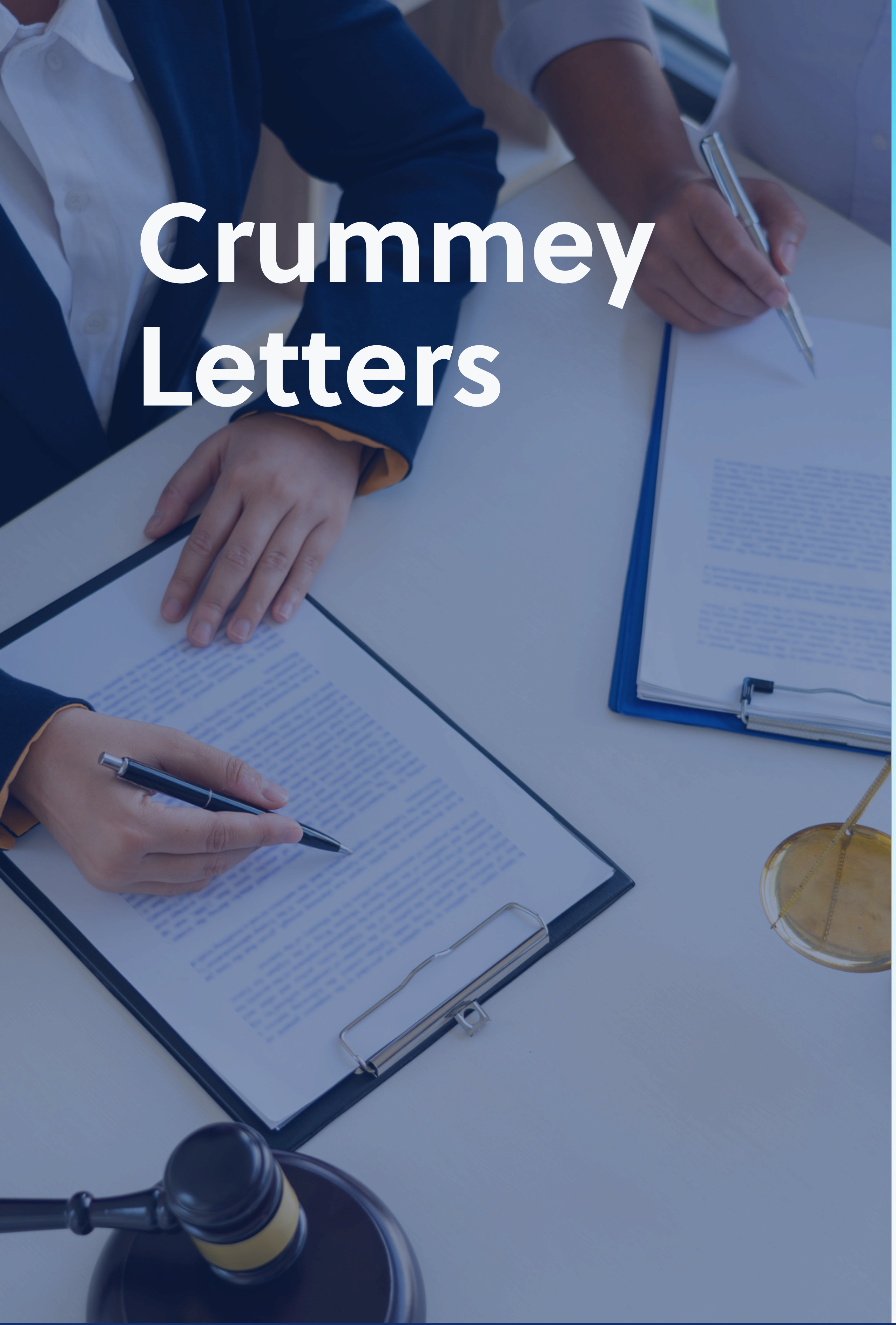


The Crummey Power

What is a Crummey Power?

