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Thomas E. Simmons, *University of South Dakota School of Law*

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How the *Crummey* Crumbles: Present Interest Planning with Trusts

Thomas E. Simmons

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I. INTRODUCTION

"Crummey" withdrawal rights are typically encountered in irrevocable life insurance trusts (or "ILITs"). A Crummey withdrawal right might read:

> Immediately following any contribution to the Trust by the grantor, the beneficiaries shall each have the right to withdraw a share of each contribution allocated to their respective separate shares as explained below. Each beneficiary may withdraw the smallest of the following amounts in any one calendar year: (a) the total amount of the grantor's federal gift tax annual exclusion for a donee in any one calendar year (recognizing that the gift tax annual exclusion is now Fourteen Thousand Dollars and no/100 ($14,000) per donee, but that it may be changed from time to time, and this withdrawal right shall reflect the annual exclusion in effect on the date of the contribution.); and (b) the beneficiary's proportionate share of the contribution to which the withdrawal power relates, determined by dividing the amount of the contribution by the number of beneficiaries. With respect to these withdrawal rights, the following rules shall apply: (1) The Trustee must reasonably notify in writing the person who would exercise each beneficiary's withdrawal right of its existence and of any Contributions made to the Trust that are subject to the withdrawal right. (2) The beneficiaries can exercise their withdrawal right by a written request delivered to the Trustee. If a beneficiary is unable to exercise his or her withdrawal right because of a legal disability, including minority, his or her parent (if the beneficiary is a minor) or any other legally authorized representative, including (but not limited to) a guardian, committee, or conservator, may receive notice of a withdrawal right and exercise a withdrawal right on the beneficiaries' behalf. If there is no legally authorized representative of a beneficiary who is under a legal disability, including minority, then the Trustee shall designate an appropriate adult individual (who may also be a Trustee but may not be the grantor) to receive notice of a withdrawal right and exercise a withdrawal right on such a beneficiary's behalf. Each beneficiary's withdrawal right is noncumulative. Each beneficiary's unexercised withdrawal right lapses thirty (30) calendar days

following the date of the contribution to which it relates. Withdrawal powers shall arise immediately after each contribution to the Trust and shall take precedence over any other power or discretion granted the Trustee or any other person.

In 1968, the doctrine of powers of withdrawal to ensure present interest gift treatment for contributions to a trust was first fully articulated by the Ninth Circuit Court of Appeals in *Crummey vs. Commissioner*.[1] Estate planning attorneys use what are now known as Crummey powers regularly, and most frequently in ILITs and other defective grantor trusts such as dynasty trusts.

The purpose of these written materials is to provide the practitioner with a certain depth and historical context in regards to Crummey powers with the objective of providing a fuller and broader grasp of where Crummey powers came from, why they are necessary, and how they work.[2]

II. **HISTORICAL OVERVIEW OF THE FEDERAL ESTATE AND GIFT TAX**

The federal estate tax was passed by Congress in 1916. Wealthier taxpayers immediately sensed a loophole. To save their estates from being taxed at death, they would use *inter vivos* gifts to transfer wealth during lifetime. Congress, having identified the loophole, closed it in 1932 with the gift tax.

A. INTRODUCTION

The gift tax, with minor exceptions, reaches all lifetime transfers "direct or indirect, and whether the property is real or personal, tangible or intangible."[3] Although initially the gift tax rates were only three-fourths those of the federal estate tax, Congress unified the tax schemes in 1976 with the concept of the unified credit and identical tax rates. But the gift tax remains essentially a backstop to the federal estate tax (as well as, arguably, the income tax, insofar as the gift tax puts limits on taxpayers' ability to make gifts as a way of shifting income-producing property to taxpayers in lower tax brackets).

The estate tax presents a relatively efficient revenue collection scheme given that each taxpayer is only exposed to the tax once, at death. The gift tax, by contrast, presents an entirely

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[1] Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

[2] The author is especially indebted to the following secondary sources: Bradley E.S. Fogel, *The Emperor Does Not Need Clothes—The Expanding Use of "Naked" Crummey Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L.REV. 555 (1998); Patrick T. Neil, *Bare-ly Legal: The Evolution of Naked Crummey Powers and a Call for Reform*, 30 FLA. ST. U.L.REV. 923 (2003) (herein, "Neil").

[3] 26 U.S.C. sec. 2511(a). "Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States." *Id.*

different problem for the Internal Revenue Service since any given taxpayer can make inter vivos gifts thousands of times during a single lifetime. If every gift represents a taxable and reportable event, the oversight costs quickly would become unmanageable, even if taxpayers were largely willing to comply with such a reporting nightmare. And many taxpayers, one could easily anticipate, would respond with noncompliance if Congress required a form 709 to be filed for every $10 birthday gift made to a grandchild.

