Counselor's Corner

by Terri Getman, JD, CLU, ChFC, RICP AEP(Distinguished)

How Much Premium Can be Transferred to a Trust Without Gift Tax? The 5 X 5 Limitation

Situation: I'm often confronted with the situation where a financial representative is working with a wealthy client with a need for life insurance for estate liquidity. The classic recommendation is for the client to establish a trust as the owner and beneficiary of the policy to avoid having the life insurance proceeds subject to estate tax. Eventually, the questions turn to how much premium can be transferred to a trust without incurring gift tax. This *Counselor's Corner* addresses this question.

Solution: The amount that can be transferred to a trust without incurring gift tax depends on the terms of the trust and the number of trust beneficiaries. To begin, a person can transfer $19,000 of gifts of a "present interest" in property to any person during a calendar year. The first $19,000 of gifts qualifies for the gift tax annual exclusion and is not included in the computation of taxable gifts of the donor during that year.[1] (The $19,000 is 2025 indexed for inflation.) This amount can be increased to $38,000 when spouses elect gift splitting. The annual exclusion does not apply to gifts of a "future interest." A gift is classified as a future interest if the beneficiaries' possession, use, or enjoyment of the transferred property is deferred to a later time.

Many individuals/grantors that want to take advantage of the annual exclusion are unwilling to place substantial sums of money at the immediate disposal of their intended beneficiaries. As a result, an irrevocable trust is often established to maintain some degree of control over the assets transferred until some specified time in the future. Since the primary purpose of using the trust is to postpone the beneficiaries' immediate enjoyment of the property, the transfers will generally be gifts of a future interest and not eligible for the gift tax annual exclusion unless the trust is carefully structured to result in present interest gifts.

One way to overcome the future interest problem inherent in transfers to a trust is to grant the trust beneficiaries a *Crummey* withdrawal right. When a grantor gives a trust beneficiary a *Crummey* right he is giving the individual the right to withdraw transfers to the trust for a limited period of time. As long as the *Crummey* right is properly administered, the grantor's cash transfers to the trust will be treated as present interest gifts that qualify for the gift tax annual exclusion.

So, if there are four trust beneficiaries with properly administered *Crummey* withdrawal rights, the grantor can shelter up to $76,000 of cash transfers ($152,000 with gift splitting) from his or her gift tax.

Generally, the beneficiaries do not exercise their *Crummey* withdrawal rights, and the cash gifts are used to pay the annual premium. **When the beneficiaries fail to exercise their *Crummey* withdrawal right, they may be treated as having made a transfer subject to gift tax to the other trust beneficiaries. Absent additional terms or conditions in the trust, the gift by a trust beneficiary is subject to gift tax to the extent the beneficiary's transfer exceeds the greater of $5,000 or five percent of the trust assets.** Thus, the limitation on how much premium can be transferred to a trust generally depends on the amount the trust beneficiary is able to transfer without gift tax.

Fortunately, various strategies have evolved to minimize or avoid the beneficiary's gift tax limitation. However, before discussing these strategies, it is first necessary to have an understanding of the beneficiary's 5 X 5 limitation.

Background to Beneficiary's Gift Tax Limitation: The Lapse Problem.
A beneficiary's power to withdraw trust property constitutes a general power of appointment since the beneficiary can direct that the funds be used for his/her own benefit.[2] In the event the beneficiary does not withdraw the funds subject to the power during the prescribed period, the general power of appointment expires (technically this is referred to as a lapse of a power of appointment). A lapse of a general power of appointment is treated for gift tax purposes as a transfer of the property subject to the power. In other words, when a beneficiary allows the withdrawal right to expire he/she is treated as having made a gift.

The Internal Revenue Code provides a safe harbor exception that shelters "small transfers" from gift tax. Under the safe harbor, only transfers greater than $5,000 or five percent of the aggregate value of the assets out of which the exercise of the lapse power could have been exercised will be subject to gift tax.[3] Note: This "5 X 5 limit" affects the trust beneficiaries – not the grantor/donor.

In other words, a grantor may avoid gift tax on a transfer equal to the full gift tax annual exclusion; however, a beneficiary allowing the lapse of a *Crummey* power in excess of the permitted $5,000 or 5 percent limitation will, absent additional trust terms or conditions, be deemed to have made a gift to the other trust beneficiaries. Furthermore, since the trust will likely require the excess amounts to be retained by the trust, the beneficiary's gift is of a future interest. Thus, the gift tax applicable exclusion amount of the beneficiary who lets his/her withdrawal right lapse will be reduced by the amount of the lapse in excess of the 5 X 5 limit. If the beneficiary has exhausted the gift tax applicable exclusion amount, the deemed transfer will be a taxable gift.