The Crummey power = a mechanism to reframe and qualify premium payments as gifts eligible for the annual gift tax exclusion.

- To get annual treatment and not cut into the lifetime gift tax exemption, you need the amounts under the exclusion to be earmarked for different people, and the contribution to be PRESENT INTEREST
- The withdrawal power enables contributions to the trust to be considered present interest gifts, which qualify for the annual exclusion.



Crummey Letters

What is a Crummey Letter?

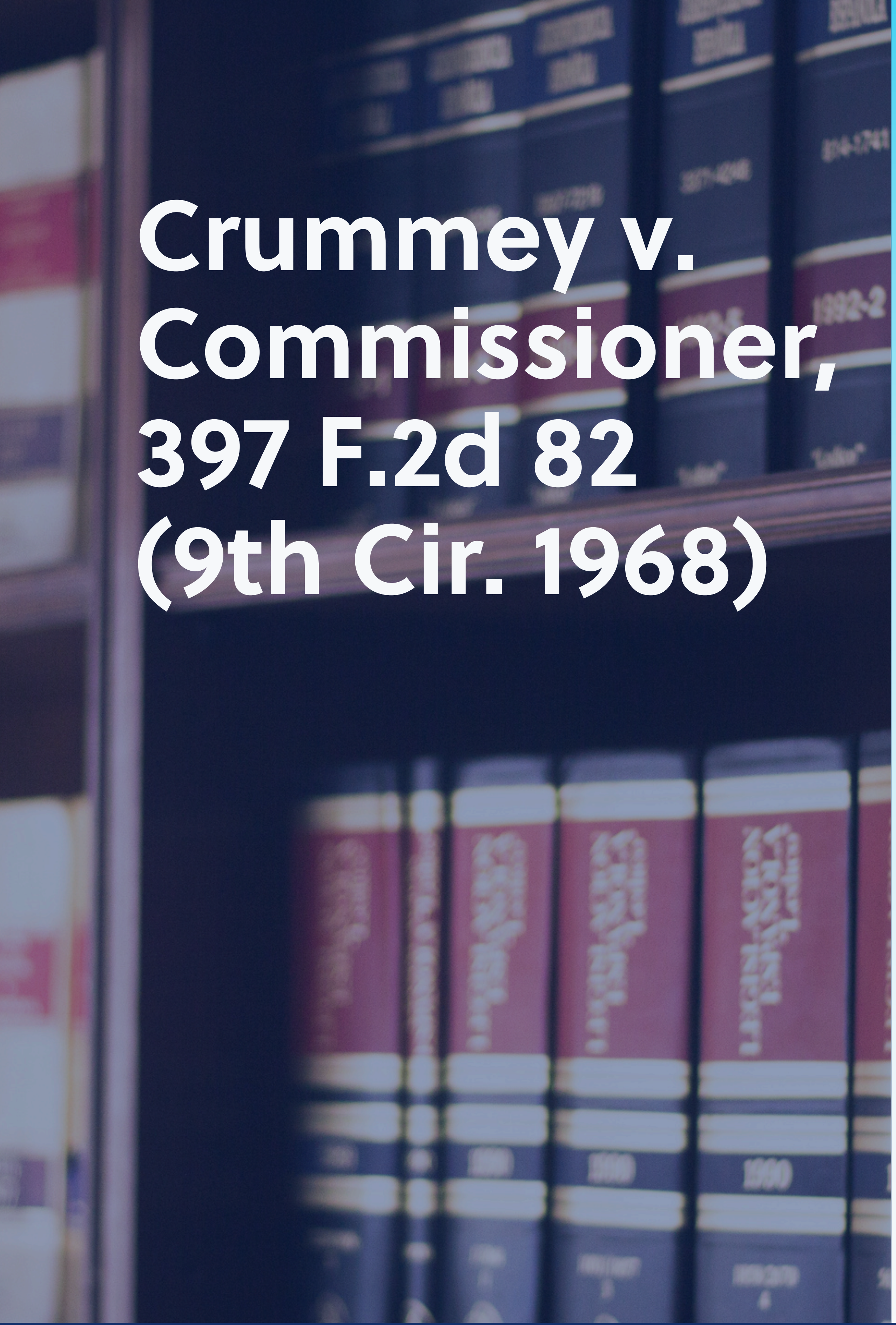
1. **<u>Notice 1- Contribution Notice:</u> Formal written notice from grantor to trustee showing contribution to the trust**
   - **From: Grantor**
   - **To: Trustee**

