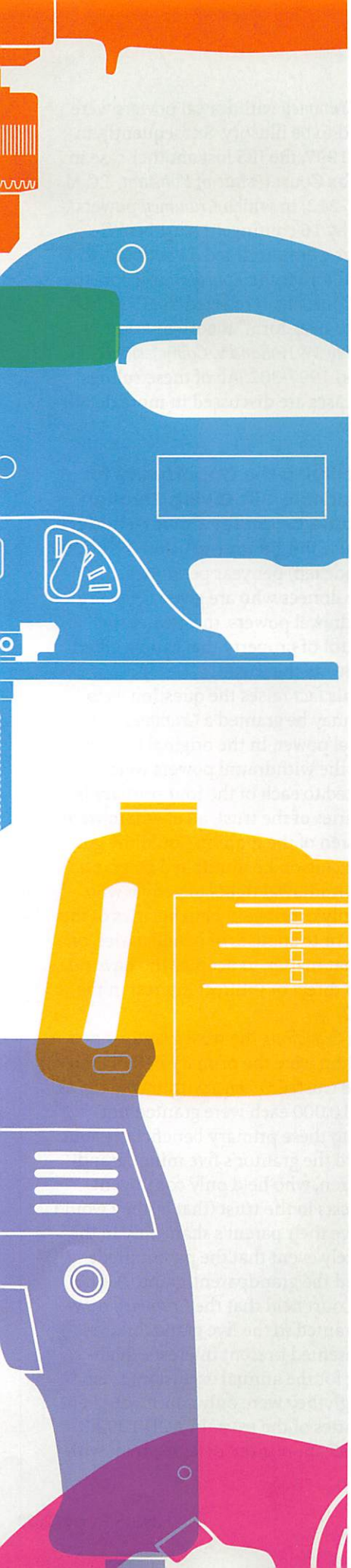

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Crummey Powers Still a Powerful Estate Planning Tool

By Robert J. Adler

In the usual case, an unfunded irrevocable life insurance trust will rely on gifts from the trust grantor to provide the funds necessary to pay future premiums. These gifts are subject to the gift tax. IRC § 2503(b) provides for a gift tax annual exclusion of up to $15,000 (as indexed through 2019) per donee per year for gifts of present interests. Gifts of a future interest do not qualify for the annual exclusion. Consequently, gratuitous transfers in trust of cash to pay life insurance premiums would ordinarily be future interest gifts for which no annually excludable amount is available.

To overcome this problem, a clever tax planner drafted a trust provision that sought to convert the payment of insurance policy premiums by a trust grantor into a gift of a present interest that would qualify for the annual exclusion. The plan works essentially as follows: The grantor would make a gift of (assume $15,000) cash to the trust. Upon receipt by the trust, each of the beneficiaries (assume three) would be given a right to withdraw one-third of the cash gift and pocket the money. If the power to withdraw were not exercised within a set period of time, the right would lapse. If none of the three power-holders exercises her withdrawal right, the trustee would then be permitted by the trust instrument to use the money for the premium payment. By transferring the premium money to the trust and giving each beneficiary at least a time-limited power to withdraw her designated portion, a present interest is created in each power-holder to the extent of the amount which she may withdraw—in our example, $5,000 each. Thus, each of the three beneficiaries has received a present-interest gift that qualifies for the annual per-donee gift tax exclusion, each gift being less than the $15,000 excludable amount (as indexed). If none of the beneficiaries exercises her withdrawal right, the $15,000 premium will be paid by the trustee, with no applicable gift tax. This technique has become an important tool in estate planning, in connection with life insurance trusts and wealth transfer tax planning generally. The time-limited power of withdrawal granted in order to create present interests in the donees have come to be known as "*Crummey* powers." By inserting a special trust provision creating a presently-exercisable power of withdrawal, the otherwise non-excludable gift of a future interest is transformed into a gift of a present interest. In