Continuing our previous example, let's assume that the four beneficiaries have been given properly drafted *Crummey* withdrawal rights and adequate time to exercise their withdrawal rights. If they choose not to exercise their rights, the $76,000 transfer qualifies for the grantor's annual gift tax exclusion and he/she escapes the imposition of gift tax. However, the tax problem lies with the beneficiaries. Absent additional terms or conditions, each beneficiary will be deemed to have made a taxable gift of $14,000 (the amount in excess of the 5 X 5 safe harbor limit). Fortunately, various strategies are available to minimize the beneficiary's gift tax.

Each of the alternative strategies discussed below has benefits and drawbacks, depending upon the interests and objectives of the grantor and the beneficiaries. In addition, the methods have received different levels of acceptance (or resistance) by the Internal Revenue Service (IRS). Consequently, all aspects of a client's situation must be assessed with the client's advisor before any judgment can be made which strategy might be best.

Alternative Solutions to the "5 X 5 Limit"
If the trust has only one beneficiary, the problem does not arise because, when the *Crummey* withdrawal power lapses, there is no other trust beneficiary to whom an imputed gift can be made.

If there is more than one trust beneficiary, some alternative solutions to avoiding imputed gifts are:

- **Limit the *Crummey* Withdrawal Amount.** One solution is to limit the amount of the *Crummey* withdrawal power so as to avoid the possibility of any "excess," which could be treated as a taxable transfer. A common drafting clause to this effect limits the withdrawal rights to the lesser of the *Crummey* beneficiary's proportionate share of additions to the trust or the amount of the gift tax annual exclusion (with gift splitting, if available), or the greater of $5,000 or 5 percent of the trust corpus. The IRS has acknowledged that limiting the withdrawal right to the 5 X 5 amount does prevent a gift when the *Crummey* power lapses.[4]

  The disadvantage of this solution is that it is not an effective way to take full advantage of the annual exclusion.

- **Multiple Demand Right Beneficiaries.** This method seeks to increase the number of beneficiaries available for the annual gift tax exclusion by naming multiple beneficiaries with *Crummey* withdrawal rights. A grantor could name his children, grandchildren, aunts, uncles, etc. to be demand right beneficiaries. There often is an implied understanding that none of these beneficiaries will exercise his/her withdrawal right, so that the lapsed gifts will be used to benefit the real beneficiaries. The IRS has consistently opposed the use of "illusory" multiple demand right beneficiaries.

- **Seed the Trust.** The safest approach is for the grantor to "seed" the trust with a large initial cash gift of $380,000 (or $760,000 in the case of gift splitting). This shelters the lapses by qualifying the trust for the maximum five percent limit since five percent of $380,000 is $19,000. Of course, the seed will be a taxable gift unless the gift tax applicable exclusion amount ($13,990,000 in 2025) is available to shelter the gift from taxes. However, future transfers are subject to the full annual exclusion without adverse gift tax consequences from lapsed withdrawal rights.

- **Use Separate Trusts or Separate Trust Shares.** Another way to avoid the 5 X 5 limitation is to create a separate trust for each beneficiary during his or her lifetime (or one trust with separate shares for each beneficiary) in combination with one of the following dispositions of the trust share at the death of the beneficiary:
  1. All the trust income and principal is payable to the beneficiary's estate in the event he or she dies prior to the full payout of the trust,
  2. Each beneficiary has a testamentary general power of appointment over his trust share.
  3. Each beneficiary has a testamentary limited power of appointment over his trust share.

  The general disadvantage of the separate trust share strategy is that the grantor may not give the trustee the ability to make trust distributions to persons other than the trust beneficiary during the beneficiary's lifetime.

  Some other factors to be considered under each distribution strategy are:

  1. **Trust share is payable to beneficiary's estate:** In this situation, if a beneficiary dies prior to the full payout of the trust, the lapse of the *Crummey* withdrawal right does not result in a taxable gift because all the property subject to the power passes to the beneficiary's estate.[5] Since a gift cannot be made to one's self, the full annual exclusion amount can be transferred to the trust without current gift tax consequences.

     This strategy has several potential disadvantages. First, since the separate trust or share must be payable to the beneficiary's estate, the value will be included in the beneficiary's gross estate for estate tax purposes. Since the trust is included in the *Crummey* beneficiary's estate, generation skipping opportunities are not available. Second, the ultimate control of the trust property is in the hands of the beneficiary. Since death of the beneficiary may require distribution of the trust property, the trustee loses control of when the trust property is distributed.

