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Trusts and Estates

# Recent Tax Court Ruling on Crummey Trusts

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Crummey trusts are an important tool for estate practitioners looking to help their clients take advantage of the annual gift tax exclusion. Despite their relative popularity, Crummey trusts are sometimes challenged by the Internal Revenue Service (IRS).[1] A recent U.S. Tax Court case, *Mikel v. Commissioner*[2] reviewed the continuing viability of Crummey trusts when the trust contains an arbitration clause and an in terrorem clause. The decision is an important lesson and review for estate practitioners who utilize these types of trusts in their practice.

## Utilizing Crummey Powers

Under federal tax law, individuals can give up to $14,000 a year to family or friends tax-free, provided the donee has a "present interest" in the money and can access the money right away. See Section 25.2503-3(b), Gifting Tax Regs. which defines a present interest as "an unrestricted right to the immediate use, possession, or enjoyment of the property or the income from property such as a life estate or term certain."

The so-called Crummey trust is a way to parlay the annual gift tax exclusion into a larger estate planning tool. The donor gifts the annual exclusion amount into a trust for the benefit of the donee. The trust satisfies the "present interest" criteria set forth in Internal Revenue Code §2503(b) because the donee gets a small window, usually 30 days, to access the money. If the donee does not access the money during this period of time, then the money remains in the trust.

*Crummey v. Commissioner*[3] was the U.S. Court of Appeals for the Ninth Circuit decision which reviewed this estate planning practice. In *Crummey*, the donors created an irrevocable trust for the benefit of their children, some of whom were minors. The trust agreement provided that following a gift of property to the trust, each beneficiary had a right to demand cash from the trust. The Ninth Circuit held that where the trustee could not legally resist the demand, the gift was a gift of a present interest and the property was subject to the annual exclusion.[4]

As stated in *Crummey* and subsequent cases, the test to determine a "present interest" is not whether the beneficiary was likely to receive the present enjoyment of the gift, but whether the beneficiary had the ability to exercise his right to withdraw trust corpus and whether the trustee could likely resist a beneficiary's demand for payment.[5] It follows that annual gift tax exclusions for trusts that utilize Crummey powers are appropriate where the trust instrument gives the beneficiaries a "bona fide unrestricted legal right to demand immediate possession and enjoyment of trust income or corpus."[6] However, the IRS has been known to deny the exclusions where the withdrawal rights are illusory.

## 'Mikel v. Commissioner'

In 2015, the U.S. Tax Court decided important questions for trusts which utilize Crummey powers in *Mikel v. Commissioner*, namely, the effect that arbitration and in terrorem provisions have on the viability of Crummey trusts.

In 2007, a New York husband and wife, Israel and Erna Mikel, each gave $1.6 million to a family trust. They both filed separate gift tax returns reporting the gifts and claiming an annual exclusion of $720,000, asserting that each gift included a $12,000 gift of a present interest to each of the trust's 60 beneficiaries. The beneficiaries were the Mikels' children, lineal descendants and their spouses. Many of the beneficiaries were 18 years of age or younger. The trust had a specific provision granting each of the beneficiaries 30 days to withdraw the $12,000 gift to them, in an attempt to utilize the practice outlined in *Crummey*.

Of particular note, the trust had an arbitration provision, stating that any dispute involving the interpretation of the trust must be submitted to a rabbinical arbitration also known as a beth din. Pursuant to the terms of the trust, the beth din was instructed to "enforce the provisions of [the trust] and give any party the rights he is entitled to under New York law." A separate provision of the trust stated the trust should be interpreted "to effectuate the intent of the parties…that they have performed all the necessary requirements for [the trust] to be valid under Jewish law."

The trust also had an in terrorem provision, which prohibited a beneficiary of the trust from directly or indirectly instituting, conducting or in any manner taking part in any proceeding to oppose a distribution of the trust's corpus by filing a court proceeding "or challeng[ing] any distribution…in any court, arbitration panel or any other means…" If a beneficiary violated the terms of the in terrorem clause, he was to be excluded from any participation in the trust and not receive any benefits from the trust.

In August 2007, pursuant to terms of the trust, each beneficiary received a document titled "Notice of Right of Withdrawal." The letter informed each recipient that a contribution had been made to him or her and that he or she had a 30-day window to withdraw the $24,000 from the trust. There was no evidence of any pre-arranged plan or understanding among the Mikels and the beneficiaries of the trust which would prevent the beneficiaries from exercising their withdrawal rights.

Upon review of the filed gift tax returns, the IRS sent the Mikels notices of deficiency determining that they were ineligible for the claimed annual exclusions. The IRS conceded that the trust afforded each beneficiary an unconditional right of withdrawal. The IRS also did not suggest any basis upon which the trustee of the trust could properly refuse to honor a timely withdrawal demand. Still, the IRS argued that there was no "present interest" in a practical sense because of the arbitration provision and the in terrorem clause. The Mikels petitioned to the U.S. Tax Court, and the parties both cross-moved for partial summary judgment.