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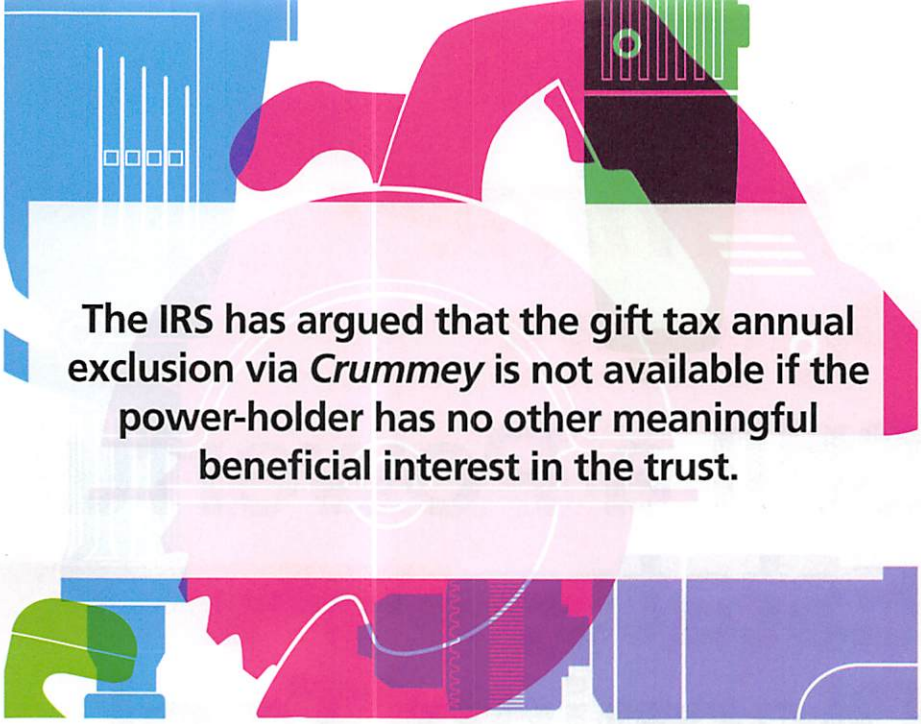


The IRS has argued that the gift tax annual exclusion via *Crummey* is not available if the power-holder has no other meaningful beneficial interest in the trust.

Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), the Ninth Circuit Court of Appeals held that an unrestricted right to the immediate use, possession, and enjoyment of an addition to a trust, whether or not exercised (and whether or not likely to be exercised), makes the transfer a present interest for annual exclusion purposes.

In Rev. Rul. 81-7, the IRS held that a *Crummey* power-holder must have knowledge of her demand rights under a *Crummey* power and must have a reasonable opportunity to exercise the power before it lapses; otherwise, the grantor will be denied the gift tax annual exclusion. Thirty days seems to be the shortest reasonable period of time between notice of the withdrawal right and lapse. Notice should contain a detailed account of the existence and duration of the power and the conditions under which it can be exercised.

Historical Context: The IRS View and *Cristofani, Kohlsaat, Holland,* and *Mikel*

The IRS has argued that the gift tax annual exclusion via *Crummey* is not available if the power-holder has no other meaningful beneficial interest in the trust. In an important taxpayer victory, the Tax Court rejected the foregoing IRS position in *Cristofani Est. v. Commissioner*, 97 TC 74 (1991). In *Cristofani*, the IRS argued that the grandchildren could not have present interests because they had no other vested interests in the trust, and the decedent never intended to benefit grandchildren in any way. The Tax Court disagreed and stated that

> the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment. . . Based upon the language of the trust instrument and stipulations of the parties, we believe that each grandchild possessed the legal right to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand.

Cristofani, 97 TC at 83.

In mid-1996 the IRS issued a revised Action on Decision (AOD 1996-10) announcement with respect to the important 1991 *Cristofani* case, along with a Technical Advice Memorandum (TAM 9628004) denying the $10,000 annual gift tax exclusion with respect to transfers in trust subject to 19 separate *Crummey* withdrawal rights. Under the facts presented in the TAM, the *Crummey* withdrawal powers were found to be illusory. Subsequently, in May 1997, the IRS lost another case in the Tax Court (*Estate of Kohlsaat*, T.C.M. 1997-212) in which *Crummey* powers held by 16 contingent trust beneficiaries were sustained. Less than two months after the *Kohlsaat* decision, the Tax Court again rejected the IRS's "substance-over-form" theory in *Estate of Carolyn W. Holland v. Commissioner*, T.C. Memo 1997-302. All of these rulings and cases are discussed in more detail below.

