Gift Tax Annual Exclusion

That Crummey Feeling & Exclusive Relief

By Stephen M. Margolin, J.D.

If an insured possesses, at his death, any life insurance incidents of ownership, the proceeds are included in his estate for tax purposes.[1] The advantage of an irrevocable trust is that the insured could transfer all incidents of ownership to it, and at his death exclude the proceeds from his taxable estate.[2]

The problem with trust ownership is that premium payments may constitute taxable gifts. This article discusses avoiding taxable gifts on the grantor and the beneficiary level.

Exclusion Present Interest Rule

Assume the insured pays premiums of $12,000 annually and he has three children. If he made a direct gift to the children of $12,000, this is offset by the $10,000[3] per beneficiary annual exclusion, so no gift tax results because it is a transfer of a interest under Internal Revenue Code Section 2503.

Premiums paid for life insurance in an irrevocable trust, however, may or may not be present interest transfers. If so, it is excluded from gift tax to the extent of the $10,000 annual exclusion ($20,000 if the grantor's spouse joins in the gift).[4] If not an annual exclusion, it eats into the $600,000 lifetime exemption.[5] Thus, we generally prefer that the premium payments from the grantor to be a present interest, offset by the annual exclusion.

For 25 years, the technique to make a premium payment a present interest has been a Crummey power. The basis of this is *Crummey v. Commissioner.*[6] A Crummey power allows one or more of the beneficiaries to withdraw an amount from the trust. The technical requirements for this advantageous result are as follows:

1. The beneficiary, or his guardian, must be given annual notice of the withdrawal power.
2. Notification, by this Crummey letter, must be given to the beneficiary a reasonable amount of time before the power lapses, for example, 30 days.
3. The Crummey withdrawal right may be limited to the lower of the amount of the annual exclusion (including gift splitting) or the five and five amount (discussed later).
4. It should provide that 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.
5. Generally, the withdrawal right is noncumulative and lapses after that 30-day notice.

Let's return to our example where grantor pays premiums of $12,000 annually, and has three children, but let's make them trust beneficiaries. Under these circumstances, the Crummey power works very well in that each beneficiary has the present right to equally withdraw one third the amount of the premiums, or $4,000. This results is the $12,000 being completely offset by the annual exclusion. Therefore, on the grantor level this has been an advantageous result. On the beneficiary, or children's, level, there could arise a problem.

Lapse of Power

Under Code Section 2514, any lapse or release of a power is a gift by the beneficiary. So, when the children allow the power to withdraw or lapse, it is a taxable gift by each of them of such property. That Code section goes on to say, however, that rule only applies to gifts exceeding the greater of $5,000 or 5 percent of the value of the property (assume for simplicity that the value of the property is zero). So, in our above example, no problem occurs on the beneficiary level, since the $4,000 lapse was under $5,000.

What happens if the premium payment paid by the grantor in the above example exceeds $5,000 for each beneficiary? For example, assume a premium payment of $27,000. The trust provides that the three beneficiary-children have the right to withdraw the lesser of the amount of the premium payment $9,000 ($27,000 divided by three) or $5,000 each. Thus, the grantor utilizes the annual exclusion only to the extent of $15,000 ($5,000 times three), which is the lesser figure. The remaining $12,000 ($27,000 minus $15,000) eats into his lifetime exemption, which means that amount is not available to protect assets from estate taxes. The reason this format is used is to avoid any gift tax consequences on the beneficiary level.

When you tell the grantor this, he tells you that his brother just did the same thing but utilized the full annual exclusion, and he wants to do the same! Is this possible? The answer is yes. To do that, the beneficiaries must be given the present right to draw down the total amount of the gift of $27,000 divided by the three of them, or $9,000 each, without the $5,000 per beneficiary limitation. Thus, at the grantor level, the grantor has utilized the full annual exclusion. However, at the beneficiary level, since the lapse of a power constitutes a gift in excess of $5,000, the amount of gift that each beneficiary has made to the trust is $4,000 ($9,000 lapse minus $5,000 statutory exception).

One way to avoid consideration of the $4,000 as made by the beneficiary, is to give the beneficiary a testamentary power of appointment over his interest. There is no completed gift because of the beneficiary's retention of control over the nonlapsed amount. This may cause an estate tax issue in the beneficiary's estate if the beneficiary dies before the trust ends.[7] This risk generally is assumable because of the younger ages of the beneficiaries. If the trust has a single beneficiary whose estate

receives the trust property upon his death, there is no gift because the donor and the beneficiary are the same person.

The Hanging Power

Another method of avoiding a problem to the beneficiary is to give the beneficiary a hanging power. A hanging power is an aggressive approach, which is deemed not valid by the Internal Revenue Service.[8] Notwithstanding that opinion, a number of practitioners respectfully disagree with the Internal Revenue Service. The hanging power works as follows: using the same example above, where the grantor pays a premium of $27,000 and the three beneficiaries have the right to withdraw $9,000 each, 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, allocable $9,000 to each beneficiary, after two years the right would lapse. This does not appear to constitute a gift by the beneficiaries, since the above Code section says that there is no gift up to $5,000 per year.

Reasonable people may disagree on the interpretation of the law. Merely because the IRS has issued the opinion that hanging powers are not valid does not make it so. A court appropriately could determine this conclusion. Similarly, the IRS has taken a position that the beneficiaries having a withdrawal right must have a vested present interest or a vested remainder interest in order to qualify as a Crummey beneficiary. The court in *The Estate of Cristofani v. Commissioner*,[9] however, held against the Internal Revenue Service. In that case, the decedent's five grandchildren each held a contingent remainder interest which would vest only if their respective parents predeceased or failed to survive the decedent by more than 120 days. There the IRS attempted to differentiate the contingent beneficiaries from beneficiaries under the *Crummey* case who were not contingent. The court, holding for the taxpayer, concluded that the proper issue was whether a beneficiary had a legal right of withdrawal.

Conclusion

Irrevocable trusts are important to avoid federal estate taxes upon the demise of the insured. To avoid gift tax consequence when premiums are paid on that insurance, the annual exclusion should be utilized. The annual exclusion excludes from taxation gifts up to $10,000 per beneficiary ($20,000 if the spouse joins in). The annual exclusion works when the transfer is of a present interest." The Crummey power makes the transfer one of a present interest. Thus, on the grantor level taxation is avoided.

Gift consequences on the beneficiary level also should be considered. A decision on how to coordinate the gift tax consequences on both levels should be carefully considered, in light of the above rules which do not smoothly mesh.

1. Code Section 2042.
2. Any transfer made within three years of death, however, generally is included in decedent's gross estate. Code Section 2035. To avoid inclusion, the trust could be the applicant and initial owner of the insurance. See *Estate of Perry v. Commissioner*, 927 F 2d 209 (5th Cir. 1991).
3. Code Section 2503(b).
4. Code Section 2513.
5. Code Sections 2010 and 2505.
6. 397 Fed. 2nd 82 (9th Circ. 1968).
7. Code Section 2041(a)(2).
8. Technical Advice Memorandum 8901004.
9. 97 TC 74 (July 29, 1991).

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