What You *Thought* You Knew about Crummey Powers

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Introduction

Granting beneficiaries of an irrevocable trust a right of withdrawal over contributions ("*Crummey* powers") in order to secure the benefits of the gift tax annual exclusion is a basic tool in every estate planner's toolbox. There are, however, many implications of granting *Crummey* powers that are often overlooked or misunderstood by estate planners and their clients. This Outline explores the principles of the gift tax annual exclusion, the origins of *Crummey* powers, ways to increase available *Crummey* powers in a trust, whether *Crummey* powers can be utilized in the context of certain types of property, various tax and non-tax aspects of including *Crummey* powers in a trust, and some alternatives for securing the benefits of the gift tax annual exclusion in trust and trust-like vehicles without the use of *Crummey* powers.

I. The Origin, Purpose and Concepts Behind the Gift Tax Annual Exclusion

A. Legislative Purpose and Amount of Exclusion. The gift tax annual exclusion, defined under Section 2503 of the Internal Revenue Code (the "Code"), has been part of the Code since 1932. The principal purpose of the exclusion is, and has always been, to shelter from gift taxation such regular and relatively small gifts as those made for weddings, birthdays and Christmas.[1] The initial amount of the exclusion in 1932 was $5,000 per donor per donee. Eleven years after its enactment, in the midst of World War II, the exclusion was reduced to $4,000, and one year later it was reduced again to $3,000, where it remained until 1981, when it was increased to $10,000. In 1997, the gift tax annual exclusion was indexed for inflation, but adjustments are only made when the cumulative effect of an adjustment is at least $1,000, rounded down to the nearest $1,000. The last such adjustment occurred in 2009, when the exclusion increased to its current $13,000 amount.

B. Scope of the Annual Exclusion

(1) Present Interest Requirement. The gift tax annual exclusion is only available for gifts of present interests in the gifted property. A present interest is an unrestricted

[1] H.R. Rep. No. 708, 72nd Cong. 1st Sess. (1932), *reprinted in* 1939-1 C.B. (part 2) 457, 478; S. Rep. No. 665, 72nd Cong 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525-526.

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right to the immediate use, possession or enjoyment of property or the income from property.[2] The exclusion will not apply to gifts of future interests, which include gifts of reversions, remainders, or 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.[3] Unless the donee of gifted property is entitled unconditionally to the present use, possession or enjoyment of the property transferred, the gift is one of a future interest for which no exclusion is allowable under the statute.[4] Any restriction that postpones these rights will create a future interest that will not qualify for the annual exclusion.[5]

(2) The Test Is When Substantial Enjoyment Begins. Whether a gift is a gift of a present interest or a future interest is a question of time. Any barrier that places a period of time between the will of the donee to immediately enjoy what has been given to him or her and the donee's actual enjoyment will create a future interest.[6] A gift is of a future interest rather than a present interest if there is any postponement of enjoyment of specific rights, powers or privileges that would be forthwith existent if the interest were present.[7]

Importantly, the test for a present interest is not when title in the gifted property *vests* in the donee, but when *substantial enjoyment begins* for the donee.[8] Even though a postponement may be of a relatively short duration, it will be fatal to the qualification for the annual exclusion.[9] Further, it is the certainty of the postponement, not the certainty of duration that will disqualify a gift for the exclusion.[10]

A gift will not be one of a future interest simply because it involves a gift of a contractual right such as a bond, a promissory note (even if no interest will be paid until maturity), or a policy of life insurance, the obligations of which are to be discharged by payments in the future.[11] A gift of all of the incidents of ownership in an unmatured insurance

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2 Treas. Reg. § 25.2503-3(b).
3 Treas. Reg. § 25.2503-3(a); *Fondren v. Comm'r,* 324 U.S. 18, 20 (1945).
4 *French v. Comm'r,* 138 F.2d 254, 257 (8th Cir. 1943).
5 *Fondren*, 324 U.S. at 26-27; *see, also, Ryerson v. U.S.,* 312 U.S. 405, 408 (1941).
6 *Fondren*, 324 U.S. at 20-21.
7 *Comm'r v. Glos,* 123 F.2d 548, 550 (7th Cir. 1941).
8 *Fondren*, 324 U.S. at 20.
9 *Braddock v. U.S.,* 73-2 USTC 12,963 (N.D. Fla. 1973) (holding that gifts of fractional interests in real property subject to a prepaid leasehold interest that would not expire for three months after the date of the gifts were gifts of future interests); *see, also, Est. of Jardell v. Comm'r,* 24 T.C. 652 (1955) (holding that gifts of mineral interests in October were gifts of future interests where donees would be entitled to benefit from production commencing as of January 1 of the following year, a delay of three months).
10 *Phillips v. Comm'r,* 12 T.C. 216 (1949).
11 Treas. Reg. § 25.2503-3(a).

policy is a gift of a present interest for which the exclusion applies, even though the policy has no cash surrender value and will lapse unless future premium payments are made. Similarly, a gift in the form of premium payments on such a life insurance policy is a gift of a present interest to the policy owner.[12]

(3) A Gift May Be a Present Interest as to Income and a Future Interest as to Corpus. For purposes of applying the gift tax annual exclusion, a gift may be separated into its component parts, less than all of which will qualify as gifts of present interests for purposes of the annual exclusion.[13] Thus, if the component comprising corpus or capital of the gift does not satisfy the present interest requirements, but the element comprising the income rights does so qualify, an annual exclusion may be allowed for the income rights.[14] A right to income will not be a present interest, however, unless, at the time of the gift, there is a requirement for a steady and ascertainable flow of income to the donee.[15]

(4) Substantial Enjoyment that Requires Action by Others Creates a Future Interest. If a donee can secure substantial enjoyment of gifted property only by joint action with others, or only with the consent of others, the gift will be a contingent gift that will be regarded as a future interest.[16] For example, the requirement that donees of a life insurance policy must act jointly to exercise certain incidents of ownership over the policy will cause a gift of an interest in the policy to fail to qualify for the annual exclusion.[17] Further, the requirement that other partners must consent to transfers of partnership interests or to the liquidation of the partnership, absent other indications of substantial immediate enjoyment, can cause a gift of a partnership interest to be a gift of a future interest that does not qualify for the exclusion.[18]

(5) The Burden of Proving Qualification for the Exclusion is on the Taxpayer. Exclusions, deductions and exemptions are matters of "legislative grace,"[19] and, as

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[12] Rev. Rul. 55-408, 1955-1 C.B. 113; *see, also,* Treas. Reg. § 25.2503-3(c) Ex. 6. On the other hand, limitations imposed upon a donee's rights to dispose of, or otherwise deal with, an insurance policy will convert the gift of such a policy into a gift of a future interest. *Skourkas v. Comm'r,* 14 T.C. 523 (1950), *aff'd*, 188 F.2d 831 (2d Cir. 1951).

[13] *Berzon v. Comm'r,* 63 T.C. 601, 615 (1975).

[14] *Comm'r v. Disston,* 325 U.S. 442, 447 (1945); *Fondren*, 324 U.S. at 21.

[15] *Disston*, 325 U.S. at 449; *Md. Nat'l Bank v. U.S.,* 609 F.2d 1078 (4th Cir. 1980); *Calder v. Comm'r,* 85 T.C. 713 (1985); I.R.S. Tech. Adv. Mem. 9751003.

[16] *Ryerson*, 312 U.S. at 408*; Blasdel v. Comm'r,* 478 F.2d 226 (5th Cir. 1973); *Chanin v. U.S.,* 393 F.2d 972 (Ct. Cl. 1968).

[17] *Skourkas*, 14 T.C. at 523.

[18] TAM 9751003. See the detailed discussion concerning annual exclusion gifts of unmarketable assets in Section IV of this Outline, below.

[19] *Templeton v. Comm'r,* 719 F.2d 1408, 1411 (7th Cir. 1983).

such, will be construed narrowly. The burden will therefore fall upon the taxpayer to demonstrate that a particular gift qualifies for the gift tax annual exclusion.[20]

II. *Crummey* Power Basics

A. Gifts to Trusts Generally. Gifts in trust are to be regarded for gift tax purposes as gifts to the beneficiaries rather than to the trustees.[21] Such gifts will therefore be considered gifts of future interests unless the beneficiaries have the immediate right to the substantial use and enjoyment of the gifted property or to the income from the property, or if certain statutory exceptions to the present interest requirement are met.

B. The Use of Withdrawal Powers to Create a Present Interest. During the 1950s, four separate cases held that a gift in trust was a gift of a present interest to a minor beneficiary where, at all times prior to the termination of the trust, the guardian of the beneficiary, and then the beneficiary himself or herself, held the power to demand the distribution of all of the trust assets to the beneficiary.[22] The utility of these decisions was limited, however, by the inherent disadvantages of providing a beneficiary the unconditional power to withdraw assets from the trust at any time.

The taxpayers in the 1968 Ninth Circuit case of *Crummey v. Comm'r.*[23] tested the boundary of this concept by (1) limiting the withdrawal rights of the beneficiaries of an irrevocable trust to the annual exclusion amount, and (2) providing that the withdrawal right would lapse at the end of the year in which the gift was made if not exercised. The IRS in *Crummey* did not actually take issue with the impact of such withdrawal powers in creating a present interest if the beneficiary was a competent adult. Rather, with regard to the minor beneficiaries of the trust, the IRS took the position it had earlier published in Rev. Rul. 54-91[24] that a transfer to an otherwise discretionary trust for a minor beneficiary is a gift of a future interest regardless of the existence of a withdrawal power if there is no legally appointed guardian to demand immediate distribution for that minor beneficiary. The Court in *Crummey*, however, not only confirmed the effectiveness of immediate and temporary withdrawal rights in creating a present interest for a gift in trust, but also held that, so long as a minor beneficiary has

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[20] *Disston*, 325 U.S. at 449; *Est. of Stinson v. U.S.,* 82 AFTR 2d Para. 98-5469 (N.D. Ind. 1988), 214 F.3d 846 (7th Cir. 2000); *Hackl v. Comm'r,* 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

[21] *Calder*, 85 T.C. 713 (1985) (citing *Helvering v. Hutchings,* 312 U.S. 393, 396 (1941); *U.S. v. Pelzer,* 312 U.S. 399, 401-02 (1941)).

[22] *Kieckhefer v. Comm'r.*, 189 F.2d 118 (7th Cir. 1951); *Gilmore v. Comm'r.*, 213 F.2d 520 (6th Cir. 1954); United *States v. Baker,* 236 F.2d 317 (4th Cir. 1956); *Trust No. 3 v. Comm'r.*, 285 F.2d 102 (7th Cir. 1960).

[23] *D. Clifford Crummey v. Comm'r.,* 397 F.2d 82 (9th Cir.1968).

[24] Rev. Rul. 54-91, 1954-1 C.B. 207.

the absolute legal right to withdraw a gift to a trust, the fact that there is no appointed guardian to act for the minor beneficiary will not cause the gift to be a gift of a future interest.

It took five years for the IRS to acquiesce to the holding in *Crummey*. In Rev. Rul. 73-405,[25] the IRS revoked Rev. Rul. 54-91 and instead took the new position that, so long as there is no legal impediment under state or local law with regard to the appointment of a guardian for a minor beneficiary, the fact that a guardian has not been so appointed at the time of a gift to a trust with a *Crummey* power will not result in a gift of a future interest.