Amplifying the Opportunity for Excludable Gift Giving Through Multiple *Crummey* Power-Holders

Because the gift tax exclusion is $15,000 (as indexed) per year per donee, the more donees who are given *Crummey* withdrawal powers, the greater the amount of property that can be gifted tax-free to the trust.

This fact raises the question as to who may be granted a *Crummey* withdrawal power. In the original *Crummey* case, the withdrawal powers were granted to each of the four primary beneficiaries of the trust, all of whom were children of the grantor. Could the gift tax exclusion be multiplied by granting withdrawal rights to people who are only contingent beneficiaries of the trust, or to spouses of beneficiaries, or, for that matter, to people who have no other direct or indirect interest in the trust?

In *Cristofani*, the trust grantor's two children were the primary beneficiaries of the trust. *Crummey* withdrawal rights for $10,000 each were granted not only to these primary beneficiaries but also to the grantor's five minor grandchildren, who held only contingent interests in the trust (that is, they would receive their parent's share only in the unlikely event that the parent predeceased the grandparent/grantor). The Tax Court held that the *Crummey* powers granted to the five grandchildren represented present interests, qualifying for the annual exclusion, even though they were only contingent beneficiaries of the trust. In AOD 1992-9, the IRS announced disagreement with

this court decision and intention to continue to challenge *Crummey* powers granted to persons who had no other interest, or only a contingent interest, in the trust.

TAM 9628004

In mid-1996, the IRS issued TAM 9628004, dealing with a set of facts that were so obviously abusive that they could serve as a case study for tax planners on how not to structure annual gifts with *Crummey* powers. In each of three consecutive years, the grantor gifted $190,000 to three trusts, claiming the annual exclusion for the entire amount as a result of having granted $10,000 *Crummey* withdrawal powers to 19 different people. Three of the power-holders were the primary trust beneficiaries (the grantor's children); the other *Crummey* power-holders were the donor's seven grandchildren (contingent trust beneficiaries), two great-grandchildren, the three spouses of the primary beneficiaries, and four spouses of grandchildren. The two great-grandchildren and the seven spouses had no interest in the trusts other than the purported *Crummey* withdrawal powers. Other abusive facts cited by the IRS were:

- The trust provisions did not require giving notice to the *Crummey* power-holders of either their rights to withdraw or the receipt of additions to the trust (from which a withdrawal might be taken).
- In one year, *Crummey* power-holders were sent notices of their withdrawal rights, dated December 27, giving them until December 31 to exercise their rights. However, the grantor did not even attempt to fund the gift to the trust until December 30, and the funds were not actually received by the trust until January 2. A similar situation occurred at the end of the following year.
- None of the withdrawal rights were ever exercised, even by those parties who had no other interests in the trusts and no economic reason not to take the money each year.

With respect to the *Cristofani* (multiple-power-holder) issue, the TAM states that "the Service generally does not contest annual gift tax exclusions for *Crummey* powers held by current income beneficiaries and persons with vested remainder interests," based upon the logic that these parties might have an economic reason not to exercise their withdrawal rights and leave the money in the trust. On the other hand, in the case of *Crummey* power-holders who hold no interests at all, the IRS argues that there is no logical explanation for such parties consistently opting not to exercise their rights to withdraw their share of the gifted property. "[T]heir non-exercise indicates that there was some kind of pre-arranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both."

Because of the instances in which there was inadequate advance notice of withdrawal rights or inadequate funding during the purported withdrawal window period, the IRS held that the grantor "did not intend gifts of present interests by granting the *Crummey* powers." Referring to Supreme Court decisions establishing the doctrine that the substance of what was intended governs, rather than the form used in attempting to structure the transaction to qualify for favorable tax treatment, the IRS concluded that the grantor "did not intend at the creation of the trusts to make bona fide gifts of present interests to any of the trusts' beneficiaries." Thus, the exclusion was denied with respect to all of the *Crummey* power-holders, even the three current income and vested remainder beneficiaries.

At the same time it issued TAM 9628004, the IRS issued a further Action on Decision (AOD 1996-10) with respect to the 1991 *Cristofani* case, reiterating that it disputed the court's reasoning and would continue to challenge *Crummey* powers that do not represent bona fide gifts of present interests, in the form of rights to immediate access to trust assets. The withdrawal rights must be in substance what they appear to be in form. This was again reiterated in April 1997 in TAM 9731004.

