

Estate planning conversations often start with big questions about wills, trusts, taxes, and long term care. Then, somewhere in the middle of setting up a trust or updating beneficiary forms, a more technical phrase appears: the “5 by 5 rule.”

Clients usually react the same way: a slight pause, a nod, then some version of, “Can you explain that again, in English?”

That is a fair request. The 5 by 5 rule sits at the intersection of tax law, trust design, and beneficiary rights. It affects how much control you keep, how much flexibility your heirs have, and in some circumstances whether trust assets remain protected.

This is the kind of rule that rarely makes it into headlines, but it quietly shapes whether your plan works the way you imagined when the time comes.

What the 5 by 5 Rule in Estate Planning Actually Is

The “5 by 5 rule” is shorthand for a common trust provision that gives a beneficiary the right, each year, to withdraw the greater of:

- 5 percent of the trust principal, or
- 5,000 dollars

If the beneficiary does not exercise that right within the year, the power to withdraw usually lapses. From a tax standpoint, that lapsed right is treated more kindly than a general power the beneficiary keeps forever.

You see this rule most often in irrevocable trusts that are designed for long term family planning, estate tax reduction, or asset protection. It can also show up in marital trusts and certain life insurance trusts.

The reason for the 5 and the 5,000 is historical. The Internal Revenue Service settled on that threshold as a safe harbor. A power limited to that amount is less likely to pull the entire trust back into a beneficiary’s taxable estate or trigger gift tax when the power lapses.

In plain English: the 5 by 5 rule lets a beneficiary tap a small, defined portion of a trust each year, while keeping the rest of the trust shielded and on its long term course.

Why Lawyers Use the 5 by 5 Rule in Trusts

From the drafting side, the 5 by 5 rule solves three competing goals that clients often have at the same time.

First, clients want their children or other beneficiaries to have some access. A trust that feels like a locked box forever can create resentment and practical problems, especially for adult children facing tuition bills, home purchases, or medical issues.

Second, they want protection. They do not want a beneficiary’s divorce, lawsuit, or creditor to swallow the inheritance. They also do not want a young, impulsive heir to burn through decades of savings in a few years.

Third, they care about taxes, even if they do not phrase it that way. The usual way they put it is, “I just do not want my kids to get hammered with taxes because I set this up the wrong way.”

The 5 by 5 rule gives the beneficiary a modest, predictable annual power without turning them into the full owner of the trust for tax or creditor purposes. It is a middle path between a fully locked trust and an outright

inheritance.

In practice, many beneficiaries never formally exercise the 5 by 5 withdrawal right. Instead, the trustee makes discretionary distributions as needs arise, and the 5 by 5 power sits in the background as a safety valve and tax planning tool.

How the 5 by 5 Rule Works Inside a Trust: A Concrete Example

Consider a simple case. You create an irrevocable trust for your daughter, funded with 400,000 dollars in investments. You name an independent trustee. The trust document says:

“Each year, my daughter has the right to withdraw the greater of 5,000 dollars or 5 percent of the trust principal as of the beginning of that year. This right expires at the end of the calendar year if not exercised.”

On January 1, the 5 percent amount is 20,000 dollars. Under the 5 by 5 rule, your daughter may withdraw up to 20,000 dollars that year without asking the trustee for discretion.

If she takes 10,000 dollars, her unused power of 10,000 lapses at year end. If she does nothing, the entire 20,000 dollar power lapses.

Under existing U.S. Tax rules, that lapsed 20,000 dollar power might be treated as a taxable gift from her back to the trust, but the 5 by 5 limit keeps it within an exception so that gift tax is not triggered. More importantly, the lapsed power does not typically pull the full 400,000 dollars into her taxable estate.

The trust assets, apart from that narrow 5 by 5 window, remain outside her estate for tax purposes and, depending on state law, may enjoy extra protection from her creditors.

This is why the 5 by 5 rule matters. It is a way of sharing some control with a beneficiary without collapsing the entire trust structure.

Clearing Up Confusion: 5 by 5 Rule, 5 Year Rule, and 7 Year Rule

Clients often mix together a handful of similar sounding concepts:

- What is the 5 by 5 rule in estate planning?
- What is the 5 year rule for irrevocable trusts?
- What is the 7 year rule for trusts?

These refer to different legal ideas.