2. **<u>Notice 2- Beneficiary Notice:</u> Formal written notice from trustee to the beneficiaries detailing contribution and their withdrawal rights. (Contains withdrawal window)**
   - From: Trustee
   - To: Grantor

Oldschool had THREE elements as beneficiaries would sign a waiver letter to the trustee.

Templates and Sample Language:

- Key provisions to include in a Crummey letter.
- Discussion of language that ensures compliance with tax law requirements.



Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968)

Background:

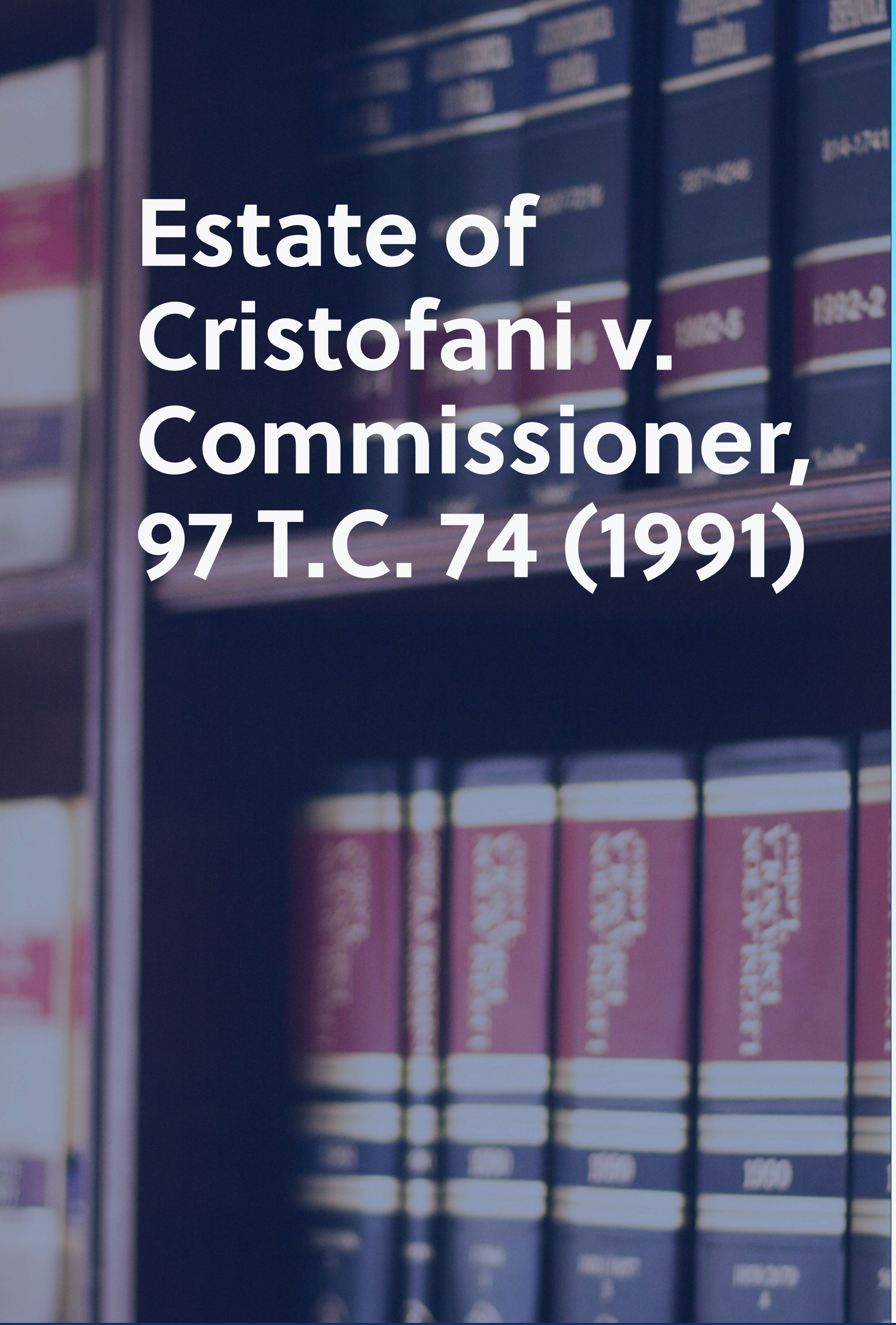
- This is the landmark case that established the concept of Crummey powers. The taxpayers created a trust for their children and gave the beneficiaries the right to withdraw contributions to the trust for a limited period. The IRS argued that these gifts were future interests (not eligible for the annual gift tax exclusion) because the beneficiaries' rights were contingent on future events. The taxpayers argued the withdrawal rights created a present interest.