Estate of Kohlsaat

In the May 1997 Tax Court memorandum decision, *Estate of Lieselotte Kohlsaat v. Commissioner*, T.C.M. 1997-212, the IRS pressed several of the elements of its position set forth in TAM 9628004. In this case, a commercial building valued at $155,000 was transferred to a trust in which the transferor's two children were the primary beneficiaries and 16 grandchildren and great-grandchildren held contingent remainder interests. The two primary beneficiaries and each of the 16 contingent remainder beneficiaries were given $10,000 *Crummey* withdrawal rights, with an adequately-noticed 30-day exercise period. The resulting aggregate of $180,000 in annual exclusions was more than enough to eliminate any transfer tax on the gift of the building. The IRS challenged the *Crummey* powers granted to the 16 contingent remainder beneficiaries.

The IRS argued that (i) understandings existed between the parties to the effect that none of the withdrawal powers would actually be exercised, (ii) the contingent beneficiaries believed they would be penalized if they exercised their withdrawal rights, and (iii) the trustees purposely withheld information from these beneficiaries; therefore, under the substance-over-form doctrine, the withdrawal rights purportedly granted to the 16 contingent beneficiaries should be ignored. Citing the *Cristofani* case, the court held for the taxpayer, rejecting the IRS's arguments, stating that the evidence did not support the allegations advanced to show that the form of the arrangement was other than its substance. Of course, it is important to note that the *Crummey* power planning in this case was infinitely cleaner than the case in TAM 9628004: There was a 30-day exercise period; adequate notice was given; and minor beneficiaries' rights were exercisable by their respective guardians.

The only negative factor, which was not even mentioned in the opinion, was the fact that during the 30-day withdrawal period the trust had no liquidity, its only asset being a commercial building.

Estate of Holland

Less than two months after the *Kohl-saat* decision, the Tax Court again rejected the IRS's position in *Holland*. In this case there were eight *Crummey* power-holders. The IRS had argued that because the family had discussed the intended use of the *Crummey*-gift funds, prior to any transfers by the grantor, there existed an informal agreement that the *Crummey* powers would not be exercised. The Court rejected the IRS's argument that there was any legally effective agreement that no withdrawals would ever be demanded. The Court simply concluded that there was no evidence that the trustee could have been prevented from paying over the funds if a demand had been made. Such a conclusion effectively rejects the IRS's substance-over-form theory, because the court seems to be requiring proof of an actual enforceable agreement between the grantor and the *Crummey* power-holders that the latter will not exercise their power.

Mikel v. Commissioner

In *Mikel v. Commissioner*, T.C.M. 2015-64, the IRS unsuccessfully advanced the argument that a non-binding arbitration provision and *in terrorem* clause in a *Crummey* trust rendered the withdrawal rights illusory. (*Mikel* involved 60 *Crummey* power holders.) The Tax Court summarized its holding as follows:

> In sum, we conclude that the beneficiaries of the trust possessed a "present interest in property" because they had, during 2007, an unconditional right to withdraw property from the trust and their withdrawal demands could not be "legally resisted" by the trustees. *Crummey*, 397 F.2d at 88; *Estate of Cristofani*, 97 T.C. at 84. Assuming arguendo that the beneficiaries' withdrawal rights must be enforceable in State court, we conclude that this remedy, which respondent concedes was literally available, was also practically available because the *in terrorem* provision, properly construed, would not deter beneficiaries from pursuing judicial relief.

Mikel, 2015-64 at 20-21.

Potential Gift and Estate Tax Exposure of Holders of *Crummey* Powers

Although the use of Crummey withdrawal powers, to the extent of $15,000 (as indexed) per donee or beneficiary can shelter the donor from gift tax, a *Crummey* power in excess of $5,000, or five percent of the value of the trust principal in any year, can have gift tax consequences and possible estate tax consequences to the beneficiary or power-holder. This additional complication is caused by the fact that a *Crummey* demand power technically falls within the definition of a general power of appointment over the property that is subject to the demand right. The possession of a general power of appointment over property is deemed to be equivalent to ownership of the property for transfer tax purposes.