B. STATUTORY AND HISTORICAL OVERVIEW

From the problem of sorting out reportable taxable gifts from ordinary non-taxable ones comes the concept of the annual exclusion. Congress does not wish to tax – or require taxpayers to report – ordinary, routine gifts such as those made on birthdays, weddings and holidays. The annual exclusion contains two requirements to meet its safe harbor of non-reportable and non-taxable "ordinary" gifts. First, the total cumulative gifts in any given calendar year to any single donee must not exceed the annual exclusion amount (currently $14,000[4] and indexed for inflation in one thousand dollar increments).[5]

Second, a gift must be a gift of a "present interest."[6] By limiting annual exclusion gifts to those involving the gift of a present interest, Congress was attempting to ensure that the annual exclusion "would apply only to those transfers it was originally meant to cover – routine, ordinary gifts."[7] An outright gift of $14,000 cash to an adult competent donee, for example, would qualify as a present interest gift covered by the annual exclusion. But Congress failed to provide a statutory definition for a present interest gift.

The IRS, in its treasury regulations, has defined a "present interest" gift as a gift other than a gift of a future interest. Stated another way, a gift does not qualify as an annual exclusion gift if it is a gift of a future interest.[8] The treasury regulations note ominously that a future

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[4] In 1932, the annual exclusion amount was $5,000. It was reduced to $4,000, then to $3,000. It remained at $3,000 from 1942 until 1981 when it was increased to $10,000. *See* Neil, *supra* note 2, at 926-27. According to calculations performed at http://www.usinflationcalculator.com/ <visited 11/3/13>, if the $3,000 annual exclusion had been simply indexed for inflation in 1942, the annual exclusion would now be over $43,000.

[5] Taxpayers can also make unlimited non-taxable *inter vivos* gifts to satisfy the educational or medical expenses of a donee. There is an unlimited deduction for gifts to a spouse or a charity.

[6] 26 U.S.C. section 2503(b)(1). "In the case of gifts (*other than gifts of future interests in property*) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person." *Id.* (emphasis supplied).

[7] Neil, *supra* note 2 at 927.

[8] The treasury regulations provide:

> (a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the "calendar period" (as

defined in sec. 25.2502-1(c)(1)). "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift.

(b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest (but not in excess of the value of the interest). If a donee has received a present interest in property, the possibility that such interest may be diminished by the transfer of a greater interest in the same property to the donee through the exercise of a power is disregarded in computing the value of the present interest, to the extent that no part of such interest will at any time pass to any other person (see example (4) of paragraph (c) of this section). For an exception to the rule disallowing an exclusion for gifts of future interests in the case of certain gifts to minors, see section 25.2503-4.

(c) The operation of this section may be illustrated by the following examples:

Example (1). Under the terms of a trust created by A the trustee is directed to pay the net income to B, so long as B shall live. The trustee is authorized in his discretion to withhold payments of income during any period he deems advisable and add such income to the trust corpus. Since B's right to receive the income payments is subject to the trustee's discretion, it is not a present interest and no exclusion is allowable with respect to the transfer in trust.

Example (2). C transfers certain insurance policies on his own life to a trust created for the benefit of D. Upon C's death the proceeds of the policies are to be invested and the net income therefrom paid to D during his lifetime. Since the income payments to D will not begin until after C's death the transfer in trust represents a gift of a future interest in property against which no exclusion is allowable.

Example (3). Under the terms of a trust created by E the net income is to be distributed to E's three children in such shares as the trustee, in his uncontrolled discretion deems advisable. While the terms of the trust provide that all of the net income is to be distributed, the amount of income any one of the three beneficiaries will receive rests entirely within the trustee's discretion and cannot be presently ascertained. Accordingly, no exclusions are allowable with respect to the transfers to the trust.

Example (4). Under the terms of a trust the net income is to be paid to F for life, with the remainder payable to G on F's death. The trustee has the uncontrolled power to pay over the corpus to F at any time. Although F's present

interest may be created "by the limitations contained in a trust."[9] A present interest is only present where the donee has an "immediate use possession, or enjoyment of property."[10]

In fact, gifts in trusts have been determined to almost always constitute gifts of a future interest and therefore not available for annual exclusion treatment. Courts faced with trying to distinguish between a present interest and a future interest for purposes of annual exclusion treatment have struggled, often reaching contradictory or vague holdings.[11] This has created difficulties for taxpayers desiring to make annual exclusion gifts by using the protective mechanism as a trust.

C. PRE-*CRUMMEY* PRECEDENT

In *Fondren vs. Commissioner*, a taxpayer created seven trusts for seven infant grandchildren and made gifts to the trustee of those trusts.[12] The trustee was given the express power to distribute funds from income or principal to the infants' support, education, and maintenance on the basis of need. The beneficiary rights were unquestionably vested in the trust, but the Supreme Court noted that this was not the deciding factor for determining whether annual exclusion treatment was allowed for the transfers as present interests.