C. <u>Annual Exclusion Gifts to Trusts that Lack *Crummey* Powers</u>. For a gift in trust to qualify as a gift of a present interest, it is not necessary for *Crummey* powers to be included in the trust instrument itself. Rather, a gift to a trust can be treated as a gift of a present interest if the instrument of transfer directs the Trustee to give one or more trust beneficiaries an immediate right of withdrawal over the gift and specifying the terms of the withdrawal right. Further, if a trust instrument contains an outdated *Crummey* power, such as a power providing the beneficiaries the right to withdraw gifted property up to an annual limit of $10,000, the instrument of transfer can increase the withdrawal power to encompass the higher annual exclusion limit.[26]

The inherent disadvantage of relying upon the use of instructions in the instrument of transfer to create *Crummey* powers is that these instructions must be provided each time a gift is made to the trust and cannot be provided *after* the gift is made. Further, if the instructions are not sufficiently specific with regard to who is to possess the withdrawal power or fails to address other material terms of the withdrawal right (such as the amount), the IRS may not accept the external instructions as sufficient to create a present interest.[27] Since donors might fail to consult with their attorneys before making a gift to a trust, a better, more failsafe option might therefore be to create a new irrevocable trust (a "pass-through trust") that contains the necessary withdrawal powers. Such a trust would provide that any gifts to the trust that are not withdrawn within the specified time frame (such as 30 days from receipt by the beneficiaries of notice of the gift and their withdrawal rights) will be distributed to the existing trust (the "target trust"). This will insure that any gifts are immediately subject to a right of withdrawal and will therefore qualify as gifts of a present interest, just as if the *Crummey* powers in the pass-through trust had been included in the target trust.

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[25] Rev. Rul. 73-405, 1973-2 C.B. 321.

[26] *See,* TAM 8445004 (direction of donor making a gift to an irrevocable trust was effective to increase the withdrawal amount from $5,000, as provided in the trust instrument, to $10,000).

[27] *See,* TAM 9532001 (annual gift tax exclusion not allowed where letter to trustee accompanying the initial gift did create a present interest in subsequent gifts.).

D. Limiting Existing Withdrawal Powers with External Instructions. If a trust contains *Crummey* powers and there is reason to either restrict the beneficiaries who are provided withdrawal rights or to limit the amounts subject to such withdrawal rights, it is possible to impose such restrictions in the instrument of transfer. The IRS has ruled privately that including a provision in a trust agreement that authorizes a donor to impose such restrictions at the time of the transfer is not a retained power over the gifted property for purposes of Section 2036 or Section 2038 of the Code.[28] The IRS has also provided technical advice that such a power is not a retention of control over the beneficial enjoyment over gifted property for purposes of causing trust income or corpus to be owned by the donor for income tax purpose pursuant to Section 674(a) of the Code.[29]

E. Withdrawal Powers are Not Necessarily Enough to Qualify a Gift in Trust for the Annual Exclusion. Merely including withdrawal powers in a trust instrument will not always insure that a gift to a trust qualifies as a gift of a present interest for purposes of the gift tax annual exclusion.

For example, if "boilerplate" provisions in the trust instrument give the Trustee the discretion to retain or redirect assets otherwise distributable to a minor or incompetent beneficiary; if the Trustee can distribute trust property subject to an unlapsed *Crummey* power to another trust beneficiary; if another trust beneficiary holds a power of appointment over assets subject to an unlapsed *Crummey* power; or if the trust instrument gives the Trustee the discretion to withhold distributions to a beneficiary holding a *Crummey* power (such as in the context of substance abuse or the existence of creditor's claims), and if the amount of any unlapsed *Crummey* powers are not excluded from the application of these provisions, then the value of the amount subject to the *Crummey* power is not ascertainable and the annual exclusion will not apply.[30] In addition, if the trust instrument requires a beneficiary to take certain actions in advance of a trust distribution or withdrawal (such as a requirement that a married beneficiary must have a premarital agreement or separate property trust in place in order to receive trust distributions), and if those actions were not taken before the gift was made, then the gift to the trust could be a gift of a future interest notwithstanding the existence of *Crummey* powers in the trust instrument. If, however, under the terms of the trust instrument, such provisions only apply to gifted property *after* the lapse of the *Crummey* power, then present interest status is preserved,

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[28] PLR 9030005.

[29] TAM 8901004.

[30] TAM 8107009 (unlimited power of invasion or diversion, which makes it impossible to value an interest, will prevent any exclusion from being claimed against a gift of the interest even though it is a present interest); *see, also,* PLR 8103074.

the amount subject to the right of withdrawal is ascertainable, and the annual exclusion should apply.[31]

Even with regard to the best drafted trust with *Crummey* powers, the annual exclusion will only be available if the gifted property would otherwise qualify for the gift tax annual exclusion if it had been gifted directly to the trust beneficiary. For example, as gifts of stock in closely held corporations, interests in limited non publicly traded partnerships or LLCs, and gift of certain other types of illiquid, not income-producing assets may not be considered gifts of a present interest. This impediment to qualifying for the gift tax annual exclusion will not change by simply providing a trust beneficiary a *Crummey* power over a trust receiving gifts of such assets.[32]

Finally, in a recent Chief Counsel Advisory memorandum (CCA 201208026, by some services reported as *ILM* 201208026), the IRS took the position that *Crummey* powers were ineffective to create a present interest in a trust agreement that imposed mandatory arbitration of disputes upon the trust beneficiaries. In the CCA, the Service stated, "Because the threat of server economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory. Consequently, no annual exclusion under §2503(b) is allowable for any of the withdrawal rights." While this CCA is not without its critics, it does stand for the principle that care must be exercised in protecting the sanctity of the beneficiary's withdrawal rights from limitations that may be unintentionally imposed by sweeping provisions in the trust agreement.

III. Crummey Powers and the GST Tax Annual Exclusion[33]

A. Generally. The generation-skipping transfer (GST) tax is a tax imposed upon transfers of wealth to or for the benefit of individuals who are, or are deemed to be, two or more generations younger than the transferor ("skip-persons").[34] The GST tax is imposed separate and apart from, and sometimes in addition to, the federal gift or estate tax. The purpose of the tax is relatively straight-forward; that is, with certain exceptions, to insure that the transfer of wealth is taxed at least once at each generation, whether or not interim generations have the actual possession or use of that wealth. The GST tax rate is imposed at the highest marginal federal

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[31] PLRs 8213074 and 8121051; TAM 8107009

[32] As noted later in this Outline, however, the use of trusts with *Crummey* powers can possibly convert such a gift to a gift of a present interest if the Trustee can satisfy the exercise of the beneficiary's withdrawal power with liquid assets or other trust property that would constitute a present interest.

[33] ***The Author wishes to recognize the contribution of time and talent by her associate, Brian P. Tsu, who was instrumental in the development of this Section of the Outline addressing the GST tax annual exclusion.***

[34] I.R.C. § 2613(a)(1).

estate tax rate, which is presently 35%.[35] Therefore, for transfers that are subject to both the highest estate or gift tax rate as well as the GST tax, the effective combined tax rate is over 50%.

The GST tax is imposed on transfers made directly to skip persons and to trusts as to which only skip persons are permissible beneficiaries ("direct skips").[36] The GST tax is also imposed upon certain trust distributions to skip persons ("taxable distributions")[37] as well as upon an entire trust at such time as there are no longer any "non-skip-persons" who are permissible beneficiaries ("taxable terminations").[38]

B. <u>The GST Tax Annual Exclusion</u>. There are several important exclusions and exemptions from the GST tax, including the GST tax annual exclusion, which is described under Section 2642(c) of the Code. Although commonly referred to as an "exclusion," the GST tax annual "exclusion" (and educational and medical "exclusions") are not exclusions in the technical sense. Instead, a direct skip that qualifies for a gift tax exclusion under Section 2503(b) or (e) maintains its character as generation-skipping transfer, but is not subject to GST tax as such transfers are assigned a zero inclusion ratio.[39]

The GST tax annual exclusion is available for direct skips so long as the transfer qualifies for the gift tax annual exclusion under Section 2503(b) of the Code.[40] Thus, an outright direct skip to an individual would have a zero inclusion ratio resulting in no use of the GST tax exemption or GST tax due. However, the availability of the GST tax annual exclusion for a direct skip into a trust for the benefit of a skip person is substantially more limited than is the gift tax annual exclusion. Specifically, in order for a gift in trust to qualify for the GST tax annual exclusion, the transfer must qualify for the gift tax annual exclusion[41] and satisfy two additional requirements:

(i) during that beneficiary's lifetime, no part of the trust principal or income may be distributed to or for the benefit of any person other than the beneficiary holding the *Crummey* power;[42] and

(ii) if that beneficiary dies before the trust terminates or is otherwise fully distributed to the beneficiary, the remaining assets of the trust must be includible in the deceased beneficiary's taxable estate.[43]

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35 I.R.C. § 2641(a).
36 I.R.C. §§ 2611(a)(3), 2612(c).
37 I.R.C. §§ 2611(a)(1), 2612(b).
38 I.R.C. §§ 2611(a)(2), 2612(a).
39 I.R.C. § 2642(c)(1).
40 I.R.C. § 2642(c)(1) and (c)(3)(A).
41 I.R.C. § 2642(c)(3)(A).
42 I.R.C. § 2642(c)(2)(A).

As a result of these additional requirements, gifts made in trust which qualify for the gift tax annual exclusion because one or more beneficiaries hold *Crummey* withdrawal powers over the trust will not qualify for the GST tax annual exclusion unless the trust is administered as individual separate shares for each of the beneficiaries holding a withdrawal right and the requirements of the GST tax annual exclusion, just described, are satisfied with regard to each such share. Further, even if separate shares are maintained for each *Crummey* power holder, use of the GST tax annual exclusion will not be appropriate if the goal of the donor is to create a dynasty trust that can pass from generation to generation without the imposition of estate or GST tax. Rather, to create such a trust, the *Crummey* powers can shield gifts to the trust from gift taxation but GST tax exemption will need to be applied to the entire gift to the trust, regardless of whether the *Crummey* power holders are skip-persons or non-skip persons.

IV. Multiplying Available Annual Exclusions: What Works and What Doesn't

A. Reciprocal Crummey Gifts *("You Scratch My Back, I'll Scratch Yours")*. A group of friends are having their regular Saturday night dinner at the Country Club, where they are complaining that despite all the money they pay to their fancy and high priced estate and trust lawyers, that dang "death tax" that just won't seem to go away. Two of them discover while taking a powder room break that they each make maximum annual exclusion gifts to their children's *Crummey* trusts every year, and, conveniently, they each have three children. One of them comes up with a bright idea: How about next Saturday they bring their check books to dinner and each of them can make annual exclusion gifts to other's Children's Trust? Maybe when they get back to the table, they can convince some of their other friends to join in, and they can really beat Uncle Sam at his game.

Unfortunately for our dinner guests, the IRS and the courts have a way of looking through these gifts based upon the principles of the reciprocal trusts.[44] The reciprocal trust doctrine describes cross transfers of property in trust by two settlors, each creating a trust to accomplish the goals of the other, made pursuant to an interrelated scheme that leaves each of the settlors in approximately the same economic position they would have been in had they created trusts and named themselves as beneficiaries.[45] With regard to reciprocal gifts, the courts have been willing to apply the principles of the reciprocal trust doctrine to determine the actual transferor based upon all of the facts and circumstances surrounding the gifts involved. The focus of the analysis is the extent of reciprocity and who the persons are who should be the

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[43] I.R.C. § 2642(c)(2)(B).
[44] *U.S. v. Grace,* 395 U.S. 316 (1969).
[45] *Exch. Bank & Trust Co. of Fla. v. U.S.,* 694 F.2d 1261, 1263 (Fed Cir. 1982).

natural objects of each transferor's bounty. To the extent that such gifts provide equal benefit to the respective donee pools, the annual exclusion will be disallowed.[46]

The reciprocal trust/reciprocal gift doctrine has been applied by the IRS specifically in the context of *Crummey* powers. In Rev. Rul. 85-24,[47] individuals who were business partners agreed to make gifts to trusts they created for each other and for the other's children. The IRS determined that such gifts should not be treated as gifts to the beneficiaries of the recipient trusts because each partner's gifts to the trust for the other partner were made in consideration for similar gifts made by the other partner. Rather, each partner was treated as making the gifts to the trusts for that partner's family.