In effect, the lapse of a *Crummey* power will be considered a gift made by the power-holder to the extent that the power is for an amount that exceeds the greater of $5,000 or five percent of the value of the trust principal. Hence, if the powers of withdrawal are limited to the "five-or-five" limitations of IRC §§ 2041(b)(2) and 2514(e), adverse transfer tax consequences upon lapse are avoided (i.e., as long as property subject to a power of withdrawal does not exceed the greater of $5,000 or five percent of the value at the time of such lapse of the aggregate assets out of which the exercise of the lapsed powers could have been satisfied). For example, assume that the *Crummey* power-holder allows a right to withdraw $7,000 lapse and that during the period when the withdrawal right could have been exercised the total value of the trust was $80,000. The five-or-five rule will treat $5,000 (the greater of $5,000 or $4,000—five percent of $80,000) as a nontaxable lapse and the remaining $2,000 as a release of a general power of appointment (in effect, as if the power-holder had transferred $2,000 of his own assets to the trust). Whether or not this will result in a taxable gift will depend upon the terms of the trust and general principles of gift taxation.

Planning Approaches for Lapse Amounts in Excess of the Five-or-Five Limitation

Testamentary Powers of Appointment

The IRS has applied Treas. Reg. § 25.2511-2(b) to irrevocable life insurance trusts containing *Crummey* powers that gave the sole beneficiary of each trust a general power of appointment over all trust property (including the lapsed property). Under this regulation, lapse of a withdrawal right is not a completed gift because of the beneficiaries' retained power to control the disposition of the trust at death. PLR 82-29-097 and 85-17-052. A limited power of appointment should yield the same "incomplete gift" tax result. PLR 90-30-005.

Vested Trust

If the trust provides that a single beneficiary, or his estate, is to receive all distributions from the trust, a lapse will not cause a gift; the gift is never deemed complete because of the beneficiary's retained power to alter the ultimate takers under his will. Treas. Reg. § 25.2511-2(b). However, the entire trust would be includible in the beneficiary's gross estate.

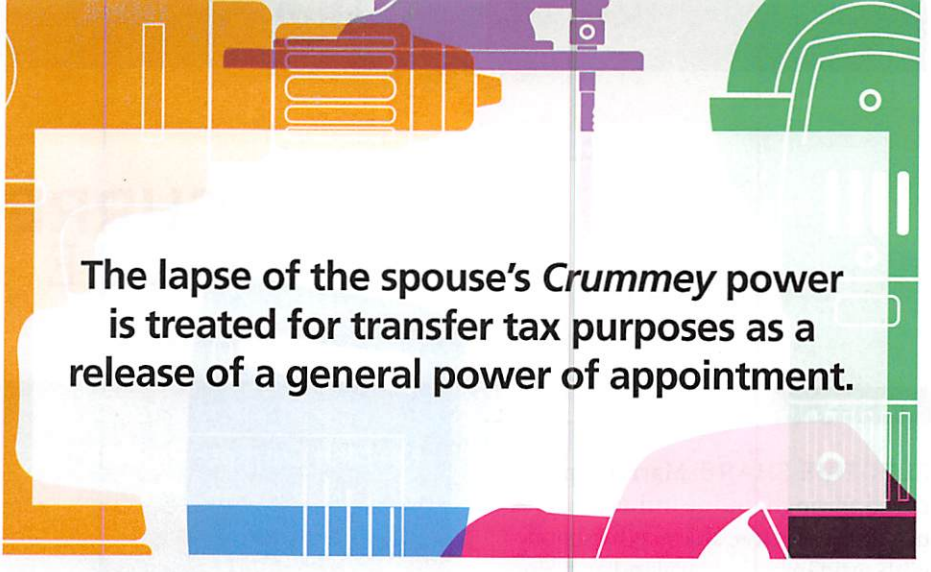
Hanging *Crummey* Powers

Perhaps the most widely used technique for avoiding gift tax on lapsed *Crummey* powers in excess of the five-or-five limit involves the preservation of the *Crummey* withdrawal right to the extent that it exceeds the five-or-five limit, and carrying it forward (i.e., leaving it open for exercise by the demand power-holder) into future calendar years (cumulatively with similar