Ruling:

- The Ninth Circuit Court of Appeals ruled in favor of the taxpayers, holding that a beneficiary's right to withdraw funds from a trust, even if temporary and not exercised, constitutes a present interest qualifying for the annual gift tax exclusion. The court emphasized that the right to withdraw must be real and immediate, regardless of whether the beneficiary exercises it.

Impact on Crummey Notices:

- Established the requirement that beneficiaries must be given a clear and timely notice of their withdrawal rights.
- Confirmed that the withdrawal period does not need to be long, as long as it provides a genuine opportunity to withdraw. In this case, the trust allowed a 15-day withdrawal period, which was upheld.
- Set the foundation for Crummey notices in ILITs, requiring trustees to inform beneficiaries of contributions and their withdrawal rights.



Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991)

Background:

- The taxpayer created a trust with Crummey withdrawal powers for her children and grandchildren. The IRS challenged the gifts, arguing that the withdrawal rights for the grandchildren were not genuine because there was an implicit understanding they would not exercise them. IRS argued that because the grandchildren were unlikely to actually exercise their withdrawal rights (they were very young and the trust assets were meant to benefit others), the gifts were not "present interests" and thus not eligible for the annual exclusion. The trust provided a 15-day withdrawal period (important for later case).

Ruling:

- The Tax Court ruled in favor of the taxpayer, upholding the annual gift tax exclusion for gifts to all beneficiaries. The court found no evidence of a prearranged agreement preventing withdrawals and confirmed that the withdrawal rights created a present interest, even for contingent beneficiaries like grandchildren.

Impact on Crummey Notices:

- Reinforced that the IRS cannot disallow the gift tax exclusion based on the assumption that beneficiaries won't exercise their rights, as long as the rights are legally enforceable.
- Clarified that Crummey powers can extend to secondary or contingent beneficiaries, broadening their use in estate planning.

Cristofani v. Commissioner made it clear that a legally enforceable withdrawal right—even if unlikely to be exercised—counts as a present interest, allowing gifts to qualify for the annual gift tax exclusion.

IRS still challenged the Crummey powers as a sham

Estate of Cristofani v. Commissioner (Memo 1992) - YES, SAME TAXPAYER

- **Key refinement:**
  - The Tax Court again sided with the taxpayer — emphasizing that the legal existence of the withdrawal right mattered, not whether the beneficiary would actually exercise it.
  - **However, the court hinted that facts and circumstances could make powers look too "illusory" (e.g., if there's overwhelming evidence that no real ability or expectation to withdraw exists).**

Turner v. Commissioner (Turner II), 102 T.C. 695 (1994)

Different case, but important.

