Trusts and Estates Law - 'Crummey' Powers: A Refresher

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Unless one is dealing with The Uniform Transfers to Minors Act or a minor's trust under Internal Revenue Code (IRC) 2503(c), generally, in order for one to avail themselves of the gift tax annual exclusion afforded under IRC 2503(b), the gift must qualify as a present interest. For example, if a donor contributed the annual exclusion amount ($13,000 per donee or $26,000 if spouses gift split) to a trust in any asset form, such as cash, real property, securities, etc., it would amount to a gift of a future interest and would not qualify for the annual exclusion.

The issue is not a question of vesting, but rather, immediate possession. In order to obtain the annual exclusion, the donor must convert the future interest held in trust to a present interest. This conversion is accomplished by giving the donee/beneficiary the opportunity to withdraw the gift from the trust with the hope that the withdrawal is never made, and the gift remains within the trust. This device was conceived from the facts set forth in *Crummey v. Commissioner*.[1]

The court found in *Crummey* that a present interest exists when a trust grants the beneficiary a withdrawal power each time the grantor transfers assets to the trust. For instance, when a grantor funds a trust with a life insurance policy, the policy represents a future interest for the beneficiaries. In order to qualify for the annual exclusion, the trust must grant the beneficiaries the power to withdraw the policy, thus creating a present interest. Even though the withdrawal power exists, the beneficiary declines the offer and the policy remains in the trust with the grantor enabled to claim annual exclusions for each beneficiary that holds the withdrawal power. Subsequent contributions are then made to cover premium payments. The power holders again decline to withdraw, giving the trustee the ability to use the funds to pay premiums. As with the initial funding, the additional contributions qualify for the grantor's annual exclusion.

Trusts that contain Crummey powers (hereinafter referred to as "withdrawal power" or "Crummey power") have been popular since the *Crummey* case because of the following advantages: (i) a donor/grantor may gift without utilizing his/her lifetime gift tax exemption, (ii) the trust may have multiple beneficiaries, (iii) there are no restrictions on investments, (iv) the trustee may have broad discretion to make distributions, (v) withdrawal powers are minimized because the grantor can stop making future contributions, and (vi) the trust may continue for as long as the grantor desires. Specifically, the utility of trusts funded with life insurance policies and closely held business interests remains strong.

Drafting Crummey Powers

A Crummey power does not create a present interest unless the beneficiary has notice that: (i) a gift has been made, and (ii) he/she has the right to withdraw. Without notice, a beneficiary's right to withdraw is illusory. Notice must be close in time to the gift, and notice requirements should be set forth in the trust to ensure notice is carried out. The trustee must give notice to each adult beneficiary and minor beneficiary's guardian or parent (preferably not the grantor).

Verbal notice has been held to be sufficient. However, the prudent approach is to provide written notice, countersigned and dated by the beneficiary to acknowledge receipt, which is held by the trustee for safekeeping. This paper trail is essential not only to combat an Internal Revenue Service (IRS) audit, but also to prevent the trustee from potentially breaching his/her fiduciary duty.

In addition to notice, the Crummey power must provide a withdrawal period that is long enough to provide the beneficiary with adequate time to exercise the power. The IRS has routinely accepted a withdrawal period of 30 days. Anything shorter could compromise creating a present interest and make gifts ineligible for the donor's annual exclusion. Because of this, gifts should not be made in late December for trusts where the withdrawal powers lapse at year's end.

Trusts with many beneficiaries must proportionally allocate withdrawal powers to preserve creating multiple present interests. One of the more recent questions before the courts is whether there is a need for liquidity, to the extent of the beneficiary's withdrawal power, in order to qualify for the annual exclusion. This is particularly relevant for trusts funded with real estate, closely held business interests or life insurance policies. While there is no clear decision that requires assets subject to withdrawal powers to be liquid, illiquidity is a factor that favors the IRS when they challenge the existence of a present interest.[2]

Once a gift to a trust qualifies for the annual exclusion, gift tax consequences are overcome by the donor, but not with respect to a beneficiary. Rather, when a beneficiary fails to exercise the withdrawal power, which is almost always the case, the power lapses and can create unexpected gift tax consequences to a beneficiary. This tax problem is referred to as the "gift over" or "gift back." Because the withdrawal power held by a beneficiary is a present interest, giving the beneficiary an unrestricted right to the immediate use and possession of property, such power is considered a general power of appointment. Thus, the lapse of the withdrawal power results in a transfer of the property subject to the power.