2. **Grant the beneficiary of each share a testamentary general power of appointment:** Gift tax can be assessed only if the transfer is a completed gift. A gift is not complete if the donor/beneficiary has not given up control over the gifted property. If a *Crummey* beneficiary is given a testamentary power of appointment, the potential gift tax, due to lapsing powers, is avoided because the beneficiary retains the right to name by will who will receive his/her share of the trust should he/she die prior to final distribution.[6] Since the beneficiary's gift is not complete, the grantor is able to grant withdrawal rights equal to the full amount of the annual gift tax exclusion.

   Like the previous strategy, the disadvantage to this method is that the full value of the trust share will be included in the *Crummey* beneficiary's estate for estate tax purposes because the beneficiary has a general power of appointment. This factor also disqualifies this trust as a generation skipping vehicle. However, the untimely death of the beneficiary does not require distribution of the trust property since the general power of appointment can be structured to entitle the appointee to the trust share only at final distribution.

3. **Grant the beneficiary of each share a testamentary limited power of appointment:** Like the previous strategy, this strategy avoids gift tax because the transfer by the beneficiary is not complete. Under this strategy, the *Crummey* beneficiary is given a testamentary power to appoint to a limited class of beneficiaries, usually his/her heirs, who will receive the unlapsed amounts at his/her death. There is no completed transfer by the *Crummey* beneficiary since he/she has the power to alter who will benefit.[7]

   The advantage of this strategy is that only a portion of the trust will be included in the *Crummey* beneficiary's estate if he/she dies before termination of the trust. Furthermore, if the beneficiary dies after termination of the trust, the limited power of appointment will not cause adverse estate tax consequences. Like the two previous examples, the existence of the limited power negates generation skipping opportunities.

- **Hanging Powers.** Another solution to prevent any lapse in excess of the "5 X 5 limit" from becoming a taxable gift is to accumulate the amount in excess of the 5 X 5 limit for use in future years when an additional 5 X 5 limit becomes available (i.e., if no gifts are made or when the trust assets increase in value). The power continues to "hang" in this fashion until it is exhausted or exercised.

  In this way, when the accumulated cash values in the life insurance policy become substantial, lapsing powers can be accelerated. For example, if the policy in the ILIT has cash value of $250,000, 5 percent or $12,500 can lapse in a given year.

  The objective is to support the tax position that no gift transfer occurs since the power holder continues to possess a general power of appointment over the unlapsed amount. The use of hanging powers works well with an ILIT where the policy premiums may end after a number of years and policy earnings are expected to be capable of paying the premiums. Under these circumstances it is possible that the accumulated excess amounts will completely lapse over time. Also, this technique works where the grantor may want to take advantage of generation skipping opportunities.

However, hanging powers have their downside. In Technical Advice Memorandum 8901004, the IRS cast doubt on the use of hanging powers. It held that it would ignore any hanging power if it contained a provision that was a type of "savings clause" ruled invalid in the case of *Commissioner v. Proctor.*[8] In Proctor, the donor made gifts that would be retroactively voided (re-characterized after the fact by a condition subsequent) if the transfer was later held subject to gift tax (by a court ruling).

Many legal practitioners disagree with this ruling. They argue that the problems addressed in this finding may well have been avoided by drafting hanging powers to expressly state that the power will not lapse to the extent it exceeds the 5 X 5 limitation (using condition precedent hanging power language). Nevertheless, until the issue is settled, care should be taken in using hanging powers.

Another downside to the use of hanging powers is the estate tax consequences to the *Crummey* beneficiary. If the beneficiary allows the power to lapse during his/her lifetime, the lapse is not includible in his/her estate to the extent that the lapse did not exceed the greater of $5,000 or 5 percent of the trust property. However, where there are accumulated unlapsed amounts, should the beneficiary die, these sums will be included in the *Crummey* beneficiary's estate.

Summary. A grantor can gift $19,000 annually per beneficiary ($38,000 with gift splitting) to an ILIT for premium expense; however, unless the trust is drafted to skirt the beneficiary's 5 X 5 limit, the grantor may be creating tax headaches for the trust beneficiaries.

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[1]IRC § 2503(b).
[2]IRC § 2514(c) defines a general power of appointment as "a power, which is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate."
[3]IRC § 2514(e).
[4]PLRs 7939061, 7947066, 8003033, 8003152.
[5]5 PLRs 8142061, 9141008
[6] Reg.§ 25.2511.2 (c) and PLRs 8517052, 8545076 and 8142061.
[7] Reg. § 25.2511-2 (b) and PLR 8229097.
[8]Commissioner v. Proctor, 142 F. 2d 824 (4th Cir. 1944), cert. denied 323 U.S. 756 (1944).