B. Withdrawal Powers Held by a Person with Little or No Interest in the Trust. Trusts may be created for the current or long term benefit of a small number of primary beneficiaries (or even a single beneficiary), yet multiple individuals with no significant interest, or a mere contingent interest, in the trust are provided rights of withdrawal in order to increase the amount that can be given to the trust each year under the gift tax annual exclusion. While such a structure can work, an understanding of some underlying concepts regarding annual exclusion gifts can help insure the desired results are achieved when drafting *Crummey* powers to be held by contingent beneficiaries or other persons.

(1) Looking Through to the Intended Beneficiary of a Gift. Many attempts have been made by taxpayers to "leverage" the gift tax annual exclusion by making a gift to one person with the actual or implied understanding that the first donee will give the gift to, or apply the gift for the benefit of, another person, who is the true and intended donee of the original gift. This technique, however, does not work, as the series of gifts will be collapsed into a single, albeit indirect, transfer from the original donor to the ultimate donee. For example, in *Heyen v. U.S.*,[48] the decedent had made over two dozen gifts of corporate stock to individuals who immediately conveyed their stock certificates over to members of the decedent's family. Not only was the gift tax annual exclusion denied for these gifts, but a fraud penalty was imposed upon the executrix of the decedent's estate for failing to report them.

Without giving it much thought, donors will often make gifts to a married couple with the expectation and belief that the couple will recognize this gift as being for the benefit of the spouse who is the child or other natural object of the donor's bounty. If the gift is

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[46] *See, Schuler v. Comm'r,* T.C. Memo 2000-392, *aff'd*, 2002-1 USTC 60,432 (8th Cir. 2002); *Sather v. Comm'r,* 78 T.C. Memo 456 (1999), *aff'd in part*, 251 F.3d 1168 (8th Cir. 2001); *Schultz v. U.S.,* 493 F.2d 1225 (4th Cir. 1974); *Furst v. Comm'r,* T.C. Memo 1962-221; Rev. Rul. 85-24, 1985 C.B. 329.

[47] Rev. Rul. 85-24, 1985-1 C.B. 329.

[48] *Heyen v. U.S.,* 945 F.2d 359 (10th Cir. 1991).

in fact treated by the couple as made to only one of them, even this more benign attempt to maximize the benefits of the annual exclusion will fail. For example, in *Cidulka v. Comm'r.*,[49] the decedent, for many years prior to his death, made gifts of stock in a family corporation to his son and daughter-in-law using the annual exclusion. With respect to each such gift, the daughter-in-law dutifully turned the gifted stock over to her husband. Although the Service offered no direct proof of an agreement that the daughter-in-law would make these subsequent transfers to her husband, the Tax Court had no trouble inferring such an agreement from that the simple fact that she did so with regard to each and every gift. Therefore, the Court disallowed the annual exclusion as to each gift from the decedent to his daughter-in-law.[50]

(2) <u>IRS Attacks on Providing Contingent Beneficiaries with *Crummey* Powers</u>. Based upon the principles described above, the IRS has been consistently hostile toward the use of contingent beneficiaries or worse, persons with no interest in a trust at all other than a *Crummey* withdrawal right, to increase the number of annual exclusions that can be used to fund a trust. For example:

> In TAM 8727003, the Service considered a trust for the primary benefit of the grantors' two sons, but over which 16 other family members held withdrawal powers. The Service ruled that it would only allow annual exclusions for the primary beneficiaries and for the small number of additional beneficiaries who actually exercised their withdrawal rights.
>
> In TAM 9045002, the Service disallowed annual exclusions for 12 family members who either held no interest at all in the subject trusts or who held a contingent interest.
> In TAM 9141008, a trust was created for the benefit of the grantor's three children, who, along with the grantor's 32 grandchildren and great-grandchildren, held *Crummey* withdrawal powers. The IRS disallowed annual exclusions as to the grantor's 32 grandchildren and great-grandchildren.

(3) <u>Score on *Crummey* Powers Held by Contingent Beneficiaries: Taxpayers 2, IRS 1/2</u>. In the 1991 case of *Cristofani v. Comm'r.*[51] the Tax Court addressed the question of whether a *Crummey* power held by a contingent beneficiary would be respected for purposes of the gift tax annual exclusion. In that case, a mother had in two consecutive years

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[49] *Cidulka v. Comm'r,* T.C. Memo 1996-149.
[50] A similar conclusion was reached by the Tax Court in *Bies v. Comm'r,* T.C. Memo 2000-338, where gifts of stock in a family business that were made by the decedent to his daughters-in-law were recharacterized as indirect gifts to his sons.
[51] *Cristofani v. Comm'r,* 97 T.C. 74 (1991).

prior to her death transferred 1/3 fractional interests in commercial real estate to a trust for the primary benefit of her two adult children. The trust agreement provided that all of the trust income would be paid to the children and principal would be paid to them for their health, maintenance, support and education. If the children, who were in good health, survived their mother, they would each receive ½ of the trust outright. If either of them did not so survive, the deceased child's trust share would be divided equally among his or her surviving children.

The two children and the decedent's five grandchildren each possessed *Crummey* withdrawal rights. It was stipulated that there was no agreement or understanding that these rights would not be exercised. Under these facts the Service sought to disallow annual exclusions for the five grandchildren. The Tax Court, however, noted that the Court of Appeals for the Ninth Circuit in *Crummey* rejected any test for a present interest that is based upon the likelihood that beneficiaries would actually receive present enjoyment of the trust property or whether a demand right would actually be exercised. Nor, stated the Tax Court, should the test be whether a beneficiary with a withdrawal power has a vested present interest in the trust or a contingent remainder interest. Rather, the test should simply be whether the beneficiary had an enforceable right to demand payment from the trustee which the trustee would be unable to legally resist.[52]

Despite the fairly resounding taxpayer victory in *Cristofani*, not long after the Tax Court issued its opinion, the Service issued AOD 1992-09 in which it stated its intention to continue to litigate cases where there are abuses of *Crummey* powers, particularly if they are under facts more egregious than those in *Cristofani* and if they arise outside of the Ninth Circuit. The IRS subsequently published PLR 9628004, in which it acknowledged the holding in *Cristofani* and stated that its position generally is not to contest *Crummey* powers held by current income and vested remainder beneficiaries. However, the IRS stated that, where withdrawal rights are held by discretionary beneficiaries or beneficiaries with remote contingent interests in the trust, their failure to exercise their withdrawal rights, which is contrary to their economic interests, must indicate that there is a prearranged plan that they will not exercise those rights.[53] Citing the principles set forth *Heyen v. U.S.*,[54] discussed above in the context of gifts that are made to one person but immediately conveyed to another. Consequently, the Service in PLR 9628004 disallowed 13 annual gift tax exclusions that were attributable to unexercised *Crummey* powers held by remote contingent beneficiaries or by individuals who had no other interest in the trusts in question other than their withdrawal rights.[55]

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[52] *Id.* at 83-84.
[53] As noted earlier, in *Cristofani*, the I.R.S. stipulated to the fact that there was no agreement or prearranged plan that the trustor's grandchildren would not exercise their withdrawal rights.
[54] *Heyen*, 945 F.2d 359 (10th Cir. 1991).
[55] *See, also,* AOD 1996-010.

Again, however, when this issue came up in a litigated case, this time from the Third Circuit, the IRS was unsuccessful. In *Kohlsaat v. Comm'r.*,[56] the decedent had created a trust and transferred to it a commercial building valued at $155,000. The decedent's two children were co-trustees and the sole current income and principal beneficiaries. The two children also each held special powers of appointment over their respective one-half interests in the trust. The two children and 16 contingent remainder beneficiaries (consisting of grandchildren, great grandchildren and certain in-laws), all held *Crummey* withdrawal powers over the trust. All of the beneficiaries were timely notified of their withdrawal rights, but none were exercised. The IRS argued that the only rational explanation for the failure of the 16 contingent beneficiaries to exercise their withdrawal powers was an implied agreement that they would not do so.

The Tax Court in *Kohlsaat* disagreed with the IRS that there was an implied agreement, noting that at trial other credible reasons were offered for why the contingent beneficiaries did not exercise their withdrawal rights. Although the opinion does not set forth these reasons, one could hypothesize that, given the nature of the trust asset, the beneficiaries did not exercise their withdrawal rights because they wanted to insure a clean chain of title, they did not want to incur the personal liability associated with ownership of real property, they wanted to retain the property under centralized management without the necessity of creating a partnership or other entity, or they might simply have wanted to keep the property in trust for creditor protection purposes and to maximize the benefit of the property for the family as a group. Whatever the reasons offered, the Tax Court found them no less compelling than the Service's explanation of an implied agreement. As a result, annual exclusions were allowed with respect to the *Crummey* powers held by all 16 contingent beneficiaries.

In one rare and unique Tax Court case, the IRS did secure a minor victory on the issue of implied agreements with regard to *Crummey* powers, which it might be expected to try to leverage into other situations. In *Trotter v. U.S.*,[57] an elderly grandmother made a gift of her condominium to a trust for the benefit of her grandchildren. The grandmother, who was suffering from recurring cancer when she created the trust, continued to live in the condominium. In lieu of paying rent, she paid utilities, insurance and taxes. Upon her death, the IRS included the residence in her estate under Section 2036(a)(1) of the Code. Accepting the position of the Service, the Tax Court noted that, not only did the facts presented suggest there was an implied agreement between the grandmother and her grandchildren that she would have the right to continued rent-free occupancy of the condominium for her lifetime (this alone would have been

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[56] *Kohlsaat v. Comm'r,* T.C. Memo 1997-212.

[57] *Trotter v. U.S.,* T.C. Memo 2001-250.

sufficient for estate tax inclusion), but there was also an implied agreement that the grandchildren would not exercise their *Crummey* withdrawal rights.

Stories have been circulating among practitioners since the *Trotter* case that the IRS is not beyond deposing trust beneficiaries after the death of the settlor of a *Crummey* trust to ask them, under oath, whether there was any agreement with the decedent that they would not exercise their withdrawal rights and whether they were threatened with penalties, such as disinheritance, if they did exercise those rights. It is therefore extremely important that this not be the message conveyed to the beneficiaries, whether direct or implied.

(4) Practical Considerations. Despite the benefits of a *Cristofani* trust for purposes of increasing the amount of annual exclusions, there are important practical considerations. In particular, the more minor, remote or contingent the beneficiaries' interests are in the trust (and the more distant their relationship is to the donor), the more likely that, over the course of time, some of these beneficiaries' *Crummey* powers will in fact be exercised. This is a particularly important consideration where a large class of beneficiaries will be needed to hold withdrawal powers over a sustained period of time, such as to fund the annual premiums on a large life insurance policy. On the bright side, the actual exercise of withdrawal powers may be helpful in the future to prove that these powers are real and enforceable and not illusory.