The Supreme Court held that a trust beneficiary must have a "right to [a] substantial present economic benefit," that is, a present right to "use, possess or enjoy" trust property for a gift to a trust for that beneficiary's benefit to qualify for annual exclusion treatment. The trust instrument (unfortunately, for the taxpayer) specifically recited the donor did not foresee that the trustee would have to invade income or principal because the infants already had "adequate and

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> right to receive the income may be terminated, no other person has the right to such income interest. Accordingly, the power in the trustee is disregarded in determining the value of F's present interest. The power would not be disregarded to the extent that the trustee during F's life could distribute corpus to persons other than F.
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> Example (5). The corpus of a trust created by J consists of certain real property, subject to a mortgage. The terms of the trust provide that the net income from the property is to be used to pay the mortgage. After the mortgage is paid in full the net income is to be paid to K during his lifetime. Since K's right to receive the income payments will not begin until after the mortgage is paid in full the transfer in trust represents a gift of a future interest in property against which no exclusion is allowable.
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> Example (6). L pays premiums on a policy of insurance on his life, all the incidents of ownership in the policy (including the right to surrender the policy) are vested in M. The payment of premiums by L constitutes a gift of a present interest in property.

26 C.F.R. sec. 25.2503–3.

[9] *Id.*

[10] *Id.*

[11] *Compare* Fondren v. Commissioner, 324 U.S. 18 (1945) *with* Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951).

[12] Fondren, 324 U.S. 18.

sufficient means of support." Present distributions, therefore, were unlikely under the circumstances. And the transfer to the trust was more of a future interest for the infant beneficiaries than a present interest.

In *Stifel vs. Commissioner*, the court also looked outside the language of the trust document itself to ascertain whether a gift to that trust could qualify as a present interest gift as to the trust beneficiaries.[13] There, the taxpayer had created trusts for his minor children (ages 4, 7, and 11). The trustee was authorized to distribute for their education, medical care, living expenses and financial obligations. The minors themselves were given "the right at any time to demand payment . . . for any unexpended income" and their guardian could require that the trust be terminated. But no legal guardians had been appointed to make the demand on behalf of a minor and the trust failed to appoint an individual qualified to exercise the withdrawal power.

The court determined that it could consider both intrinsic (the language of the trust) as well as extrinsic (the absence of any authorized court-appointed guardian to exercise the withdrawal powers) and held that the transfers to the trust were of a future interests. Therefore annual exclusion treatment was unavailable to the taxpayer.

Both *Fondren* (from 1945) and *Stifel* (from 1952) represented conservative, straightforward, and rather unimaginative approaches to the analysis of whether a trust beneficiary had received what was better characterized as a present as compared to a future interest by means of a donation to the trustee. In the late 1960s, however, the world was afire with creative energy and new ways of thinking. Some of that must have trickled down to the justices on the panel which heard *Crummey* which issued its earth-shattering decision in the spring of 1968.

III. *CRUMMEY* AND THE PRESENT INTEREST REQUIREMENT FOR ANNUAL EXCLUSION GIFTS

A. *CRUMMEY*

Dr. D. Clifford Crummey and his wife (who is unnamed in the decision) created an irrevocable trust for their four children (who are named; John, Janet, David and Mark), some of them minors and some of them young adults.[14] The trust provided, in relevant part:

> The Trustee may receive any other real or personal property from the Trustors (or either of them) or from any other person or persons, by lifetime gift, under a Will or Trust or from any other source. Such property will be held by the Trustee subject to the terms of this Agreement. A donor may designate or allocate all of his gift to one or more Trusts, or in stated amounts to different Trusts. If the donor does not specifically designate what amount of his gift is to augment each Trust, the Trustee shall divide such gift equally between the Trusts then existing, established by this Agreement. The Trustee agrees, if he accepts such additions,

[13] Stifel v. Commissioner, 197 F.2d 107 (2nd Cir. 1952).
[14] Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

> to hold and manage such additions in trust for the uses and in the manner set forth herein. With respect to such additions, each child of the Trustors may demand at any time (up to and including December 31 of the year in which a transfer to his or her Trust has been made) the sum of Four Thousand Dollars ($4,000.00) or the amount of the transfer from each donor, whichever is less, payable in cash immediately upon receipt by the Trustee of the demand in writing and in any event, not later than December 31 in the year in which such transfer was made. Such payment shall be made from the gift of that donor for that year. If a child is a minor at the time of such gift of that donor for that year, or fails in legal capacity for any reason, the child's guardian may make such demand on behalf of the child. The property received pursuant to the demand shall be held by the guardian for the benefit and use of the child.