excesses from other years). The cumulative carry forward amount would be reduced, and it is hoped eventually eliminated, through lapses within the annual five-or-five limitation in future years in which lapses of *Crummey* powers, if any, fall below the five-or-five limitation. In PLR 89-01-004, the IRS described a particular hanging power arrangement and ruled, in effect, that it was ineffective and that the beneficiaries holding powers had made gifts to the extent the total amount subject to withdrawal power exceeded the portion sheltered by the five-or-five rule. The ruling relied on the principle of *Comm'r. v. Proctor*, 142 F.2d 824 (4th Cir. 1944). In the facts of that case, a transfer was made subject to a condition subsequent to the effect that if the transfer were later determined by a court to be a taxable gift the transfer would be canceled and the property returned to the transferor. The court held that such a condition was void because it violated public policy by requiring a court to rule on an issue that by virtue of the court's ruling could become moot. Although the application of this rationale to a properly drafted hanging power provision is highly questionable, and probably incorrect, PLR 89-01-004 has never been tested in court. In any event, it would be inapplicable in the case of a hanging power provision drafted so that the determination of the extent to which the withdrawal demand right does not lapse and is carried forward is keyed to a mechanical numerical formula (applying the five-or-five rule) without the use of language that conditions it specifically to potential tax consequences.

Estate Tax Consequences to the *Crummey* Power Holder Upon Lapse of the Demand Power

In general, IRC § 2041(a)(2) includes the value of property subject to a general power of appointment that was released or exercised before the decedent's death in the decedent's gross estate if the result of the release or exercise is the creation of a retained interest described in IRC §§ 2036, 2037, or 2038. For example, in the case of a



Crummey power granted to a spouse, if the demand power is not limited by the five-or-five limitation, the lapse of the spouse's *Crummey* power is treated for transfer tax purposes as a release of a general power of appointment. Under these circumstances, if the post-death dispositive provisions give the surviving spouse a life-income interest in trust assets, an estate tax problem is created in that the spouse has made a transfer (i.e., a transfer of the lapse amounts in excess of the five-or-five limitation) with a retained life income interest. See IRC § 2036.

Gift Tax Exclusion and Generation Skipping Transfer Taxability

It is important to realize that a lifetime gift that creates an interest in a so-called "skip person" is potentially subject to generation-skipping transfer tax (GSTT), even though the gift qualifies as excludable from gift taxation. In other words, not all gifts that are excludable from gift taxation (by reason of the $15,000 (as indexed) gift tax annual exclusion) are excludable from the operation of the GSTT. For example, if a donor were to make a gift of $30,000 to a *Crummey* trust from which the donor's child and grandchild have *Crummey* powers and an income interest, each beneficiary would effectively be receiving a $15,000 gift, each of which would qualify for the $15,000 annual per donee exclusion from gift tax. However, the periodic distributions of income from the trust to the grandchild would be taxable distributions, subject to GSTT, with no GSTT benefit having been derived from the fact that the original gift was excluded from gift tax. There are, however, certain limited situations in which gifts qualifying for gift tax exclusion are also excluded from GSTT. See IRC § 2642(c). To the extent that a gift directly to a skip person (a "direct skip") would qualify for the $15,000 gift tax annual exclusion, it also qualifies for exclusion from GSTT. A gift that qualifies for gift tax exclusion as a direct payment of educational or medical expenses of a skip person also qualifies for GSTT exclusion. A gift to a trust, which qualifies for the annual $15,000 gift tax exclusion, is GST tax-free if the trust is for the exclusive benefit of one individual who is a skip person, and the trust assets will be includible in such skip person's gross estate if the trust has not terminated before her death. Where the aforementioned requirements are not met, it is necessary to allocate an appropriate amount of the GSTT exemption to annual exclusion transfers in order to exempt future generation-skipping transfers.

Conclusion

The recent history of estate tax legislation demonstrates that the issue has become captive to political interests. There is no reason to expect an end to this situation. In this state of uncertainty, attention must be directed to techniques that ensure successful estate planning whether the estate tax exemption is $3.5 million, $11.4 million, or anything in between, or higher or lower. That's why the *Crummey* trust is still such a powerful and indispensable estate planning tool. ■