

# Lapse and Release of Crummey Powers

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## **Lapse and Release of Crummey Powers**

A trap in using Crummey powers arises from the power's lapse. A Crummey power is a general power of appointment. Because the Code categorizes the release of a general power of appointment as a taxable gift, without careful drafting of the trust instrument, the lapse of a withdrawal right may effectively give rise to the beneficiary donating a taxable gift to the trust.

Code § 2514(b) provides the exercise or release of a general power of appointment will be treated as a transfer by the holder of the power of appointment who released the power. Under Code § 2514(e) a lapse of a power of appointment is considered a release. An exception to this rule is set forth under Code § 2514(e)(1)(2) which provides that a lapse of power (and not a release or a waiver of the power) not exceeding \$5,000 or 5% of the value of the assets out of which the power can be satisfied will not be treated as a transfer. This means that a lapse of a Crummey withdrawal right in excess of the so-called "5 and 5 limitation" will be treated as a transfer to the other trust beneficiaries by the Crummey withdrawal beneficiary, while a lapsed withdrawal right within the 5 and 5 limits will continue to be treated as a transfer by the donor. As such, a lapse in excess of the 5 and 5 statutory protection amount can cause disastrous estate, gift, and generation-skipping transfer (GST) tax consequences.<sup>1</sup>

Because a lapse in excess of the 5 and 5 amounts constitutes a taxable release by the holder of the power, it is usually best to draft the beneficiary's Crummey withdrawal rights to fall within the 5 and 5 limits. Without such a limitation on the amount of the withdrawal right, and absent other drafting protections in the trust instrument (such as a hanging right of withdrawal or the beneficiary having a separate trust share and holding a

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<sup>1</sup> Grassi, *supra* note 44, at 40.

testamentary power of appointment over the amount of the withdrawal right in excess of the 5 and 5 amount), the lapse of such right in excess of the 5 and 5 amount will constitute both a taxable release under Code § 2514(b) and an immediate gift of future interest to the other Crummey trust beneficiaries.<sup>2</sup>

There are two ways to treat the taxable release and gift issue. The first way is to establish initially separate trust shares for each Crummey trust beneficiary and give the beneficiary a testamentary limited power of appointment over his or her trust share or over the amount in excess of the 5 and 5 amount. This will prevent the lapsed amount in excess of the 5 and 5 limitation from being a completed gift to the other trust beneficiaries.<sup>3</sup> But the separate trust share coupled with a testamentary limited power of appointment will not avoid the taxable release problem of Code § 2514(e). As a result, when the beneficiary dies, the assets over which the beneficiary retained a testamentary limited power of appointment (such as the amounts in excess of the 5 and 5 amount) will be included in the beneficiary's gross estate under Code § 2041(a)(2). Additionally, because the beneficiary has a retained interest in the separate trust, all (or a portion) of the value of the trust share will be included in the beneficiary's gross estate upon his or her death.<sup>4</sup> The impact of the cumulative taxable release is a retained interest by the beneficiary and can possibly result in all (or a portion) of the beneficiary's separate trust share being included in his or her gross estate for estate tax purposes.<sup>5</sup> This approach, however, can work where the grantor's spouse is not a beneficiary, the Crummey trust is not designed to be a long-term generation-skipping dynasty trust, and the beneficiary's

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<sup>2</sup> *Id.*

<sup>3</sup> Treas. Reg. §§ 25.2511-2(b)

<sup>4</sup> See Code § 2036(a).

<sup>5</sup> See Treas. Reg. § 2041-3(d)(5).

estate would most likely incur little or no federal estate tax if the beneficiary were to die before the termination of his or her interest in the trust.

The second way to deal with the taxable release and gift tax problem is to allow the Crummey withdrawal right to continue with regard to any amount in excess of the 5 and 5 amount – this is known as a Hanging Crummey power.<sup>6</sup>

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<sup>6</sup>Grassi, *supra* note 44, at 40.



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