Pursuant to IRC 2514(e), the value of the property subject to a lapsed power that is greater than $5,000 or 5 percent of the trust principal is the amount gifted by the beneficiary. This limitation to the beneficiary's gift back is referred to as the "five-and-five" power. In avoiding this adverse gift tax consequence, trusts should be drafted to account for the five-and-five power. One such approach is to draft a hanging withdrawal power so that the excess over the five-and-five amount hangs over to future years, until the lapse of the power will not violate IRC 2514(e).

Attempts to Limit Powers

Crummey powers remain popular in estate planning because they provide the means to qualify gifts for a donor's annual exclusion, and IRS attacks have been generally unsuccessful. While the taxpayer has fared far better than the IRS, there are two key issues that the IRS has kept in their sights. They are as follows: (i) whether contingent beneficiaries can be given withdrawal powers, and (ii) whether there is a pre-arranged understanding that the beneficiaries will not exercise their withdrawal powers. Additionally, year after year, the Legislature has proposed limitations on Crummey powers. Given the difficult economic times, Democratic control of the Congress, and the eroding transfer-tax base, proposed legislation may actually come to fruition during the Obama administration.

In *Cristofani v. Commissioner*,[3] the IRS challenged the validity of granting Crummey powers to remote contingent beneficiaries. The issue before the Tax Court was whether minor grandchildren who were merely contingent beneficiaries had a sufficient enough interest to be holders of withdrawal powers. The primary trust beneficiaries were the grantor's children, and both the children and grandchildren were granted withdrawal powers.

The IRS disallowed the annual exclusions for the grandchildren's gifts, claiming that a present interest was not created because the grandchildren were only contingent beneficiaries. The Tax Court disagreed, reasoning that the question of whether a present interest exists is determined by a beneficiary's unrestricted

right to withdraw and not the beneficiary's ultimate interest in the trust.

Notwithstanding its loss in *Cristofani*, the IRS continued to litigate withdrawal powers granted to contingent beneficiaries.[4] Six years after *Cristofani*, the Tax Court again rejected the IRS's challenge in *Kohlsaat v. Commission*.[5] While the IRS continued to lose these battles, their position has been steadfast in the face of adverse Tax Court decisions, which has left estate planners cautious when drafting withdrawal powers.

Ultimately, a donor must balance the desire to maximize withdrawal powers with the requirement to give such powers to beneficiaries who are not too remote. A withdrawal power should never be given to a beneficiary with no other interest in the trust. At a minimum, a contingent interest must be present and the more prudent approach is to make the power holder a current beneficiary. In the case where trust distributions are at the trustee's discretion, making the Crummey power holder a current beneficiary should not be problematic.

In light of the losses since *Cristofani* on the contingent beneficiary front, the IRS has modified its approach by challenging unexercised withdrawal powers on the theory that there is a pre-arranged understanding for the beneficiary not to exercise the power.[6] The rationale is straightforward, but has also not been overly successful. According to the IRS, a pre-arranged understanding must exist if a remote contingent beneficiary fails to exercise the withdrawal power because the beneficiary's ultimate interest in the trust is tenuous and unlikely to result in any economic benefit.

A more recent IRS ruling extended this type of challenge to beneficiaries with vested remainder interests. In Technical Advice Memorandum 200341002, an irrevocable life insurance trust was created for the benefit of the grantor's children and four charities. Both the grantor's children and the charities were given withdrawal powers. The current beneficiaries were the grantor's children and, upon the grantor's death, the children and the charities each received a percentage of the remaining trust assets.

While the charities had a vested remainder interest, the trustees could distribute the funds subject to the charities' withdrawal power to the grantor's children. Thus, by failing to exercise their withdrawal powers, the charities risked losing all economic benefit from the trust. Given these facts, the IRS concluded that a pre-arranged understanding existed, and the IRS denied the annual exclusion for gifts made with respect to the charities' withdrawal powers.