Attorneys who create *Cristofani* trusts where there is a risk of actual exercise of *Crummey* powers need to consider available pre-emptive measures. First, if the trust has a substantial long-term cash flow need that must be funded annually (such as the need to fund large annual insurance premiums), it is advisable to have well more *Crummey* power holders than strictly necessary so that additional contributions can be made to make up for the withdrawn amounts. Donors should also have the ability to determine which beneficiaries should have the right to withdraw with regard to each contribution so that withdrawing beneficiaries can be excluded as to future contributions. (This technique is discussed in Section II.D of this Outline above). Finally, to dissuade beneficiaries from exercising their withdrawal rights, or at least not to disadvantage those that fail to exercise their withdrawal rights, the trust instrument can provide that the withdrawing beneficiary's future rights will be reduced by the amount withdrawn. It is important not to create an excessive penalty for such withdrawals, however, as this could have a negative impact upon the qualification of the gift as a present interest; specifically, such a penalty could support the argument that there was an implied understanding that the beneficiary would not exercise the withdrawal power and would be severely penalized for acting contrary to that understanding, resulting in the disallowance of the annual exclusion.

C. <u>Gift Splitting in the Context of Crummey Powers</u>.[58] A common way to leverage annual exclusion gifts is for a married donor to split gifts with his or her spouse[59]. I.R.C. § 2513 provides that spouses may elect to treat gifts made by either of them as being made one-half by each spouse – even when the property is entirely the separate property of the one of them. The benefits of gift splitting are powerful even in community property states, as they can permit a donor spouse to make gifts of separate property while benefiting from both spouse's annual exclusions, applicable exclusions and GST tax exemptions.

(1) <u>Rules and Mechanics for Making the Gift Splitting Election</u>. In order for a married couple to split gifts, three basic requirements must be met: (1) the gift must be made during the marriage; (2) each spouse must be a U.S. citizen or resident at the time the gift is made; and (3) b*oth spouses must consent* to splitting gifts.[60]

To make a gift splitting election, each spouse must consent, either on the other's gift tax return if both spouses are required to file, or both spouses may consent on one spouse's gift tax return if only that spouse is required to file.[61] Once the election is made, it automatically applies to all gifts made by either spouse during that year (including gifts not reported on the gift tax return and gifts that are revalued after the return is filed). In that regard, Section 2513 is an all-or-nothing section – meaning that in any year that spouses elect to split gifts, they must split <u>all</u> gifts made by either spouse during the year; they cannot pick and choose. [62] Further, the election to split gifts, once made, may be revoked at any time up to April 15 of the year following the transfer; after that date, the election is irrevocable even if later gifts are discovered that might have persuaded a non-donor spouse not to gift split.[63]

When only one spouse makes gifts and those gifts do not exceed twice the annual exclusion amount for any beneficiary, only the donor spouse needs to file a gift tax return and the non-donor spouse can consent to the election on that return. If, however, any gifts made in a calendar year exceed twice the annual exclusion per donee, both spouses will need to file a gift tax return in order to make the gift-splitting election.[64]

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[58] ***The Author wishes to recognize the contribution of time and talent by her associate, Emily Nicholson, who was instrumental in the development of this Section of the Outline addressing gift splitting in the context of Crummey powers.***

[59] The same technique allows donors to leverage the available gift tax applicable exclusion.

[60] I.R.C. § 2513(a).

[61] Treas. Reg. § 25.2513-2(a).

[62] Treas. Reg. § 25.2513-1(b).

[63] Treas. Reg. § 25.2513-3.

[64] *See* Treas. Reg. 25.2513-2(a)(1) (noting that, where consent may have been signified on multiple gift tax returns filed during the year, the most recently filed return controls); *but, see* Rev. Rul. 80-224, 1980-2 C.B. 281 (spouses may not later elect to split gifts in a calendar year where the deadline for filing a gift tax return has passed and one spouse has already filed a gift tax return without making the election).

Consider the following examples, illustrating the manner in which the election must be made:[65]

> EXAMPLE ONE: In 2011, Husband made gifts valued at $27,000 to a trust for a single beneficiary with a *Crummey* power over the gift to the extent of the gift tax annual exclusion (including split gifts). Wife made no gifts. If gift splitting is elected, then each spouse will be deemed to have made a gift of $13,500, $13,000 of which will be sheltered by the annual exclusion. Because Husband's gift is more than double the annual exclusion, in 2012 both spouses will be required to file a gift tax return and elect to split gifts.
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> EXAMPLE TWO: In 2011, Husband made gifts valued at $14,000 to a trust in which two beneficiaries hold equal *Crummey* powers over the gift to the extent of the gift tax annual exclusion (including split gifts). Wife made no gifts. Only Husband is required to file a gift tax return in 2012. On the return, Wife consents to split gifts. As a result of the election, each spouse is deemed to have made a $7,000 gift. Wife does not have to file, because when the gift is split, each of Husband and Wife have made a gift under the annual exclusion amount.
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> EXAMPLE TREE: In 2011, Husband made gifts valued at $22,000 to a trust with a single beneficiary holding a *Crummey* power over the gift to the extent of the gift tax annual exclusion (including split gifts). Wife made gifts valued at $8,000 to the same beneficiary outside of the trust. To split gifts, each spouse is required to file a gift tax return in 2012. As a result of the election, each spouse will be deemed to have made a gift of $15,000 each to the same donee, $13,000 of which will be sheltered by the annual exclusion.
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> EXAMPLE FOUR: During 2011, Husband made gifts valued at $22,000 to a trust in which his daughter holds a *Crummey* power over the gift to the extent of the gift tax annual exclusion (including split gifts). In the same year, Wife made gifts of $11,000 to a different trust for her daughter, who also holds a similar *Crummey* power. Even though the gifts were made to different donees and, with gift splitting, will all be sheltered by the annual exclusion, in order to make the gift splitting election, one spouse will have to file a gift tax return. Because in this example Husband's gift to his daughter's trust is more than his own annual

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[65] *See* Treas. Reg. § 25.2513-1(d) (examples are adapted from this regulation, with updated numbers and a more comprehensive analysis).

exclusion amount, he will be the one to file in 2012, and Wife can consent to the splitting of gifts on Husband's return.[66]

(2) <u>Combining Gift Splitting with *Crummey* Powers</u>. A gift cannot be split if the value of the gift is not ascertainable. This can create issues when a gift splitting election is combined with *Crummey* powers. The wrinkle in combining gift splitting with *Crummey* powers stems from the manner in which the election to split gifts is made and the lapse of time between the time of the gift and the time that such an election is made and becomes irrevocable.

Imagine a typical *Crummey* power which gives beneficiaries the ability, within 30 days after the contribution, to withdraw the amount of the contribution that qualifies for the gift tax annual exclusion. The non-donor spouse will not have given his or her consent until the gift tax return is filed in the following year (and the election, if made on a return filed before April 15, does not become irrevocable until that date). How will the trustee and beneficiary know what portion of the contribution is covered by the non-donor spouse's annual exclusion until the non-donor spouse gives his or her consent?

Drafting around this issue carries some traps that need to be considered. If the donor were to condition the beneficiary's withdrawal right on his or her spouse's consent to split the gift, the beneficiary's interest is no longer a present interest, but rather, is contingent upon some future event (the spouse's election or non-election). The IRS has ruled that if a *Crummey* power is so limited, the value of the withdrawal right is unascertainable and the annual exclusion does not apply.[67] To avoid this result, there are several options. One option is for each spouse to actually contribute ½ of each gift to the trust, either by creating sufficient community property from one spouse's separate property before making the gift if the couple lives in a community property state, or by making gifts equally from each spouse's separate property, in which case gift splitting is unnecessary. Another option is to provide either in the trust instrument or in the instrument of transfer that, if the donor is married, the amount available for withdrawal is determined as if all gifts were split between the donor and his or her spouse, regardless of whether the gift splitting election is actually made. As noted in Section II.D of this Outline above, instructions of this nature in a trust instrument can be modified by a written instrument from the donor accompanying a gift to the trust to provide that gift splitting should not be assumed for that particular gift.

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[66] *See* Treas. Reg. § 25.6019-2.

[67] PLR 8022048.

(3) Tax Consequences of Gift Splitting Elections

(a) Gift Tax. When electing to split gifts, the non-donor spouse will generally be considered a transferor for gift tax purposes as to one-half of each gift that is subject to the gift splitting election.[68] However, the non-donor spouse is not treated as a transferor as to any portion of the transfer in which the non-donor spouse has an interest (a concept that is discussed more fully in Section IV of this Outline below with regard to *Crummey* powers held by spouses).[69]

(b) GST Tax. Section 2652(a) of the Code provides that, when a gift splitting election is made, the non-donor spouse will be considered a transferor for GST tax purposes.[70] While the concept is similar as with regard to the gift tax consequences of gift splitting, the rules for the GST tax are slightly different in the context of trusts in which the non-donor spouse also has a beneficial interest. Specifically, for GST tax purposes, the non-donor spouse will always be considered a transferor as to one-half of the entire value of the property transferred, *including* any portion of the transfer in which the non-donor spouse has an interest.[71]

(c) Estate Tax. Even though the non-donor spouse is the transferor for gift and GST tax purposes when a gift splitting election is made, the non-donor spouse is *not* the transferor for estate tax purposes, and, more specifically, for purposes of the reinclusion of trust assets in the donor's estate under Sections 2036-2038 of the Code.[72] In PLR 200130030, a wife made contributions to a trust for the benefit of her husband and children, who each held *Crummey* powers. The wife made annual contributions to the trust not in excess of twice the annual exclusion, and elected to gift split with her husband. The IRS ruled that as to the third party interests in the trust, the election to split gifts was valid for gift tax and GST tax purposes, but that "wife will be treated as transferor of the entire value of the gifts to trust for purposes of

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[68] *See, e.g.*, PLR 200130030; *see generally* I.R.C. § 2513(a).

[69] *Compare* Treas. Reg. §26.2652-1(a)(4) (treating the non-donor spouse as the transferor regardless of the ultimate beneficiaries, including the non-donor spouse) *with* I.R.C. § 2513(a)(1) (limiting split gift treatment to transfers to third parties).

[70] I.R.C. § 2652(a)(2); *see, also,* PLRs 200442051, 200551009. However, transferor status with respect to trusts containing withdrawal rights for GST purposes can be a bit more convoluted. Because the non-exercise of a withdrawal right makes the beneficiary a transferor with respect to the amount of that withdrawal right, the donor will be considered a transferor *except* to the extent the transfer to the trust exceeds $5,000 or 5% of the amount of the transfer. *See* Treas. Reg. § 26.2652-1(a)(5) Ex. 5.

[71] *Compare* Treas. Reg. §26.2652-1(a)(4) (treating the non-donor spouse as the transferor regardless of the ultimate beneficiaries, including the non-donor spouse) *with* I.R.C. § 2513(a)(1) (limiting split gift treatment to transfers to third parties).

[72] *See* PLR 200130030.

Sections 2036 through 2038. Sections 2036 through 2038 do not apply to property interests the decedent did not actually own and thus did not transfer."[73]

For estate tax purposes, when a spouse dies, the personal representative of his or her estate will be required to include the deceased spouse's half of any split gifts in excess of the gift tax annual exclusion in calculating adjusted taxable gifts.[74] However, a special rule applies if § 2035 is triggered with regard to taxable gifts made within three years of the donor spouse's death.[75] In that case, the personal representative of the donor spouse's estate must include *the entire amount* of the gift in his or her adjusted taxable gifts and may take credit for the entire gift tax paid on the gift. As for the non-donor spouse, he or she will then include half of the gift in his or her adjusted taxable gifts, but will not receive any credit for gift tax paid.[76] This rule creates a potential for double taxation if the consenting spouse predeceases the donor spouse and the donor spouse subsequently dies within the three-year period. In that particular scenario, the estate of the consenting spouse will have to file a claim for refund as to any overpayments.[77]

(d) **Income Tax.** For income tax purposes under Sections 671-678 of the Code, when a gift splitting election is utilized to make gifts in trust, the status of a non-donor spouse as a transferor is as yet unclear. It could easily be argued that the non-donor spouse is not a transferor. Per Treasury Regulation § 1.671-2(e)(2), "a person who…makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679." Read in context with § 2513 (which expressly states that the election to split gifts only applies for gift tax purposes) and with § 2652 (which allows gift splitting for GST tax purposes under slightly different rules), it would appear that the tax consequences of the gift splitting election are generally defined by statute as to the consenting spouse. The implications of the non-donor spouse not being considered a transferor for purposes of Sections 671-678 of the Code would essentially allow a married couple to double contributions to an "intentionally defective" grantor trust created by the donor spouse without jeopardizing grantor trust status as to that spouse.