The 5 by 5 rule relates to a beneficiary’s annual withdrawal power from a trust. The 5 year rule for irrevocable trusts usually shows up in Medicaid and long term care planning. Medicaid has a 5 year “lookback” period in most states, during which transfers to an irrevocable trust can be penalized if you apply for Medicaid to pay for nursing home care.

The 7 year rule for trusts is more commonly a U.K. Inheritance tax concept, where transfers made more than 7 years before death can fall outside the estate for tax purposes. In the U.S., people sometimes use “7 year rule” loosely when they really mean older life insurance or gifting strategies, but it is not a formal U.S. Rule like the Medicaid 5 year lookback.

So the 5 by 5 rule is not the same thing as the Medicaid 5 year rule or any 7 year rule. It deals with how much a trust beneficiary can pull out each year while keeping the trust’s broader tax and protection benefits intact.

Estate Planning Context: Wills, Trusts, and Your House

Once you understand why a 5 by 5 power might appear in a trust, the next natural question is whether you should be using a trust in the first place, especially for your home.

Clients frequently ask: Is it better to leave a house in a will or trust? [comprehensive estate planning attorney near me](#) The honest answer is, "It depends on what you want to accomplish."

If you leave your home in a will, that house will usually go through probate before your heirs can retitle or sell it. In some states that is a manageable process. In others, it is expensive and slow. A will is also public once it is filed, so anyone can see who inherited the property.

If you place your house in a properly funded revocable living trust, you usually avoid probate for that property. Upon your death, the successor trustee can follow the instructions in your trust and retitle or sell the house without court supervision. The trust is private, and you can still change or revoke it while you are alive and competent.

For many families, a revocable trust is the best way to leave your house to your children if the goals are probate avoidance, privacy, and smoother administration. You can say, for example, that the house should be sold and the proceeds divided, or that one child may buy out the others at appraised value, or that the house can be held in trust for a few years so a surviving spouse or minor child can stay there.

Things get more complicated with irrevocable trusts. Clients sometimes ask, "Can a nursing home take your house if it is in a trust?" The answer hinges on what type of trust, who created it, and when. A revocable living trust does not usually protect a house from nursing home costs, because you still control it. An irrevocable trust created and funded more than 5 years before a Medicaid application may offer protection, but only if it is structured correctly and complies with state law.

That brings us to the downside of putting your house in an irrevocable trust. You give up meaningful control. You usually cannot freely sell or refinance the property without the trustee's cooperation and, sometimes, a written amendment signed by all beneficiaries. You may complicate property tax exemptions and capital gains planning. And if circumstances change, unwinding an irrevocable trust is difficult, sometimes impossible.

For these reasons, I tell clients that irrevocable trusts should be used only when clear, strong goals justify the rigidity. When someone asks, "What are the only three reasons you should have an irrevocable trust?" my short list typically looks like this: long term asset protection, advanced estate tax planning, and serious Medicaid planning for projected nursing home costs. Outside those situations, a revocable trust often gives enough control and flexibility.

Probate, Beneficiaries, and Accounts That Bypass the Court

A trust is only one way to keep assets out of probate. Another frequent question is: Which bank accounts avoid probate?

Generally, an account avoids probate if it passes automatically by contract at death. That can happen in several ways. Most banks and investment custodians offer "payable on death" or "transfer on death" designations. Retirement accounts such as 401(k)s and IRAs pass by beneficiary form. Joint accounts with right of survivorship usually go to the surviving owner automatically.

A brief comparison helps:

1. Retirement accounts with designated beneficiaries, such as IRAs and 401(k)s, pass by contract and typically do not pass through probate, unless the estate is named as beneficiary.
2. Bank and brokerage accounts with transfer on death or payable on death designations pass outside probate to the named person or trust.
3. Life insurance proceeds go to the named beneficiary, not through probate, unless the estate is named.
4. Joint tenancy accounts with right of survivorship pass to the surviving joint owner automatically.
5. Properly funded revocable trusts hold accounts and avoid probate for those assets, because the trust continues after your death.

The key theme is that probate applies to assets still titled in your individual name with no valid beneficiary or trust arrangement.

That flows into one of the most important practical questions: Who should I not name as a beneficiary?

I generally caution clients about naming minor children directly, because a court may need to appoint a guardian to manage the funds until the child reaches legal adulthood. I also caution against naming someone who is receiving needs based government benefits, like certain disability or Medicaid benefits, without routing the inheritance through a supplemental needs trust. And I ask clients to think twice before naming a person with serious addiction, financial mismanagement, or creditor problems as an outright beneficiary, when a trust could protect them from themselves and from outsiders.