This ruling shows the IRS's desire to continue to attack Crummey powers. In reality, it is understood, without being stated, that beneficiaries will not exercise their withdrawal powers once they become aware of the purpose of the trust. However, if a beneficiary exercises his/her power, the trustee can exclude the beneficiary prior to the next gift. While this fact is not fatal to an IRS challenge, any type of formal agreement or supporting factors that indicate the existence of a pre-arranged understanding is subject to attack by the IRS.

Finally, even if the IRS continues to be unsuccessful, the ultimate limit to withdrawal powers could come from Congress. In the past, Congress had many opportunities to limit withdrawal powers and they chose not to do so. Today, we are suffering from an enormous deficit that is projected to grow over the next decade. This just may be the fiscal crisis that pushes Congress to enact limits to Crummey powers.

In 2008, the Staff of the Joint Committee on Taxation proposed estate tax reforms, some of which seek to drastically curtail using lapsing withdrawal powers to maximize a donor's exclusion amount.[7] The relevant reforms are as follows: (i) limit Crummey powers to donees that are direct or noncontingent beneficiaries (effectively overturning *Cristofani*), (ii) limit the application of the annual exclusion to Crummey powers that cannot lapse during the donee's lifetime, and (iii) limit Crummey powers to situations where: (a) there is a "meaningful possibility" that the power will be exercised, and (b) there is no evidence of a pre-arranged

understanding not to exercise. These limitations could have severe consequences. Specifically, if reforms two and three are enacted into law, the utility of the Crummey power in tax planning could become effectively eliminated.

Extending the Use

Recently, Crummey powers have been used in more non-traditional situations when dealing with minors. A common trend for a 2503(c) minor's trust is to draft the trust as a hybrid. This allows the trust to function as a 2503(c) trust until the beneficiary turns age 21, at which time the trust converts to a Crummey trust. The benefit of this hybrid approach allows annual gifts to continue to be eligible for the donor's annual exclusion and can avoid the requirement to distribute trust assets when the beneficiary reaches age 21.

The Supreme Court justices in New York have taken a similar approach when dealing with compromise orders and supplemental needs trusts. In order to overcome the issue of a minor's right vesting upon reaching age 21, a withdrawal power is given to the minor at the age of majority. If the minor fails to exercise the power, the trust continues and the assets remain intact within the trust.

Another use of Crummey powers is to reverse or alter the beneficial ownership of an asset from a previous transfer. This technique can be useful in correcting poorly planned transactions that were initiated in preparation for Medicaid eligibility. In the scramble to remove assets from a family member's name, individuals often focus on the short-term goal of beating the Medicaid look-back period and not on the ultimate estate planning objectives of the transferor.

A simple example is transferring dad's house, solely owned by him, to one of his four children, his oldest son. Once the look-back period passes, the family realizes that one child has 100 percent ownership of dad's only asset, which dad intends to pass to all of his children equally. Instead of making gifts to his siblings by utilizing his lifetime gift tax exemption amount, this dilemma can be solved by simply having the son gift his siblings' share, using his annual exclusion amounts, to a Crummey trust for their benefit. Depending on the size of each sibling's family, this transfer can be accomplished in just a few years without negative gift tax consequences.

Conclusion

Crummey powers are a popular technique because they allow donors to utilize their annual gift tax exclusion amount in fulfilling estate planning objectives and they provide new utility in dealing with minors. While the formalities and IRS challenges must be respected, short of a congressional enactment, *Crummey* powers should be around for the foreseeable future.

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Endnotes:

1. 397 F.2d 82 (9th Cir. 1968).

2. See *Estate of Trotter v. Commissioner*, T.C. Memo. 2001-250 (2001); *Hackl v. Commissioner*, 118 T.C. No. 14 (2002).

3. 97 T.C. 74 (1991).

4. See *Cristofani v. Commissioner*, 97 T.C. 74 (1991), Action on Decision, 1992-009; *Cristofani v. Commissioner*, 97 T.C. 74 (1991), Action on Decision, 1996-010; PLR 9731004.

5. T.C. Memo. 1997-212 (1997).

6. See *Estate of Trotter v. Commissioner*, T.C. Memo. 2001-250 (2001).

7. Joint Committee on Taxation, Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform, April 2, 2008, available at http://www.jct.gov/x-23-08.pdf.