However, and perhaps rather confusingly, Treasury Regulation § 1.671-2(e)(1) defines a "grantor" as "any person to the extent such person…directly or indirectly makes a gratuitous transfer of property to a trust." The Regulations further define "gratuitous

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[73] *Id.*
[74] *See* I.R.C. § 2001(b).
[75] I.R.C. §2001(e).
[76] I.R.C. § 2001(e); *see, also,* I.R.C. § 2001(d) (discussing estate tax credit for gift tax paid).
[77] *See* Rev. Rul. 81-85, 1981 C.B. 452; *see, also,* Diana S.C. Zeydel, *Gift Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* J. TAX'N, Jun. 2007, at 12.

transfer" as any transfer of property regardless of whether such transfer is considered a gift for gift tax purposes.[78] So, the IRS's treatment of grantor trusts for income tax purposes would seem to hinge on whether the non-donor spouse is deemed to have made an indirect "gratuitous transfer." One could argue that a simple election to treat the donor spouse's property as half from the non-donor spouse does not constitute a transfer of property by the non-donor spouse; on the other hand, the IRS could take the position that an election to treat a gift as being one-half from the non-donor spouse constitutes a gratuitous transfer by that spouse.

Thus, while it does not appear that the non-donor spouse making a gift splitting election should be a transferor for grantor trust purposes, the IRS has not ruled on this specific issue. Therefore, if grantor trust status as to the donor spouse is essential to the outcome of an overall plan, then perhaps gift splitting should be avoided.

V. **Donor's Spouse as a Beneficiary of *Crummey* Trust**

Often a client will want to create a *Crummey* trust for the benefit of a spouse and children, commonly for the purpose of holding a life insurance policy on the client's life to replace his or her income in the event of premature death. There are a number of important considerations when spouse's hold *Crummey* powers over a trust.

A. The Spouse/Beneficiary Should Not Contribute to the Trust. Most advisors and their clients recognize that there are adverse tax consequences when a trust beneficiary is also a contributor of gifted funds to the trust. Nevertheless, this common sense concept seems to be regularly disregarded in community property states in the context of the creation and funding of trusts in which a spouse will have a lifetime beneficial interest and, in particular, with regard to irrevocable life insurance trusts created by one spouse for the benefit of the other.

To insure that no portion of the trust assets are included in the spouse's estate for estate tax purposes under Section 2036 of the Code, it is essential that any insurance policies transferred to the trust and any funds gifted to the trust to support those policies are the separate property of the non-beneficiary spouse. In community property states like California, it may be necessary for a couple to execute a formal agreement to transmute the couple's community interest in any existing insurance policies or other assets being gifted to a trust into the separate property of the donor spouse.[79] Further, if annual gifts are to be made to the trust for policy premiums or other purposes, both spouses should open bank accounts in their own names, and they should execute a valid property agreement transmuting community to separate property and

[78] Treas. Reg. § 1.671-2(e)(2)(i), (ii).
[79] *See, e.g.,* Rev. Ruls. 2003-40, 2003-1 C.B. 813 and 94-69, 1994-2 C.B. 241.

confirming the separate property nature of the individual accounts. Then each year they should execute a community property partition agreement pursuant to which community funds are withdrawn from a joint account and divided equally into the separate property bank accounts of the two spouses. The donor spouse will use his or her separate bank account to make gifts to the trust that benefits the non-donor spouse. The non-donor spouse can use the funds in his or her separate account for any purpose.

B. Splitting Gifts to Trusts in Which Spouse is also a Beneficiary. An issue arises where gift splitting (discussed in Section IV.C of this Outline above) is desired for gifts to a trust in which the non-donor spouse has a beneficial interest.

(1) Revenue Ruling 56-439. The IRS first tackled the issue of split gifts to a trust in which the spouse is a beneficiary in Revenue Ruling 56-439. In the facts set forth in the ruling, both the spouse and the third party beneficiaries had potentially unlimited access to trust assets. The Service took the position that, because the interest held by the non-donor spouse pursuant to the trust terms was not severable from the interests held by third party beneficiaries, gifts to the trust could not be split.

(2) Case Law. In *Robertson v. Comm'r.*,[80] the Tax Court for the first time considered whether a transfer to a trust in which a non-donor spouse had an interest qualified for split gift treatment. The donor spouse created a trust, the terms of which provided for income to his wife for life, remainder to third party beneficiaries, with a power of invasion for the wife's "maintenance and support."[81] In analyzing whether the remainder interest qualified for split gift treatment, the Court established a two part test: first, whether the wife's invasion power was limited to an ascertainable standard, and second, whether the invasion power was likely to be exercised based on the wife's other financial resources and standard of living.[82] The Court held that: (1) the invasion power for "maintenance and support" was sufficiently ascertainable, and (2) the wife's significant financial resources outside the trust made it extremely unlikely that the invasion power would ever be exercised.[83] Thus, the Court concluded, the entire remainder interest qualified for split-gift treatment.[84]

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[80] *Robertson v. Comm'r.*, 24 T.C. 246 (1956).
[81] *Id*. at 246-47.
[82] *Id*. at 251.
[83] *Id*. at 251-52.
[84] *Id*. at 252-53. The *Robertson* two-part test was confirmed by the Tax Court in *Kass v. Comm'r*, T.C. Memo 1957-227. However, the *Kass* Court did not substantively analyze either part of the test due to the taxpayer's failure to present information regarding financial situation and standard of living.

In a later case, *Wang v. Comm'r.*,[85] the Tax Court again applied the two-part test to determine whether a transfer to a trust qualified for split gift treatment. Here, the Tax Court held that an invasion power for "proper comfort, care and health, or for any emergency" was not sufficiently ascertainable.[86] In so holding, the *Wang* Court did not need reach the second part of the analysis (the non-donor spouse's financial condition) because the first part of the test was not met and, on that basis alone, gift splitting was not available.[87]

(3) <u>PLR 200345038</u>. This PLR is one of the few recent IRS authorities involving split gift transfers to a trust. The facts of the PLR involve a husband who established three irrevocable trusts, one of which benefited his wife and daughter, the other two of which benefited his wife and each of his sons. The trusts provided income and principal for each beneficiary's health, education, maintenance and support. The IRS ruled that, since the wife's interest was subject to an ascertainable standard, the gifts qualified for split treatment. Perplexingly, though clarifying the first part of the *Robertson* test (that is, whether the wife's invasion power was limited to an ascertainable standard), the IRS failed to apply the second part of the test (whether the invasion power was likely to be exercised based on the wife's other financial resources and standard of living) and, as such, leaves open whether the IRS intended to eliminate the second part of the test, or simply overlooked its application.

(4) <u>Transfers to Trusts in Which a Non-Donor Spouse has a *Crummey* Power</u>. If the non-donor spouse holds a *Crummey* power with regard to a trust, gifts to the trust should still be able to be split between the donor and non-donor spouse, provided that the non-donor spouse's interest in the trust and in the gifted property is ascertainable and severable from the remaining beneficiaries' interests. Otherwise, the value of the gift to the other trust beneficiaries cannot be ascertained and gift splitting cannot be elected with regard to that gift.[88] Further, when electing to split gifts with regard to a trust in which the non-donor spouse has a *Crummey* power, the non-donor spouse should be considered a transferor for gift tax purposes,[89] but only with regard to the portion of the gift over which he or she does not have an interest.[90]

Unfortunately, the state of the law in this area is as yet unclear; PLRs have reached differing results.[91] Nevertheless, the growing consensus among commentators appears

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[85] T.C. Memo 1972-143.
[86] *Id.*
[87] *Id.*
[88] PLR 200616022
[89] *See, e.g.*, PLR 200130030; *see, generally,* I.R.C. § 2513(a).
[90] I.R.C. § 2513(a)(1) (limiting split gift treatment to transfers to third parties).
[91] *Compare* PLRs 2006616022 and 200422051 (ignoring Crummey withdrawal rights held by third parties in analyzing the non-donor spouse's interest in the trust) *with* PLR 200130030 (ruling that the third parties' withdrawal rights trumped the non-donor spouse's discretionary interest in the trust).

to be that split gift treatment should be allowed for any portion of the trust that is not reachable by the spouse, and the value of the gift is discounted by any withdrawal right the spouse may possess. For example, if a trust grants a spouse a $5,000 withdrawal power and grants each of two children a $13,000 withdrawal power, and thereafter the donor spouse makes a $31,000 contribution to the trust, the spouse's $5,000 withdrawal right may not be split, but the remaining $26,000 may be split – resulting in the non-donor spouse making a $13,000 annual exclusion gift, and the donor spouse making a $18,000 gift.

C. <u>Trusts Created by Spouses for Each Other</u>. On occasion, both spouses may wish to create trusts for the other spouse, either for the purpose of holding life insurance, to convey assets to each other for asset protection purposes, or for a variety of other tax or non-tax reasons. Such planning is certainly possible, including the ability to provide each other *Crummey* powers over the trusts. However, care needs to be taken in structuring such trust. First, as noted in Section A above, action must be taken by the spouses to insure that neither spouse makes a gift to his or her own trust. In addition, it is important to make certain that the spouses do not create *reciprocal trusts* for one another, a concept discussed earlier in Section IV.A of this Outline above with regard to attempts by unrelated persons to increase the number of annual exclusions available to by making gifts to trusts for the benefit of each other's children.

In the context of trusts created by spouses for one another, it is essential to insure that the trusts do not create the appearance that "the arrangement, to the extent of mutual value, [leaves] the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."[92] Running afoul of this concept would result in each spouse being deemed to create the trust for his or her own benefit, causing the trusts to be "self-settled" for gift, estate, GST, and income tax purposes.[93]

Generally, the reciprocal trust doctrine can be avoided by insuring trusts created by spouses for each other are sufficiently different so that the spouses would not be in the same economic positions if each had created the trust for his or her own benefit. For example, one court has held that the reciprocal trust doctrine could not be applied between spouses where one spouse was granted a lifetime special power of appointment over the trust for that spouse's benefit and the other was not.[94] Other differences between the two trusts could be the inclusion of children as current permissible beneficiaries in one spouse's trust and not in the other,[95] or providing one spouse a mandatory income interest or a "*five or five*" power while not providing

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[92] *U. S. v. Estate of Grace*, 395 U.S. 316 (1969), at 324.
[93] *See*, Rev. Rul. 74-533, 1974-2 C.B. 293.
[94] *Estate of Levy v.Comm'r*, T. C. Memo 1983-453 (1983).
[95] *See,* PLR 9643013.

such interests or powers to the other spouse.[96] A trust might also require a co-Trustee to approve distributions to a spouse in one trust but not in the other.