The Tax Court held that Dr. Crummey was entitled to claim an annual exclusion as to the gifts in trust for his adult children, but not for his minor children. The minors lived with both parents and no guardian had been appointed. The minors, the IRS argued, had not received "anything more than paper rights" because they lacked the legal capacity to enforce the demand rights against the trustee.[15]

The Ninth Circuit disagreed. Although the court conceded that it appeared highly unlikely that a demand would ever be made, the court examined California law and determined that a minor (at least a minor age 14 or older) is vested with certain demand rights and can, in fact, own property. Declining to follow a strict reading of *Stifel*, and uncomfortable with a holding which would permit the IRS to arbitrarily "step in and decide who is likely to make an effective demand," the court held that annual exclusion treatment should be extended to the gifts in trust made by Dr. Crummey and his spouse.

B. PLANNING OPPORTUNITIES AND PITFALLS

Once *Crummey*'s impact was absorbed by planners, widespread use of the court's holding evolved quickly. Typically, a donor wishing to make gifts in trust which qualify for annual exclusion treatment would confer a lapsing power to withdraw specified amounts from the trust. The amount is usually the greater of (a) the annual exclusion in effect at that time (e.g., $14,000 in 2013); or (b) the greater of $5,000 and 5% of the value of the trust. Assuming that the beneficiary does allow the withdrawal power to lapse without exercising it, the gift reverts to the trust and the annual exclusion applies to the grantor's gift.

Several pitfalls involving the use of Crummey powers are always present. The beneficiary must be notified of the right to withdraw, and the notification must be properly documented and preserved in case the IRS later reviews the gift in question.[16] Anything less than a 30-day right to withdraw runs the risk of an IRS challenge.

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[15] *Id.* At 87.

[16] Notices ideally should not be made near the end of a calendar year to avoid the withdrawal period "spilling over" into a second year.

The beneficiary must be given an actual, genuine right to withdraw and so there is always the risk that the beneficiary will, in fact, exercise the right. And the donor must resist the urge to enter into actual agreements with the beneficiaries not to exercise their withdrawal rights. If the IRS can show that there is even an informal or implied "lapse agreement" then the withdrawal power is illusory and the annual exclusion will be properly denied.

Finally, permitting beneficiaries to waive their current or future withdrawal rights is ill advised.[17]

IV. **THE EVOLUTION OF *CRUMMEY***

A. *CHRISTOFANI*

The *Christofani* case was decided 23 years after *Crummy*. In 1984 and 1985, Maria Cristofani made gifts to her two children and five minor grandchildren in trust.[18] Each of the seven individuals were given the power to demand up to $10,000 from the trustee when a contribution was made to the trust.

Only the grantor's two children were named a primary beneficiaries of the trust itself, however; the five minor grandchildren were contingent remaindermen. A grandchild would receive a future interest in the trust only if their parent failed to outlive the donor by 120 days. The IRS declined to recognize these "naked" Crummey powers.

The tax court held for the taxpayers, concluding that *Crummey* does not require "that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income in order to qualify for the [annual] exclusion."

Cristofani thereby expanded the class of eligible Crummey beneficiaries to future contingent remainder beneficiaries of a trust.

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[17] With regards to life insurance trusts, a couple of additional pointers can be mentioned. First, the grantor should not pay life insurance premiums directly; rather, he or she should make contributions to the trust with the trustee advancing the premium payments on life insurance owned by the trust. Second, the trustee should ideally hold the grantor's contribution during the entire withdrawal period and only advance payments from the trust towards payment of life insurance policy premiums after ascertaining that the withdrawal rights have gone unexercised.

[18] Cristofani v. Commissioner, 97 T.C. 74 (1991).

B. FINAL OBSERVATIONS

Crummey powers appear to be with us for the long haul. There has been criticism of the doctrine underlying Crummey rights, but it's worth remembering that the doctrine of present interest gifts itself is a poorly framed and inadequately drafted creation of statute.[19] The effectiveness of Crummey rights depends in large measure on the performance of a trustee. A trust with Crummey withdrawal rights does not do well on auto-pilot since notices may be overlooked and formalities ignored.

Thomas E. Simmons
Assistant Professor
University of South Dakota
School of Law
414 East Clark Street
Law School Faculty Suite 212
Vermillion, SD 57069
Tel. 605.677.5361
email: tom.e.simmons@usd.edu

[19] For criticism of *Crummey*, *see, e.g.*, Kristen L. Zook, *A Not-So-Crummey Way to Avoid Taxes: A Call for Congressional Action to Eliminate Abuse of the Present Interest Requirement*, 58 SYRACUSE L.REV. 583 (2008).