The Most Common Inheritance Mistake I See

Estate planning errors tend to repeat themselves. Over the years, the most common inheritance mistake I see is not a technical tax issue. It is inconsistency.

Clients will sign a thoughtful will or revocable trust, then fail to update beneficiary designations or account titles. Ten years later, assets pass in directions no one expects.

Beneficiary forms override the will. A life insurance policy still naming an ex spouse goes to that person, regardless of what the will says. A retirement account with "Estate" listed as beneficiary goes through probate even though the rest of the plan is set up to avoid it.

The second most common mistake is the "set it and forget it" attitude for decades. Families change. Laws change. The 5 by 5 rule might not even have existed when an older trust was drafted, or the estate tax exemption might have been at a very different level. Yet documents written for a young family stay in place when the children are in their 40s and grandchildren are arriving.

In practice, a good rule of thumb is to review your estate plan after major life events: marriage, divorce, births, deaths, major property purchases or sales, a significant inheritance, or a serious health diagnosis. Even a brief check every 5 years can catch issues before they become expensive fights.

Tax Questions Clients Ask About Inheritance and Gifts

Eventually, every conversation reaches taxes. People ask, "How much can you inherit from your parents without paying taxes?" or "What is the best way to gift money to an adult child?"

Here, it helps to separate income tax from estate and gift tax.

In many situations in the U.S., you do not pay income tax on an inheritance itself. You might pay income tax later on earnings generated by inherited assets, or on certain retirement account distributions, but the receipt of money

or property from a parent at death is often not income taxable.

Estate and gift tax are different. They apply to the total size of what someone transfers, either during life or at death. The federal exemption has been historically high in recent years, in the multi million dollar range per person, but it is scheduled to change again in 2026. Many parents' estates fall below that threshold, which is why you often hear that you can inherit "millions" without paying federal estate tax. State estate or inheritance taxes can be stricter, though, and those vary widely.

For lifetime gifts, there is an annual exclusion amount you can give to any one person without even filing a gift tax return. That amount adjusts periodically for inflation. Beyond that, you can still gift larger amounts, they just start to chip away at your lifetime exemption.

When someone asks about the best way to gift money to an adult child, the right approach depends on purpose. If the goal is simply helping with a down payment, a straightforward cash gift within or slightly above the annual exclusion might be fine. If the goal is long term protection, setting up a trust for that child, possibly with a 5 by 5 withdrawal right, can provide structure and shielding.

One subtle tax point that often surprises people: inherited assets usually receive a "step up" in income tax basis to their value at the decedent's death. That can be a major reason to avoid certain pre death transfers of appreciated property. Handing a heavily appreciated house outright to a child during your life might cause more capital gains tax later than letting them inherit it at death with a new, higher basis.

Medicaid Planning, the 5 Year Lookback, and the So Called "Loophole"

When the conversation turns to nursing homes, the tone changes. The fear of losing everything to long term care costs is very real.

Clients ask blunt questions: How to avoid Medicaid 5 year lookback? What is the Medicaid loophole? Can a nursing home take your house if it is in a trust?

There is no magic loophole that reliably lets you transfer assets away at the last minute and still have Medicaid pay for care. Medicaid has a 5 year lookback period in most states for long term care coverage. If you transfer assets to an irrevocable trust or give them away during that period, Medicaid can impose a penalty that delays your eligibility.

The 5 year rule for irrevocable trusts in this context means that assets transferred into the trust more than 5 years before applying for Medicaid may be outside that lookback window, provided the trust is drafted and administered correctly. Timing is everything. Creating an irrevocable trust at age 85 when you are already in a nursing home is very different from settling one at 70 when you are healthy.

Some planners talk about a Medicaid "loophole," but what they usually mean is simply careful, legal use of the rules: certain exempt assets, allowable spousal transfers, "spend down" strategies that swap countable assets for non countable ones, or the early use of irrevocable trusts well before crisis hits. None of that changes the reality that Medicaid is needs based and heavily regulated.

The interplay between Medicaid rules and the 5 by 5 provision is delicate. In many states, if a trust beneficiary has too much power to demand distributions, Medicaid may treat part of the trust as an available resource. That means a 5 by 5 withdrawal power, if used in the wrong kind of trust, could undermine the very asset protection the trust was meant to provide. This is one reason Medicaid oriented irrevocable trusts often avoid giving the person applying for Medicaid any right to withdraw principal at all.