- IRS attacked Crummey powers where powers were given to a broad group (children, grandchildren, and strangers) with little to no real benefit to some beneficiaries.
- **Key limitation:**
  - **Court disallowed annual exclusions for gifts where the withdrawal rights were found to be illusory, because:**
    - **Beneficiaries were financially dependent on the donor, or**
    - **Beneficiaries were unlikely to be notified properly,**
    - **Or beneficiaries had no realistic way to exercise the rights.**

IRS still challenged the Crummey powers as a sham

Bottom line:

- The Crummey right must be meaningful — not just legally there, but also realistic in practice.
- Courts will look at facts like notice, understanding, and actual independence of the beneficiary.

Avoiding Common Mistakes

- **What happens when you fail to send Crummey notices or provide incomplete letters?**
  - You can jeopardize the gift tax exclusion the grantor purports to use.
  - You can jeopardize the exclusion of the entire policy from the grantor's taxable estate.
- **Ensuring consistent and timely communication with beneficiaries.**
- **Why Grantors should NEVER pay premium outright**
  - CAN MAKE ENTIRE POLICY, not just premium amount, includible in estate, thereby defeating the purpose of the trust in the first place

Steps for Funding the ILIT

Transferring Ownership of Existing Policies

- How to properly transfer an existing life insurance policy to an ILIT.
- Avoiding the "three-year rule" (IRC §2035) and the estate tax implications of improper transfers

Purchasing a New Life Insurance Policy

- Best practices for purchasing life insurance through the ILIT, ensuring the trust is the owner and beneficiary from inception.

Handling Premium Payments

- How to structure and make premium payments so they qualify as gifts under the annual gift tax exclusion (utilizing the Crummey power).
    - USE ANNUAL vs. QUARTERLY OR MONTHLY PAYMENT SCHEDULE TO REDUCE ADMINISTRATIVE BURDEN
- The process for the grantor to make contributions to the trust, and how the trustee uses the funds to pay premiums.

