Feeling Crummey? Try the Annual Exclusion

◆ *BY STEPHEN M. MARGOLIN*

If an insured dies owning any life insurance, the proceeds are taxed as part of his estate. To avoid taxation, he can transfer ownership to an irrevocable trust, but even so, premium payments constitute taxable gifts. There is, however, a way around this dilemma.

The Annual Exclusion Present Interest Rule

Assume the insured, who has three children, pays annual premiums of $12,000. If he makes a direct gift to the children of $12,000, it's offset by the $10,000 per beneficiary annual exclusion. No gift tax arises because it's a transfer of a "present interest" under Internal Revenue Code (IRC) Sec. 2503.

If premiums paid for life insurance in an irrevocable trust are present interest transfers, they're excluded from the gift tax up to the $10,000 annual exclusion ($20,000 if the spouse joins in the gift). If you don't make them present interest transfers, it will eat into the $600,000 lifetime exemption.

For 25 years, the technique for making a premium payment a present interest has been a Crummey power, which is a grant to one or more beneficiaries to withdraw an amount from the trust. The technical requirements for this are:

◆ The beneficiary or his guardian must be given annual notice of the withdrawal power;

◆ Notification must be given a reasonable amount of time before the power lapses;

◆ The Crummey withdrawal right may be limited to the amount of the annual exclusion or the five-and-five amount (discussed later), whichever is lower;

◆ If the beneficiary of the withdrawal right is under a legal disability of any kind, the withdrawal right may be exercised by his legal guardian;

◆ The withdrawal right is noncumulative and lapses after the 30-day notice.

Under the original example, the Crummey power allows each beneficiary the present right to equally withdraw one-third the amount of the premiums, or $4,000. The annual exclusion completely offsets the $12,000. Though this can be advantageous to the grantor, there could be problems for the children.

Lapse Of Power

Under IRC Sec. 2514, any lapse or release of a power is a gift by the beneficiary. To be taxable, however, the gift must be greater than $5,000 or 5 percent of the property value. So when the children allow their withdrawal power to lapse, the resulting gift of $4,000 is not taxable.

But what happens if the premium payment paid by the grantor is $27,000? The three children have the right to withdraw the lesser of the premium payment of $9,000 ($27,000 divided by three) or $5,000 each. The grantor uses the annual exclusion only to the extent of the lesser figure ($15,000). The remaining $12,000 eats into his life-

Keys To Assist The Sale

To avoid taxation of insurance benefits, an insured can:

◆ Transfer ownership to an irrevocable trust

◆ Use the annual exclusion present interest rule through a Crummey power

◆ Give the beneficiary a "hanging power"

The Crummey provision lets your client use the annual exclusion to avoid having premiums considered as taxable gifts.

time exemption, which means that amount is not available to protect assets from estate taxes.

When you tell the grantor this, he informs you his brother just did the same thing but was able to use the full annual exclusion and he wants to do the same thing. Is it possible?

One way to avoid the $4,000 being considered a gift from the beneficiary is to give the beneficiary a general testamentary power of appointment over his interest.

Yes, but the beneficiaries must be given the present right to draw down the total amount of the $27,000 gift, or $9,000 each, without the $5,000 per beneficiary limitation. Thus, the grantor has used the full annual exclusion. And since lapse of the beneficiaries' power constitutes a gift of $9,000 less the $5,000 statutory exception, the amount of each beneficiary's gift to the trust is $4,000.

One way to avoid the $4,000 being considered a gift from the beneficiary is to give the beneficiary a general testamentary power of appointment over his interest. There is no completed gift because the beneficiaries retain control over the non-lapsed amount. This may cause an estate tax issue in the beneficiary's estate if he dies before the trust ends, but the risk generally is assumable. If the trust has a single beneficiary whose estate receives the trust property at the beneficiary's death, there is no gift because the donor and the beneficiary are the same person.

Hanging Power

Another method of avoiding a tax to the beneficiary is by giving the beneficiary a "hanging power." Though the Internal Revenue Service (IRS) questions the validity of this approach, many practitioners disagree. Here's how it works.

Using the same example as above, the language of the trust would state that each beneficiary has a continuing right to withdraw funds from the trust, but that right lapses to the extent of $5,000 per year. Thus, if there were only one premium payment with a $9,000 withdrawal allocable to each beneficiary, the right would lapse after two years. This doesn't appear to constitute a gift by the beneficiaries, since the IRS says there is no gift up to $5,000 per year.

Reasonable people may disagree on the law's interpretation. Similarly, the IRS has taken the position that beneficiaries having a withdrawal right must have a vested present interest or a vested remainder interest to qualify as a Crummey beneficiary.

In 1991, however, the tax court in *Cristofani* ruled against the IRS on that point. In that case, the decedent's five grandchildren each held a contingent remainder interest that would vest only if their respective parents predeceased or failed to survive the decedent by more than 120 days.

There, the IRS tried to differentiate the contingent beneficiaries from non-contingent beneficiaries under the Crummey case. The court, holding for the taxpayer, concluded that the proper issue was whether a beneficiary had a legal right of withdrawal.

To avoid gift taxes when premiums are paid on insurance, the annual exclusion should be used.

Irrevocable trusts are important to avoiding federal estate taxes. To avoid gift taxes when premiums are paid on insurance, the annual exclusion should be used. The annual exclusion works when a "present interest" is transferred and excludes gifts up to $10,000 ($20,000 with spouse) from taxation. The Crummey power makes the transfer one of present interest, so the tax on the grantor is avoided. ◆

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