D. <u>Trusts for Non-Citizen Spouses.</u> Gifts to spouses who are not U.S. citizens do not qualify for the gift tax marital deduction provided under Section 2523 of the Code.[97] However, there is an annual gift tax exclusion available for such gift transfers. Specifically, if a gift to a spouse does not qualify for the gift tax marital deduction otherwise provided under Section 2523 of the Code *solely because the donee spouse is not a U.S. citizen*, and if the gift otherwise qualifies for the gift tax annual exclusion under Section 2503(b) of the Code, then, pursuant to Section 2523(i)(2) of the Code, the exclusion available under Section 2503(b) is increased for that gift from $10,000, as referenced in Section 2503(b), to $100,000 ($139,000 in 2012 on an inflation adjusted basis).[98]

As suggested above, there are two important criteria must be satisfied for the increased gift tax annual exclusion for gifts to non-citizen spouses to apply. First, the gift must otherwise qualify for the gift tax annual exclusion under Section 2503(b), meaning, among other things, that the gift must be a gift of a present interest. Second, the gift must have otherwise qualified for the gift tax marital deduction under the provisions of Section 2523 but for the fact that the transferee was not a U.S. citizen.[99] Consequently, gifts of otherwise non-deductible terminable interests will not be excludable from gift taxation beyond the normal gift tax annual exclusion amount.

With limited exceptions, gifts in trust for the benefit of a non-citizen spouse will not qualify for the expanded gift tax annual exclusion, even if a *Crummey* power is provided. The regulations do provide, however, that a gift in trust for a non-citizen spouse that provides a qualifying income interest for life *and a testamentary general power of appointment over the principal of the trust* will qualify for the expanded annual exclusion, *but only to the extent of the value of the spouse's income interest.*[100] On the other hand, because there is no lifetime QTIP trust election available for a transfer in trust for the benefit of a non-citizen spouse, if the non-

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[96] *See,* PLR 200426008.
[97] I.R.C. § 2523(i).
[98] I.R.C. § 2523(i)(2). While, in 1997, Congress did not specifically index the $100,000 annual exclusion for transfers to non-citizen spouses for increases in the cost of living, as it did the gift tax annual exclusion under Section 2503(b), the IRS has interpreted the cross reference to 2503(b) that is found is Section 2523(i) to incorporate by reference a cost of living adjustment. Therefore, the current amount of the gift tax annual exclusion for transfers to a non-citizen spouse is $136,000. Rev. Proc. 2011-52, I.R.B2011-45 at § 2.31.
[99] *Id.*
[100] Treas. Reg. § 25.2523(i)-1(d) Ex. 3.

citizen spouse is not provided a testamentary general power of appointment over a trust, then no part of a transfer to that trust will qualify for the expanded annual exclusion.[101]

VI. Notice and the "Mechanics" of *Crummey* Powers[102]

A. General Notice Requirement. In order for a gift made to an irrevocable trust to qualify for the annual exclusion, it is the position of the IRS that each beneficiary must have (1) actual notice of his or her withdrawal right, and (2) a reasonable opportunity to exercise the withdrawal right prior to its lapse.[103]

B. "Actual" Notice. The IRS requires that the beneficiary of an irrevocable trust have actual notice in order for the gift to qualify for the annual exclusion. The theory behind this requirement is that without actual notice the beneficiary's demand right is illusory.[104] This requirement can certainly be satisfied by providing the beneficiary with written notice, which thereby imparts actual notice on the beneficiary. However, where written notice is not provided, the actual notice requirement can still be satisfied by showing the beneficiary had actual knowledge of the demand right.[105] That being said, from an evidentiary standpoint, demonstrating that a beneficiary had actual knowledge of a demand right can be more difficult than simply providing a copy of a form of written demand right notification (a "*Crummey* Letter"). Thus, the preferred method of evidencing actual notice to the beneficiary is through a *Crummey* Letter delivered to the beneficiary, so that the donor has evidentiary proof that the beneficiary had actual notice.

C. The Contents of "*Crummey* Letter". To provide maximum evidentiary effect, a *Crummey* Letter should include: (1) a statement that a gift was made to the trust for the benefit of the beneficiary; (2) the amount of the gift subject to the beneficiary's demand right; (3) the demand right exercise period; and (4) a request that the beneficiary notify the trustee if the beneficiary wishes to exercise the demand right. The *Crummey* Letter may also include an attached acknowledgment with instructions that the beneficiary sign and return the acknowledgement, in order to provide documentation of the beneficiary's receipt of the notice. However, the acknowledgement should not contain language effectuating a waiver by the beneficiary of the demand right. This is important because a demand right is technically a

[101] Treas. Reg. § 25.2523(i)-1(d) Ex. 4.

[102] ***The Author wishes to recognize the contribution of time and talent by her law clerk, Eric A. Baggett who was instrumental in the development of this Section of the Outline addressing the notice requirements for effective Crummey powers.***

[103] Rev. Rul. 81-7, 1981-1 C.B. 474.

[104] Rev. Rul. 81-7, 1981-1 C.B. 474.

[105] PLRs 8008040, 8022048, 903005.

general power of appointment, the exercise or release of which constitutes a taxable gift.[106] While a lapse of a general power of appointment constitutes a taxable release, a "*five or five*" gift tax exclusion is available for a general power of appointment that is allowed to lapse.[107] Thus, if a beneficiary allows a demand right to lapse, the *five or five* exclusion is available to shield a portion of the demand right from an unintended taxable gift to the other beneficiaries of the trust. However, the exclusion may not be similarly available where the beneficiary affirmatively waives the demand right as part of the acknowledgement.

D. <u>Absence of Written Notice</u>. As stated above, the actual notice requirement does not necessitate written notice. In fact, no revenue rulings or private letter rulings have ever required that the trust agreement contain a provision requiring written notice. However, in the absence of written notice, the taxpayer will bear the burden of proof of demonstrating the beneficiary's actual knowledge of the demand right, which may prove difficult. In one case, the Tax Court determined that a beneficiary had satisfied its burden with regard to actual knowledge of the demand right, where the beneficiary was provided with verbal notice.[108] Similarly, the IRS may find that the actual notice requirement is satisfied where the facts and circumstances demonstrate that the beneficiary possessed actual knowledge. For example, the IRS allowed an annual exclusion where the beneficiaries were minors and their guardian, who was serving as trustee, did not provide herself with written notice.[109] Likewise, where the beneficiary was the spouse of the grantor and also served as trustee, no written notice was required because the IRS found that the beneficiary had actual knowledge of her demand right.[110] In certain cases, the IRS has permitted a single written notice provided in year one to constitute actual notice for subsequent years when written notice is not provided.[111] However, these cases have been limited to scenarios typically involving annual contributions to irrevocable life insurance trust that were made on the same day of the year in the same amounts in order to cover annual premium payments.[112] Although prior scenarios have been limited to life insurance trusts, a parallel argument could made to support actual notice, where a single notice is provided for an annual recurring payment made to any type of irrevocable trust.

E. <u>Notice Should Not Be Waived</u>. A beneficiary who has been provided with written notice of a demand right, and waives the right to future written notifications, may have actual knowledge of the demand right; however the IRS has specifically disapproved such an approach to establish actual notice. For example, in a private letter ruling, where the

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[106] I.R.C. §2514(b)(c)
[107] I.R.C. §2514(e)
[108] *Estate of Carolyn W. Holland v. Comm'r*, T.C. Memo 1997-302.
[109] PLR 9030005
[110] PLR 8008040
[111] PLRs 8121069, 8133070
[112] PLRs. 8121069, 8133070

beneficiaries were provided with notice of their demand right upon initial contributions to the trust and then subsequently waived their right to be notified of future contributions, the IRS found that the future contributions were not gifts of a present interest as the beneficiaries did not have actual notice of those contributions.[113] Specifically, the IRS stated that a beneficiary must have current notice of any gift for that gift to be a transfer of a present interest, as without such notice, a beneficiary cannot have "a real and immediate benefit of the gift".[114]

F. **Reasonable Opportunity.** Even where a beneficiary has actual notice of a demand right, the IRS also requires that the beneficiary of an irrevocable trust have a reasonable opportunity to exercise the demand right in order for the gift to qualify for the annual exclusion.[115] The IRS has not specifically stated what constitutes a reasonable exercise period. However, several private letter rulings have held that a beneficiary had a reasonable opportunity to exercise a demand right where a beneficiary was afforded at least a thirty day exercise period.[116] Conversely, where the beneficiary was afforded only three days to exercise a demand right, the IRS determined that the right was illusory and disallowed the annual exclusion.[117] On the other hand, in *Cristofani*, the beneficiaries were afforded only a 15 day exercise period, and the court found that the transfer qualified for the annual exclusion.[118] However, the length of the exercise period was not specifically challenged by the IRS in *Cristofani*. Thus, until a shorter exercise period is specifically approved, a beneficiary should be afforded at least 30 days to exercise a demand right.

G. **Exercise Period.** It is important to make sure that the exercise period begins immediately upon the date of the transfer, rather than on the date of notice, even if notice is not simultaneously provided, as any delay in the beneficiary's ability to exercise the demand right might create a future interest, thereby disqualifying the transfer from the benefit of the annual exclusion.[119] So long as the demand right is immediately exercisable, the lapse of the exercise period may be based on either the date of the transfer or the date the notice is provided, as the IRS has approved both methods.[120] However, if lapse of the exercise period is based on the date of the transfer and notice is not simultaneously provided, the exercise period should be made sufficiently long enough to ensure that the beneficiary has at least 30 days to exercise the demand right after receiving notice. Also, it is important to make sure that the exercise period is not contradicted by the terms of the trust. Some trust agreements provide that demand rights

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[113] PLR 9532001
[114] PL9532001
[115] Rev. Rul. 81-7, 1981-1 C.B. 474.
[116] PLRs 200130030, 200123034, 200011054, 199912016, 9311021.
[117] Rev. Rul. 81-7, 1981-1 C.B. 474.
[118] *Cristofani v. Comm'r,* 97 T.C. 74 (1991)
[119] PLR 8433024.
[120] PLRs 8008040, 8103074, 805118.

automatically lapse on December 31 of each year, regardless of when the contribution is made. In such a case, the terms of the trust may result in a curtailed exercise period of less than 30 days for transfers made after December 1. The better approach is to provide a 30 day exercise period, even if a demand right carries over into the next year, as it is immaterial if the time period in which a beneficiary may exercise a demand right ends in a different calendar year.[121]

H. **Notice to Minor and Incompetent Beneficiaries.** An issue that arises frequently in the context of *Crummey* trusts is how to structure notice to minor or incompetent beneficiaries.

(1) **No Guardian Need Be Appointed to Act.** Whether and how minor beneficiaries can hold withdrawal powers over a gift to a trust was the principle issue in question in the *Crummey*[122] case itself. The specific question in *Crummey* was whether providing a withdrawal power to a minor beneficiary with no acting guardian can create a present interest in a gift to a trust. In that case, two of Mr. and Mrs. Crummey's four children holding withdrawal powers were financially dependent minors living at home. Gifts were made to the trust two weeks before the end of the year and the withdrawal rights over those gifts lapsed at the end of the year. The court stated that, while it was highly unlikely that a guardian would be appointed to make the withdrawal or that the minor beneficiaries knew or would ever know about the gifts to the trust that gave rise to the withdrawal rights, because under the trust document and local law the minors had the right to demand withdrawal of gifted assets up to the annual exclusion amount, the gifts to the trust were gifts of a present interest.

The IRS acquiesced to the holding in *Crummey* in Rev. Rul. 73-405[123], where the Service ruled that a minor beneficiary of a trust can possess a valid right of withdrawal for purposes of the gift tax annual exclusion even though the beneficiary is legally unable to exercise the power and no guardian has been appointed to act for the beneficiary.

(2) **Who Should Have the Power to Act for the Minor?** Although it is clear that minors can hold valid *Crummey* powers, some practitioner remain concerned as to who should be provided notice and the right to act on behalf of a minor beneficiary. There is authority for the premise that a gift to a *Crummey* trust for the benefit of a minor beneficiary is a gift of a present interest even though the parent with the authority to act for the minor is the donor.[124] However, there have been no rulings or cases specifically addressing whether a donor acting for

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[121] Rev. Rul. 83-108, 1983-2 C.B. 167.