 **PARKER**
LAW OFFICES

**TRUST ATTORNEY
ORANGE COUNTY**

Parker Law Offices

28202 Cabot Rd 3rd floor, Laguna Niguel, CA 92677
(949) 385-3130
<https://www.estateandtrustlawyer.com/orange-county-wills-and-trust-attorney/>

Will and Testament of
**LAST WILL
AND
TESTAMENT**



This is a good example of where careful drafting and a clear purpose matter more than buzzwords. Using a 5 by 5 rule in a general estate planning trust for children is one thing. Using it in a Medicaid trust for yourself is quite another.

What Absolutely Does Not Belong in a Simple Will

Clients sometimes want to pour everything into a will: pet care instructions, business succession, retirement account rules, even specific directions on how every checking account should be handled.

Some of that belongs elsewhere. For instance, what should not be included in a will? Here are three categories that are better handled by other documents or tools.

First, assets that already pass by beneficiary designation or joint ownership. Listing your IRA or life insurance in your will is usually unnecessary, and sometimes harmful, because the beneficiary form controls. If you want those assets to go into a trust, you usually change the beneficiary designation rather than rewriting the will.

Second, detailed medical or end of life instructions. Those belong in advance directives, living wills, and health care powers of attorney, not in a will that might be read days after major medical decisions have already been made.

Third, overstuffed personal instructions that change frequently, such as which grandchild should receive which piece of personal property. A separate letter of wishes or personal property memorandum, referenced by the will and easily updated, is often more practical than rewriting the will for every new piece of jewelry.

Keeping the will focused helps ensure it remains clear and enforceable. The more you try to cram in, the more likely you are to create conflicts with other parts of your overall plan.

How Much Does It Cost to Have an Estate Planning Attorney?

Cost is always part of the conversation, and people are often hesitant to ask directly. They search online instead: How much does it cost to have an estate planning attorney?

Fees vary widely by region, complexity, and the attorney's experience. A very simple will and basic incapacity documents might cost a few hundred to a couple thousand dollars. A more comprehensive estate planning package, including a revocable trust, coordinated beneficiary designations, and deeds to retitle real estate into the trust, often lands in the low to mid four figure range in many markets.

Truly complex plans involving multiple irrevocable trusts, family businesses, and detailed tax planning can cost significantly more.

The more important question is what you receive for that fee. What is comprehensive estate planning, in a way that justifies the investment?

From my perspective, comprehensive planning means at least these pieces are considered and coordinated: your will, any trusts, durable powers of attorney, health care directives, beneficiary designations, asset titling, tax exposure, long term care concerns, and realistic family dynamics. It also means the plan is designed to be administrable, so that your chosen executor or trustee can actually carry it out without unnecessary friction.

One sign you are getting real value is whether the attorney helps you see trade offs. For example, they should talk candidly about whether the flexibility of a revocable trust suits you better than the rigidity of an irrevocable one, or whether a 5 by 5 power for your adult child makes sense given their financial habits.

Pulling It Together: Using the 5 by 5 Rule Wisely

The 5 by 5 rule is a technical tool, but it connects to very human concerns: control, generosity, protection, and fairness among your heirs.

Used well, it can:

- Give beneficiaries modest annual access to funds while preserving protection and tax benefits.
- Reduce the risk that a trust you created for good reasons becomes a lifelong frustration for the person it is designed to help.

Used thoughtlessly, it can:

- Undermine Medicaid asset protection if placed in the wrong kind of trust.
- Create confusion for trustees and beneficiaries who do not understand the annual withdrawal mechanics.

The wider estate plan matters just as much as the rule itself. Whether you leave your house in a will or trust, whether you rely on irrevocable trusts for Medicaid or asset protection, which bank and retirement accounts you steer around probate, how you choose and name beneficiaries, and how you handle gifts to adult children all interact with technical provisions like the 5 by 5 rule.

The best estate planning feels tailored. It reflects not just what the tax code or Medicaid manual allows, but who your beneficiaries are, what you have worked to build, and how you want to be remembered when someone eventually opens the file with your name on it.

Parker Law Offices

28202 Cabot Rd 3rd Floor, Laguna Niguel, CA 92677

9493853130