Steps for Funding the ILIT

Other Funding Considerations

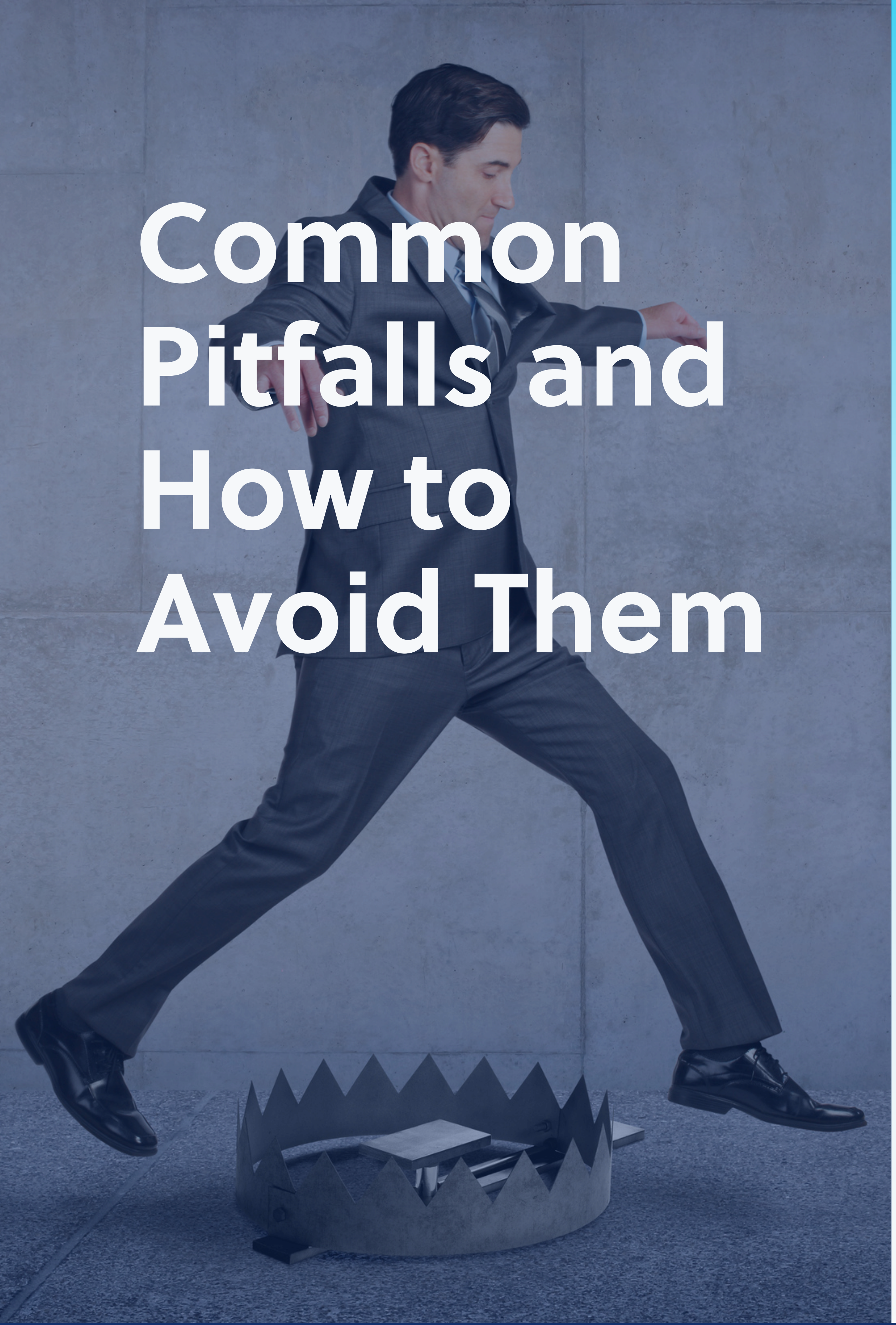
Record Keeping

- How to fund the ILIT with cash to purchase a new policy or to cover premium payments.

PRO TIP: KEEP A CRUMMEY LEDGER

- To track premium payments, the contribution notice and all of the withdrawal notices and who got them.