[122] *Crummey v. Comm'r*, supra note 23; *see, also*, *Naumoff v. Comm'r, T.C. Memo 1983-435 (1983).*

[123] Rev. Rul. 73-405, 1973-2 C.B. 321.

[124] *See* PLR. 8008040. *See, also, Estate of Carolyn W. Holland v. Comm'r,* T.C. Memo 1997-302 (1997)

a minor beneficiary could be a retention of the ability to direct the disposition of the gift, thereby risking the estate tax inclusion of the gifted assets in the donor's estate under 2036 or 2038 of the Code (which would also trigger a three-year look back under 2035 of the Code). To avoid this risk, the trust agreement might provide that the withdrawal rights must be exercised by a parent acting for the minor who is not the donor. However, this might not be practical if both parents are donors or if the donor and the child's other parent are estranged and the donor does not want the other parent having any rights over or even any knowledge of the existence of the trust. To address this concern, the trust instrument might provide that the Trustee has the power to designate an adult to receive notice on the part of the minor and to exercise the minor's rights of withdrawal.[125] Of course, when a minor beneficiary attains the age of majority under state law, that beneficiary should be provided notice like any other beneficiary and the right to exercise his or her own right of withdrawal. If the trust instrument provides its own definition of "minor" and "adult" beneficiaries that differs from state law, it would be advisable to exclude that definition in the context of when a beneficiary is considered to be an adult for purposes of exercising a *Crummey* power.

(3) <u>Incompetent Beneficiaries and Special Needs Provisions</u>. The same principles that permit a minor beneficiary to possess a *Crummey* power should also apply to beneficiaries who are legally incompetent adults. If, however, the trust contains special needs provisions for an incompetent adult which would limit the beneficiary's withdrawal rights in order to preserve public benefits, then the withdrawal right will not be a gift of a present interest. Importantly, the existence of *Crummey* powers in a special needs trust will almost certainly be a resource that must be considered in determining whether the beneficiary qualifies for needs-based public benefits. In addition, the lapse of a *Crummey* power held by the beneficiary of a special needs trust could convert a third party special needs trust to a self-settled special needs trust, which, among other negative consequences, could permit the state providing benefits to seek recovery from the assets remaining in the trust at the beneficiary's death. Therefore, a trust that is intended to be a special needs trust should not incorporate *Crummey* powers that are exercisable by the beneficiary whose benefits are being preserved.[126]

VII. "<u>Last Minute" Crummey Gifts</u>

The call comes in from your client's daughter telling you that your client has had a stroke, her prognosis is not good, the next $123,000 premium on the $5,000,000 insurance policy that is held in the client's irrevocable *Cristofani* trust is past due and well into its grace period,

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[125] *See Perkins v. Comm'r*, 27 T.C. 601 (1956). *See, also,* PLRs 8229097, 8024084 and 8022048.

[126] For a more thorough discussion of issues involved in drafting special needs trusts, *see* Amber K. Quintal, *Planning For Individuals with Disabilities: Special Needs Trusts*, Practical Lawyer, Spring 2008.

and there is no cash in the trust to pay the premium. The daughter wants to know how they can go about funding the trust using annual exclusion gifts.

A. **Gifts by Incompetent Donors**

(1) Someone Must Have the Legal Authority to Make Gifts. It is well established that gifts made on an incompetent donor's behalf without proper authority are void and, because a void gift can be revoked by or on behalf of the donor, such gifts are includible in the donor's gross estate under Section 2038 of the Code.[127] Therefore, when contemplating last minute annual exclusion gifts for an incompetent client, the first question that must be answered is whether anyone has the legal authority to make gifts on the client's behalf.

State law is determinative of whether anyone is in possession of the legal authority to give away an incompetent person's property.[128] For example, the California Probate Code provides that a power of attorney may not be construed to grant authority to an attorney-in-fact to make gifts of the principal's property in trust or otherwise *unless expressly authorized* in the power of attorney. Thus, in *Swanson v. Comm'r.*, a California power of attorney that authorized Mrs. Swanson's agent "to manage and dispose of Mrs. Swanson's property, and to conduct business on her behalf" was insufficient to constitute express authorization to make gifts under California law. As a result, 38 last minute annual exclusion gifts were brought back into Mrs. Swanson's estate under Section 2038. On the other hand, in *Frank v. Comm'r.*,[129]an agent acting under a New Jersey power of attorney for an incompetent principal was given the power "to make gifts, without consideration in any amount to anyone" as well as the power "to withdraw and receive income or corpus of a trust." Under this combination of powers, the agent was able to withdraw shares in a family owned corporation from the principal's trust, place those shares in the principal's name, and then immediately transfer those shares to the principal's wife, all for the purpose of securing a minority discount for the value of those shares in the estates of both spouses. Because the agent had the legal authority under New Jersey law to take these actions on the decedent's behalf, and because the proper steps were followed, the Court held that the gift should be respected and upheld.

In some states, specific reference to the power to make gifts is not required for an agent acting under a power of attorney to make gifts. In some respects, life for the last minute estate planner can be more treacherous in these states as it may not be clear whether anyone has the power to make gifts. For example, two separate cases, both decided on the basis of Virginia

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[127] *Jalkut v. Comm'r,* 96 T.C. 675, 678 (1991).
[128] *Swanson v. Comm'r,* 46 Fed. Cl. 388 (2000), *aff'd*,, 87 AFTR 2d 2001-2345 (Fed. Cir. 2001) (unpublished opinion).
[129] *Frank v. Comm'r,* 69 T.C. Memo 2255 (1995).

law, produced different results under similar circumstances. In the first case, *Casey v. Comm'r.*,[130] the Court noted that while neither Virginia statutory law nor existing case law demonstrated any requirement that a broad durable general power of attorney must specifically authorize donative transfers of the principal's property for the agent to possess that power, it was highly likely that, should the issue be brought before the highest court in the state, it would adopt that requirement as a matter of public policy. As a result, despite the fact that the agent had a broad general power of attorney and simply continued the pattern of past giving by the principal, the Court concluded the gifts made by the agent should be included in the decedent's estate because the agent was not expressly authorized to make gifts.

Two years later, in *Ridenour v. Comm'r.*,[131] the Tax Court reached an entirely different conclusion when applying Virginia law to similar facts. In that case, the decedent had a strong pattern of regular gifting to certain individuals. Three weeks before his death from renal failure and while the decedent was incompetent, his agent acting under a broad general power of attorney without specific gifting authority made just under $100,000 of gifts to nine different donees, most of whom were past recipients of gifts from the decedent, but some of whom were not. The Service argued that the holding in *Casey* was directly on point and that all of these gifts should be declared void. However, between the issuance of the ruling in *Casey* and the rendering of the Court's opinion in *Ridenour*, the Virginia legislature enacted an amendment to state law clarifying that an agent under a durable power of attorney that is given "full power to handle the principal's affairs or deal with the principal's property" had the inherent power to make gifts. This law was enacted after the gifts had been made in *Ridenour*. Nevertheless, the Court in *Ridenour* viewed the new law as evidence that the *Casey* court had made an erroneous assumption about the public policy of the State of Virginia. Consequently, the gifts in *Ridenour* were upheld, including gifts to those donees who were not past recipients of gifts from the decedent.

(2) <u>Transfers Directly from Revocable Trusts</u>. A frequent problem for last minute gifting is trying to identify who actually has access to assets for purposes of making these gifts: the agent or the successor trustee of the incompetent person's trust? Once this is ascertained, the next question is whether the fiduciary with access to the assets is also the fiduciary with the power to make gifts. The most common quandary is that the agent acting under a durable power of attorney or a court appointed guardian or conservator has been given the authority to make gifts for the incompetent person, but the incompetent person's assets are tied up in a revocable trust that does not authorize the trustee to make gifts or distributions to

[130] *Casey v. Comm'r,* 948 F.2d 895 (4th Cir. 1991).

[131] *Ridenour v. Comm'r,* T.C. Memo 1993-41, *aff'd*, 36 F.3d 332 (4th Cir. 1994).

anyone other than the grantor during his or her lifetime.[132] The best solution under these circumstances is for the agent, guardian or conservator to withdraw assets from the trust, take them into the incompetent grantor's name, and then make the desired gifts. Sometimes, however, the agent or guardian does not have the power to withdraw trust property, or time is of the essence and it is simply more efficient and effective to make gift transfers directly from the incompetent person's revocable trust.[133]

In TAM 9309003, the Service considered a situation where gifts were made directly from a decedent's revocable trust at his guardian's direction. In that TAM, the decedent's revocable trust agreement reserved in the decedent as grantor the power to withdraw trust assets at anytime. In the event that the decedent became incompetent, the trust directed the trustee to make distributions to the decedent or for her benefit, but to no other person. When the decedent became incompetent, the Court appointed a guardian of her estate and authorized the guardian to continue to make gifts consistent with the decedent's past giving practices. Using this authority, the guardian directed the trustee to make transfers to a number of the decedent's family members. In reviewing the facts after the decedent's death, the Service concluded that although distributions were not authorized from the trust to any person but the decedent, they were in substance withdrawals by the guardian on the decedent's behalf followed by gifts to the ultimate donees.[134]

B. <u>Deathbed Gifts: No Relation-Back of Uncashed Checks</u>. Another issue when making last minute gifts is whether the gift will be deemed completed before the client takes his or her last breath. Generally, the gift must be delivered, accepted and beyond any right of revocation by the decedent or an agent or other personal representative acting on his or her behalf. The most sticky problem in this regard involves the use of checks to make last minute annual exclusion gifts. It is a well established rule that a non-charitable gift is not complete for transfer tax purposes until the donor has parted with dominion and control such that he has no power to change the disposition, whether for his own benefit of the benefit of another.[135] Whether such control has been relinquished is a matter of state law. Under the laws of most, if

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[132] Prior to 1997, holding assets in a revocable trust presented problems even for competent grantors. Generally, the rule had been that gifts made by a grantor directly from his or her revocable trust were treated as the relinquishment of a power of the grantor described under 2038 of the Code, resulting in inclusion of the gifted assets in the grantor's estate under Section 2035 if the grantor died within three years of the gift. This issue was resolved by Congress by the 1997 Tax Act through the enactment of Section 2035(e) which excludes from Section 2035 gifts made by competent grantors directly from their revocable trusts.

[133] *See* discussion *supra* note 146 and accompanying text.

[134] *See, also* TAM 9413002.

[135] *Metzger v. Comm'r,* 100 T.C. 204, 208 (1993), *aff'd*, 38 F.3d 118 (4th Cir. 1994); *Estate of Elizabeth C. Dillingham v. Comm'r,* 903 F.2d 760 (10th Cir. 1990); Rev. Rul. 96-56, 1996-2 C.B. 161 (*modifying* Rev. Rul. 67-396, 1967-2 C.B. 351).

not all states, a person who drafts a personal check can stop payment on that check at any time before it clears his or her bank. As a result, unless and until gift checks have actually been paid by the donor's bank, the gift is incomplete.[136] If the donor dies before the gift is complete, the gift will be included in the decedent's estate under Section 2038 of the Code. Therefore, to improve the chances of making successful last minute cash gifts, it is always preferable to use a non-cancelable means of transferring funds, such as cashiers checks, money orders or wire transfers, particularly if time is running out and it is not possible for the intended donees to present their checks personally to the donor's bank for payment before the donor's death.

