

**Withdrawal Rights and
Crummey Trusts**

***What is a
Withdrawal Right?***

Trust Agreements frequently include "withdrawal rights" that apply to all gifts to the Trust. A withdrawal right is the right, given to the beneficiary of a trust, to withdraw all or a portion of each gift made to the trust. For example, if a \$1,000 gift is made to a trust and a beneficiary has a withdrawal right over that gift, he or she can withdraw up to \$1,000 from the trust.

***What is a
Crummey Trust?***

A "Crummey" Trust is simply a trust containing withdrawal rights. The name comes from a taxpayer who used withdrawal rights in an irrevocable trust in the 1960's. The IRS challenged him, and he was forced to go to court. Dr. Crummey won his case – the court held that granting withdrawal rights was a valid estate planning technique. Since that time, *Crummey* withdrawal rights have become widely used in estate planning.

***Why are
Withdrawal Rights
used?***

Normally, gifts to a trust do not qualify for the annual \$17,000 per donee "present interest exclusion" from federal gift taxes (described below)¹. However, when the trust beneficiaries have withdrawal rights, gifts to the trust will qualify for the exclusion.

***What is the present
interest exclusion?***

Under the Internal Revenue Code, the so-called "present interest exclusion" allows every individual to make gifts of up to \$17,000 per year/per recipient without any gift tax concerns. The exclusion is computed on a per donor/per donee basis. So, for example, a married couple with three children can make tax-free gifts of up to \$102,000 per year to their children. Gifts in excess of the exclusion – or that do not qualify for the exclusion – count against the donor's federal gift tax exclusion amount. This amount is \$12,920,000 in 2022.²

***How do
Withdrawal Rights
work?***

Withdrawal rights give each beneficiary a limited window of time to withdraw up to his or her pro rata share of gifts made to the trust each year (not to exceed the annual gift tax exclusion amount per year). Beneficiaries with withdrawal rights may either exercise the right (i.e., take the money) or choose not to, in their own absolute discretion; however, if the beneficiary is a minor, then his or her parent or guardian exercises the right (or elects not to exercise the right) for the beneficiary. For tax purposes, a gift to a trust with withdrawal rights is treated like a direct gift to the beneficiaries who have the withdrawal rights. As a result, the gift qualifies for the present interest exclusion.

¹ Note that the annual gift tax exclusion amount is adjusted for inflation. \$17,000 is the annual exclusion amount in 2023 and will be used for illustration purposes. It will be \$18,000 in 2024. The current year's amount would be applied in any year that a gift is made.

² Note that the federal gift tax exclusion amount is adjusted for inflation. For persons dying between 2019 and 2025, the exclusion amount was increased to \$10,000,000, adjusted for inflation after 2011. The exclusion amount in 2023 will be \$13,610,000.

Are there different types of Withdrawal Rights?

Generally, there are two basic types of withdrawal rights that can be included in a trust agreement: "full" withdrawal rights and "5 & 5" withdrawal rights. A beneficiary with a "full" withdrawal right has the right to withdraw all or any part of his or her pro rata share of every gift, up to the annual gift tax exclusion amount; a full withdrawal right thus takes full advantage of the annual gift tax exclusion amount. So, in the above example, if a husband and wife with three children give \$102,000 to a trust for the children, and if the children all have full withdrawal rights, each child has the power to withdraw up to \$34,000, and the full \$102,000 is covered by the exclusion.

A beneficiary with a 5 & 5 withdrawal right is generally limited to withdrawing the lesser of the annual gift tax exclusion amount and the "5 & 5" amount. The 5 & 5 amount is \$5,000 or, if greater, 5% of the value of the trust on the last day of the year in which the gift is made. Also, while the present interest exclusion is computed on a per donor/per donee basis, the 5 & 5 amount is computed on a simple per donee basis: each donee gets only one 5 & 5 amount per year even if there are multiple donors.

So, returning to the above example, if a husband and wife with three children give \$102,000 to a trust for the children, and if the children all have 5 & 5 withdrawal rights, the 5 & 5 amount limits each child's withdrawal right to \$5,000, and only \$15,000 of the gift qualifies for the exclusion; the remaining \$87,000 counts against the parents' \$12,920,000 gift tax exemptions. However, if the value of the trust (including the \$102,000 gift) was at least \$680,000, then the 5 & 5 amount would not limit the withdrawal right (because 5% of \$680,000 is \$34,000), and the full \$102,000 would qualify for the exemption.

How long do Withdrawal Rights last?

All withdrawal rights eventually terminate or "lapse." The exact timing and nature of the lapses will be described in detail in the trust agreement. However, as a general rule, a beneficiary's withdrawal right – other than a "hanging" withdrawal right (described below) – will lapse somewhere between 30 and 90 days after the beneficiary receives notice of the gift.

What is a "Hanging" Withdrawal Right?

A "hanging" withdrawal right (a/k/a "hanging power") differs from an ordinary withdrawal right in the manner of its lapse. Like an ordinary withdrawal right, a hanging withdrawal right will generally be fully exercisable for 30 to 90 days. Unlike an ordinary withdrawal right, a hanging withdrawal right does not lapse completely at the expiration of the stated term; instead, it lapses only to the extent of the 5 & 5 amount (discussed above). The excess amount, if any, does not lapse until the following year (or later). Further, all lapses in a single calendar year are aggregated and must stay within the 5 & 5 limit.

For example, if a \$10,000 gift was made to a trust in year 1 and the beneficiary had a full withdrawal right, \$5,000 of his right would probably lapse in year 1 and the remaining \$5,000 would not lapse until the following year. If a second \$10,000 gift was made in year 2, no portion of this second gift would lapse during year 2 because the first gift's lapse would have already exhausted the 5 & 5 limit on lapses in year 2. If this scenario repeats for several years, the total amount subject to withdrawal could be substantial.

On the other hand, if (or when) the value of the trust became large enough or the donors stopped making gifts to the trust, the lapses would catch up with the gifts and, eventually, the withdrawal rights would lapse completely. For instance, if a trust's only asset was a \$1,000,000 life insurance policy on the grantor, the 5 & 5 amount would probably be \$5,000 during the grantor's life (assuming the cash value was \$100,000 or less) but in the year of the grantor's death – when the \$1,000,000 proceeds were received – the 5 & 5 amount would increase to \$50,000. As a result, the outstanding withdrawal rights would begin lapsing at a rate of \$50,000 per year instead of \$5,000 per year.

What are some of the advantages and disadvantages of withdrawal rights and withdrawal right lapses?

By including withdrawal rights in a trust, the grantor can make substantial transfers to the trust without any notable gift tax consequences. The major practical disadvantage of withdrawal rights is that one or more of the beneficiaries with withdrawal rights might choose to exercise them, thus removing property from the trust, causing difficulties for the trustees and thwarting the grantor's intent. While this is certainly their right, most beneficiaries realize that their withdrawal rights are part of a carefully designed estate plan, the purpose of which is to increase their inheritance. As a result, we find that withdrawal rights are rarely exercised.

Withdrawal rights and their lapse have certain tax disadvantages as well. For instance, any beneficiary who dies while in possession of an unlapsed withdrawal right will be required to include a portion of the trust in his or her estate. This exposure is increased to the extent that the total gifts to the trust in any year exceed the 5 & 5 amount (i.e., the amount by which the withdrawal rights lapse). Under certain circumstances, even lapsed withdrawal rights may create estate tax issues at the time of the beneficiary's death. Tax and administrative issues associated with the exercise and lapse of withdrawal rights can be very technical and appropriate counsel should be consulted regarding specific questions.