Common Pitfalls and How to Avoid Them

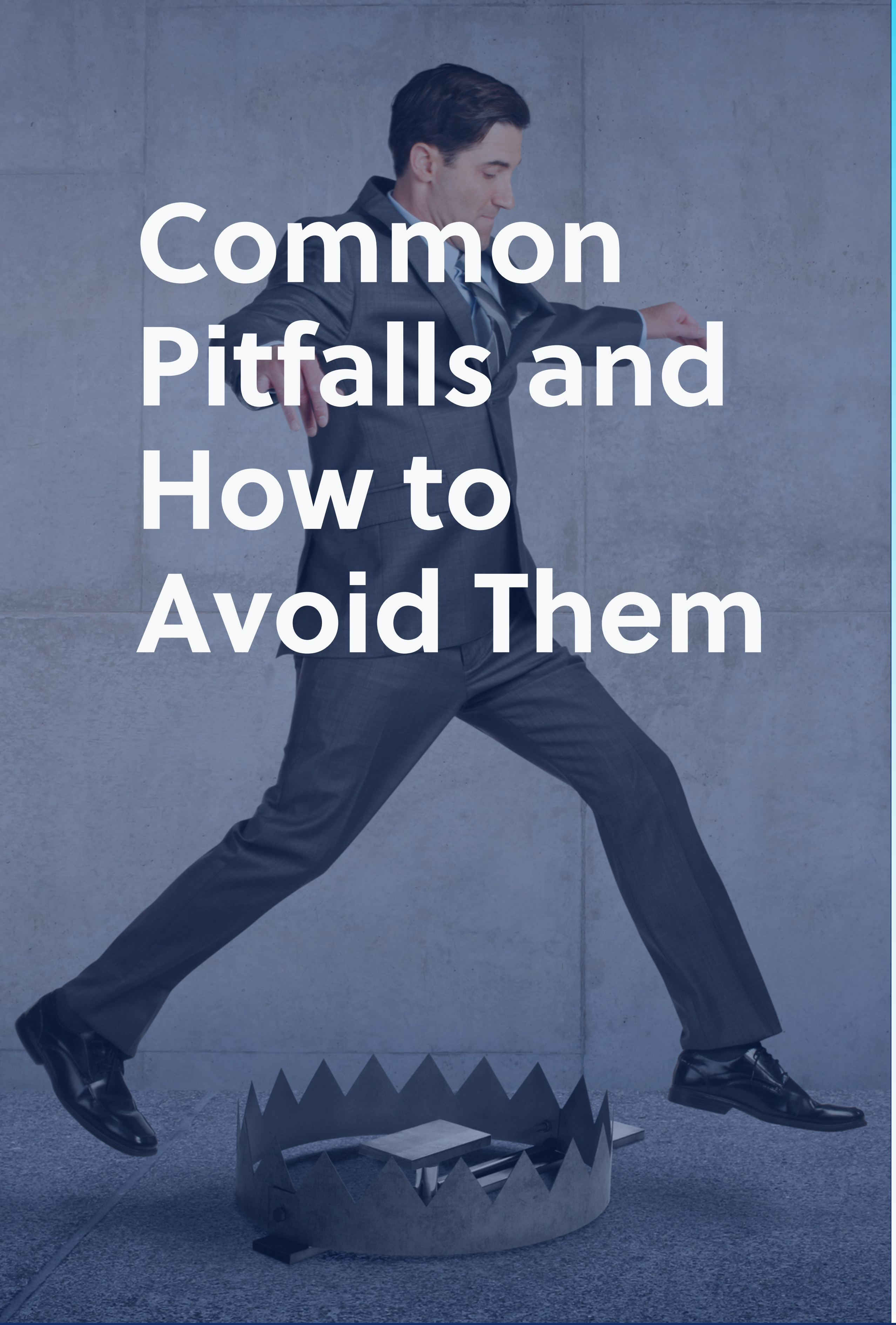


Failure to administer Crummey Notices properly

- **Pitfalls:** Neglecting to send Crummey notices, late notices, or notices with incorrect or incomplete information.
- **How to Avoid:** Establish a clear process for preparing and sending notices, including record-keeping strategies to prove compliance.

Improper funding of the Trust

- **Pitfalls:** Failing to transfer ownership of policies correctly or violating the "three-year rule" (causing inclusion of proceeds in the grantor's estate).
- **How to Avoid:** Ensure the ILIT is both the owner and beneficiary of the policy from the beginning or take proper steps if transferring existing policies.



Common Pitfalls and How to Avoid Them

Mistakes in premium payments

- Pitfalls: Incorrectly making premium payments directly or using non-gifted funds.
- How to Avoid: Clear protocols for contributions by the grantor, including proper Crummey power withdrawals and premium payments by the trustee. GET A CRUMMEY LEDGER!

Trustee mismanagement

- Pitfalls: Trustees failing to understand or fulfill their fiduciary duties, resulting in legal or tax issues.
- How to Avoid: Ongoing education for trustees regarding their fiduciary duties and proper administration of the ILIT. Trustee best practices for documenting all administrative steps and communications.

Tax and legal risks

- Pitfalls: Risks of an IRS audit for noncompliance with Crummey notice requirements.
- How to Avoid: Other legal and tax risks associated with the improper funding or mismanagement of the trust.

Conclusion and Q&A

Key takeaways

- Best practices for Crummey notices and proper ILIT funding.
- How to avoid common pitfalls in ILIT administration.

Questions?

Resources

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Email info@trustate.com with questions.