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The Gift That Keeps On Giving:
How one gift becomes two or more for tax purposes

"When you go to your Victor Dealer's to hear the three models of Victor-Radio, you will find them beautiful, compact, and soundly built, as become Victor instruments. You will recognize them as the gift that keeps on giving…a royal gift…at a very low price!"

- Victor Radio slogan, 1920s

The Victor Talking Machine Company (soon after the ad above appeared becoming the RCA Victor Division of the Radio Corporation of America) came up with the slogan "The gift that keeps on giving" in an effort to sell radios. In 1986, Congress came up with its own version of "The gift that keeps on giving" in order to collect taxes. Here's how IRS – the "enforcer" for Congress -- does it:

Imagine that Dad creates an irrevocable life insurance trust (an "ILIT") to shelter life insurance proceeds from estate tax at his death. Sis and Junior are the beneficiaries of the trust. The annual premium for the policy is $30,000; Dad contributes that amount to the trust to enable it to pay the premium. That contribution looks like Dad's only gift, and it is . . . but there's another gift-giver hidden in the thicket we call the Internal Revenue Code.

Let's look for that second donor. We begin with Dad's tax advisor explaining that, in 2026, each taxpayer may lawfully avoid taxation $19,000 given to any one person (with no limit on the number of persons to whom such gifts are given), but the gift must be of a "present interest" in order to exclude that $19,000 from exposure to gift tax.[1] "Present interest" status is achieved by giving trust beneficiaries the right (a "Crummey" power) to withdraw part or all of each contribution made to the trust.[2] (Mr. Crummey was the first person successful in litigating this technique against the government.)

Giving Sis and Junior Crummey powers solves Dad's gift tax problem. $19,000 X 2 = $38,000. He has an $8,000 "cushion" above the $30,000 premium amount. Dad's done giving and owes no tax on his gift.

BUT . . . this is where Congress steps in if neither Sis nor Junior exercises a Crummey withdrawal right. Congress says (in section 2514(e) of the Internal Revenue Code), "Dad's done giving, but you're not, Junior. Because you did *not* withdraw from the trust – because you let your withdrawal right ***lapse***, you passively 'gave' part of the trust to those who will be its ultimate beneficiaries."

How much of Dad's original gift did Junior give to those ultimate beneficiaries? He gave what Dad gave minus what section 2514(e) says that he need not report as his own gift. That amount is the <u>greater</u> of $5,000 and 5% of the value of the trust estate. 5% of $30,000 is only $1,500, so the arithmetic for Junior's gift is $19,000 minus $5,000 or $14,000. That's how much of his own lifetime exemption[3] Junior used by not

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[1] $19,000 is adjusted frequently for inflation.
[2] For more on how Crummey powers work, see our Occasional Paper titled "How to Start Your Own Bank."
[3] The exemption is $15,000,000 per estate owner in 2026. It's not technically an "exemption," but the provisions of the Internal Revenue Code make it work like one.

exercising his Crummey right of withdrawal. The analysis is the same for Sis if she doesn't exercise her withdrawal right.

Dad could use more of his lifetime exemption if he wanted to preserve his children's exemptions. He could tell the trustee, "I'm giving you $30,000, but you should send a Crummey notice to each of my children telling each that he or she can withdraw only $5,000 of that amount." That way Dad would use $20,000 of his lifetime exemption -- $30,000 minus a $5,000 annual exclusion for Junior and a $5,000 annual exclusion for Sis – and neither child's exemption would be affected. Each family's unique facts should be examined in making a decision about which generation's lifetime exemption to reduce, keeping in mind that Junior's exemption won't be reduced until he dies, hopefully many years down the road. Once again, the same analysis works for Sis.

But there's more; there are the grantor trust rules. Either approach by Dad causes each of his children to become what the Internal Revenue Code calls a "grantor" of the trust to the extent of the aggregate value of the lapsed Crummey rights over the years. Being a "grantor" means being an owner and being taxed on a proportionate part of the trust's income. After, say, one year, that portion would be 1/6 -- $5,000/$30,000. The income tax cost for the children in a typical case is nonexistent or modest since an ILIT rarely has taxable income or can be managed with a low-income goal in mind.

There could be a second risk, however, that a trust grantor bears – namely, the risk that the amount accumulated in what could be called the "lapse account" will be taxed as part of Junior's or Sis's estate at death. Each family's particular situation must be examined in detail, but this adverse grantor trust factor could increase the size of the estate of a second-generation family member.

Planning techniques not discussed here could reduce the amount of a lapse gift and mitigate the impact of the grantor trust rules, but the majority of estate owners doing life insurance planning using an ILIT will find themselves described in these two pages and wishing that the law would allow the gift-giving to end with them.

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