In the Tax Court, the Mikels relied upon *Crummey* and its progeny and argued that the annual exclusion should apply because the trust gave each beneficiary an unrestricted right to withdraw the gifts for a 30-day period and timely notices concerning their withdrawal rights were sent and received.

The IRS argued that while the beneficiaries, in practice, had a right to immediately withdraw the money from the trust, these were not legally enforceable rights. The IRS argued that the beneficiaries would be dissuaded from enforcing their rights under the trust because of the arbitration and in terrorem clauses, and thus they did not have an enforceable right.

The Tax Court ruled for the Mikels finding that all of the trust beneficiaries had a present interest in the property. It found that the beneficiaries had an unconditional right to withdraw property from the trust which could be enforced through a beth din. The court rejected the IRS's argument that a beneficiary must be able to go before a state court to enforce his withdrawal rights. Further, it stated that the IRS had not set forth any explanation why a beth din was not enforcement enough.

The Tax Court also reviewed the (admittedly) unclear in terrorem clause and interpreted it as only covering situations where the beneficiary was opposing or challenging a trustee's distribution to another beneficiary. The court did not interpret the clause to include any action to compel a trustee to honor a timely withdrawal demand. Thus, it concluded that the in terrorem provision, when properly construed, would not deter beneficiaries from pursuing judicial relief.

## Analysis and Practice Tips

Despite the ruling of the Tax Court, this case highlights several practice tips that should guide estate practitioners when utilizing Crummey powers in trust documents.

First, the viability of the arbitration clause may have turned on the fact that the trust terms required the beth din to follow the laws of New York State. New York law provides that an arbitration award may be confirmed, vacated or modified pursuant to CPLR 7510 and 7511. This may have been determinative for the court when finding that the beneficiaries had a legally enforceable right. The same result may not follow if the arbitration clause were drafted differently, or if New York was not the governing law.

Second, the Tax Court, while noting the provision was "not a paragon of draftsmanship," construed the in terrorem provision to only cover challenges to distributions to other beneficiaries. The court focused on the "most sensible limiting construction" in interpreting the clause, relying upon several canons of construction, including noscitur a sociis, a Latin phrase which translates to "it is known by its associates."[7] This canon holds that "the meaning of an unclear word or phrase should be determined by the words immediately surrounding it."[8]

While this may have been the right result, the Tax Court went to great lengths to support its construction of the clause. A hypothetical beneficiary cannot be assured that a New York State court would interpret the in terrorem provision the same away as the Tax Court (due to the ambiguity of the clause) and thus might very well be deterred from pursuing judicial relief.

Practitioners should be mindful of this ruling. In terrorem clauses should be used sparingly. If a client insists upon an in terrorem clause, any clause should specifically state that it does not apply to actions brought by beneficiaries to enforce any withdrawal rights. It is also important to coordinate the Crummey power provision with the other provisions of the trust so that the trustee does not have the authority to otherwise defeat any exercise of the Crummey power.

There are some other good practices to remember when using Crummey powers including:

1. There must not be any arrangement with the donee that he will not exercise the Crummey power. See *Trotter v. U.S.*, T.C. Memo 2001-250 (where the Tax Court found an implied understanding that the donor would continue to use and enjoy the condo after it was transferred to the trust, causing estate tax inclusion and finding Crummey powers were a mere "paper formality without economic substance.") The benefits of keeping assets in a trust can be explained to a beneficiary, but the trustee or grantor must never imply that withdrawals are prohibited.

2. The withdrawal period should not be too short. While the IRS has accepted periods of 15 days,[9] 30 days is more frequently utilized.

3. Withdrawal notices should be sent using a method that can provide proof of mailing.

4. Notices should be sent so that the withdrawal period expires before the end of a tax year to avoid confusion.

5. Be wary of the "five-and-five" rule. If you are gifting more than $5,000 or 5 percent of the trust principal, draft a hanging withdrawal power so that the excess over the five-and-five amount hangs over to future years. For more information on this, see Radigan, "Crummey Powers: A Refresher," NYLJ Nov. 2, 2009.

# Conclusion

Crummey trusts have proven to be a useful mechanism for gifting money out of an estate without gift tax consequences. When utilizing these trusts, estate practitioners should be aware of the Mikel case for the guidance it provides drafters.

**Endnotes:**

1. See *Cristofani v. Commissioner*, 97 T.C. 74 (1991) distributed July 15, 1996, stating that the IRS "will continue to litigate cases whose facts indicate that the substance of the transfers was merely to obtain annual exclusions and that no bona fide gift of a present interest was intended."

2. *Mikel v. Commissioner*, T.C. Memo 2015-64 (2015).

3. 397 F.2d 82 (9th Cir, 1968).

4. See Id at 88; See also *Cristofani v. Commissioner*, 97 T.C. 74 (1991).

5. See *Cristofani*, supra n.5; see also *Crummey*, supra n.5.

6. *Mikel v. Commissioner*, T.C. Memo 2015-64 (2015).

7. Id.

8. Id., at fn. 7.

9. *Cristofani*, supra n.5.

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