VIII. Annual Exclusion Gifts Involving Debt

A. Gifts of Debt Relief - Debt Owed by a Natural Person. Relief of individual indebtedness that is provided with donative intent is a gift of a present interest in the amount of the debt relief.[137] The legal issue in most such cases is therefore not whether the gift is one for which the annual exclusion applies, but rather the timing of the gift; in other words, whether the gift was complete when the debt was relieved or when the original loan was made. The answer to this question turns on whether the original transfer created a bona fide debt.[138]

A loan made to a trust for the benefit of a family member will be subject to special scrutiny, and the presumption will be that the transfer is a gift.[139] To rebut this presumption, the transferor must show that, at the time of the loan, he or she had a reasonable expectation of being repaid.[140] Further, the transferor must demonstrate that he or she possessed the intention to enforce the loan if it was not timely paid.[141] Whether there was a reasonable expectation of repayment and an intention to enforce the loan is based upon all of the relevant

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[136] *Est. of Newman,* 111 T.C. 81 (1998), *aff'd*, 203 F.3d 53 (D.C. Cir. 1999); *DiSanto v. Comm'r,* 78 T.C. Memo 1220 (1999); *Rosano v. U.S.,* 245 F.3d 212 (2d Cir. 2001).

[137] Treas. Reg. § 25.2511-1(a); *Haygood v. Comm'r,* 42 T.C. 936 (1964); *Kelley v. Comm'r,* 63 T.C. 321 (1974).

[138] Treas. Reg. § 25.2511-1(a). Note that, where a debt is canceled in full as to a debtor that no longer has any reasonable prospects of repaying the debt, a better tax result may be achieved by taking a bad debt deduction, particularly if the debtor is insolvent before and after the debt in canceled or there are other circumstances that would cause debt relief to be excluded from income taxation for the debtor pursuant to § 108 of the Code or applicable case law. For an interesting case in which bad debt deductions were allowed for the cancellation of over $100,000,000 of loans made by Bunker Hunt to his children to cover their margin calls when the prices of silver and gold collapsed in the late 1970s, *see, Hunt v. Comm'r.,* T.C. Memo 1989-335.

[139] *Miller v. Comm'r,* T.C. Memo 1996-3 (*citing Harwood v. Comm'r,* 82 T.C. 239, 258 (1984); *Reynolds v. Comm'r*, 55 T.C. 172, 201 (1970)).

[140] *Id.* (citing *Van Anda v. Comm'r,* 12 T.C. 1158, 1162 (1949)).

[141] *Id.* (citing *Maxwell v. Comm'r,* 98 T.C. 594 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993); *Musgrove v. U.S.*, 33 Fed. Cl. 657, 664 (1995)).

facts and circumstances, no one of which is necessarily determinative.[142] These include (a) whether there is a promissory note or other written evidence of the debt; (b) whether the obligation bears interest; (c) whether the debt is secured; (d) whether there is a fixed maturity date; (e) whether records were maintained by the transferor and/or the transferee trust (such as on the trust accounting) that reflect the transaction as loan; (f) whether federal income tax reporting was consistent with the treatment of the transfer as a loan; (g) whether any actual payments were made on the loan; and (h) in the event of default, whether there was a demand for payment.[143]

A common gifting strategy is to loan money to children, grandchildren or others, or to trusts for their benefit, and then to forgive the loan incrementally from year to year using the gift tax annual exclusion. So long as the facts do not suggest that the incremental debt forgiveness is part of a prearranged plan to forgive the debt payments as (or before) they become due, a gift will be made at the time of the forgiveness, and such gift will take into account both principal and accrued but unpaid interest.[144] On the other hand, it is the position of the Service that, if there is a pre-arranged plan to forgive the debt, the initial transfer is not a loan but a gift and, therefore, the annual exclusion is not available to shelter the amount of that gift from immediate taxation as payments are forgiven in later years.[145]

The courts have not consistently supported the Service with regard to the tax treatment of prearranged plans of debt forgiveness. For example, in *Haygood v. Comm'r.*,[146] the Court agreed that it was the intent of the seller of real property to forgive payments due on a purchase money note as they came due. This intent, however, did not override the validity of the original note as an enforceable obligation under state law, which represented adequate consideration for the property sold. Therefore, the Court determined there was no gift at the time of the initial transfer and that the gift tax annual exclusion applied each time a note payment was canceled.[147] The IRS has not acquiesced to the decision in *Haygood*, however, and taxpayers should anticipate that any pre-arranged plan of debt forgiveness will be subject to challenge. To

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142 *Id.* (citing *Maxwell*, 98 T.C. at 604).
143 *Id.* (citing *Zimmerman v. U.S.*, 318 F.2d 611, 613 (9th Cir. 1963); *Montgomery v. U.S.,* 87 Ct. Cl. 218, 229 (1938); *Maxwell*, 98 T.C. at 604).
144 Rev. Rul. 81-264, 1981-2 C.B. 186 (citing Treas. Reg. § 25.2511-1; *Republic Petroleum Corp. v. U.S.,* 397 F. Supp. 900 (E.D. La. 1975).
145 Rev. Rul. 77-299, 1977-2 C.B. 343 (sale of real property for a note with annual payments that are forgiven each year under the annual exclusion is a gift of the property and not a sale); *see, also, Deal v. Comm'r,* 29 T.C. 730 (1950) (sale of remainder interest in property in return for non-interest bearing, unsecured demand notes, paid annually through debt cancellation using the annual exclusion, was a gift of the remainder interest).
146 *Haygood*, 42 T.C. 936 (1964).
147 *Id.* at 946-47; *see, also, Kelley*, 63 T.C. at 323-24; *Wilson v. Comm'r,* T.C. Memo 1992-480 (involving a self-canceling installment note).

avoid such a challenge, a preferred approach may be to make cash gifts to a debtor trust, which the trustee may, in the trustee's discretion, apply to pay down a debt to the donor. Regardless of whether debt is reduced by gifts of cash or by gifts of debt relief, however, it is imperative that all the necessary documentation is in place to show that the debt is a bona fide obligation that the transferor intends to be repaid, that payments are actually made as scheduled, that the transaction is reported as debt on the books of the transferor, that interest payments (or imputed interest, as discussed below) are properly reported for federal income tax purposes, and that action is taken to collect the debt in the event of a default.

B. <u>Gifts Involving Below-Market Interest or No-Interest Loans</u>. As to term loans entered into, and demand loans outstanding after, June 6, 1984, if such loans are gift loans and are either interest-free or bear below-market interest, interest will be imputed for federal gift and income tax purposes under Section 7872 of the Code. A loan is deemed a "gift loan" under Section 7872 if the foregone interest is in the nature of a gift. In such case, the lender is deemed for gift tax purposes as having made a gift to the borrower of the amount of the foregone interest, and the borrower is deemed for income tax purposes as having paid that amount back to the lender. Where such loans are between natural persons or trusts for the benefit of natural persons, the deemed gift of forgone interest is a gift of a present interest for which the annual exclusion applies.

The determination of whether a gift loan bears below-market interest, the amount of the imputed interest, the timing of the deemed gift from the lender to the borrower, and the timing of the deemed interest payment from the borrower to the lender, differs depending upon whether the loan is treated as a loan with a definite maturity date or a demand loan.

(1) <u>Gift of Imputed Interest on a Loan With a Definite Maturity Date</u>. A loan has a definite maturity date if it is payable on a date certain, including a date that is determined actuarially (such as on the basis of a person's life expectancy).[148] A gift loan with a definite maturity date is deemed to bear below-market interest if the value of all payments to be received under the loan on a present value basis is less than the amount of the loan, the discount rate for this purpose being the applicable federal rate in effect on the date of the loan.[149] The difference is deemed a gift by the lender on the date of the loan.[150] Although the gift is deemed to be made on the date of the loan, for income tax purposes, the lender is treated as receiving from the borrower a payment equal to the imputed interest element each year on the last day of the borrower's taxable year.[151]

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[148] Prop. Treas. Reg. § 1.7872-10(a)(2).
[149] Prop. Treas. Reg. § 1.7872-7; *Frazee v. Comm'r,* 98 T.C. 554 (1992).
[150] Prop. Treas. Reg. § 1.7872-7(a)(1); I.R.C. § 2512(b).
[151] Prop. Treas. Reg. § 1.7872-6(b)(3). If, however, the borrower is an entity rather than a natural person, imputed interest is deemed received on December 31. Prop. Treas. Reg. § 1.7872-6(b)(3).

(2) Gift of Imputed Interest on Demand Loans. A loan is a demand loan if it is payable upon demand of the lender or if the maturity date is otherwise indefinite.[152] A gift loan that is a demand loan is deemed to bear below market interest if the interest rate payable is less than the applicable federal rate.[153] For this purpose, the applicable federal rate is the rate published pursuant to Section 1274(d) of the Code, compounded semi-annually. The gift is the amount of the foregone interest and is computed using a "blended rate" that is published under Section 7872(e)(2) of the Code and which is the average of the short term rates published on January 1 and July 1 of each calendar year in which amounts are outstanding under the loan.[154] The date of the deemed gift and deemed interest payment is the last day of the borrower's taxable year.[155]

(3) Forgiving Interest as It Comes Due. As discussed above, a lender may choose to make an annual exclusion gift to a borrower in the form of a forgiven payment. This will not serve to avoid the tax consequences of the imputed interest element of a below-market loan unless a substantial part of the gift involves the forgiveness of principal as well as accrued interest and a principal purpose of the forgiveness is to confer a benefit upon the borrower.[156]

C. Debt in a Trust and the Use of *Crummey* Powers. When a trust with *Crummey* powers is a borrower, so long as the underlying debt is a bona fide debt and not a disguised gift, gratuitous relief of indebtedness, forgiveness of interest due, or acceptance of below market interest by the lender should be a gift of a present interest to the trust beneficiaries so long as there are other assets to distribute if a beneficiary, and if such distributable assets would constitute a present interest should the beneficiary exercise his or her withdrawal right and receive those assets. If, however, there are no assets available to distribute to the trust beneficiaries that would constitute a present interest, then debt forgiveness to the trust will likely be a gift of a future interest regardless of the existence of *Crummey* powers.

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[152] I.R.C. § 7872(f)(5).

[153] I.R.C. § 7872(e)(1).

[154] Where the aggregate amount of all below market loans that are outstanding between two taxpayers is less than $250,000, for amounts that are not outstanding for the entire calendar year, taxpayers can elect to use the "approximate method" for imputing interest as opposed to the "exact method." Prop. Treas. Reg. § 1.7872-13(b)(1)-(2). The exact method uses daily compounding to determine imputed interest and is more complex to compute. The approximate method uses daily pro ration and, while easier to compute, may result in a higher overall rate of imputed interest.

[155] Prop. Treas. Reg. § 1.7872-6(b)(3). If, however, the borrower is an entity rather than a natural person, imputed interest is deemed received on December 31.

[156] Prop. Treas. Reg. § 1.7872-11(a).

IX. The Gift, Estate, GST and Income Tax Implications of Holding Crummey Powers

Crummey powers are rather ubiquitous and are included in most intervivos irrevocable trusts as though they were mere boilerplate. However, the existence of *Crummey* powers in a trust document has important, and sometimes very complex tax implications for the trust and the beneficiary holding the withdrawal power. These consequences seem to be frequently overlooked by attorneys drafting *Crummey* trusts, accountants filing related income, gift and estate tax returns, and insurance and financial advisors who tell their clients they just need a "simple" *Crummey* trust for purposes of holding life insurance policies or making gifts for the benefit of their spouse, children, grandchildren or other beneficiaries. An understanding of these implications is essential for the proper drafting and implementation of *Crummey* provisions in trust documents.

A. A *Crummey* Power is a *General* Power of Appointment. A *Crummey* power is a power held by a trust beneficiary to withdraw trust assets that is not limited by an ascertainable standard related to the beneficiary's health, maintenance, support or education. As a result, a *Crummey* is a general power of appointment within the meaning of Section 2041 of the Code. Under general principles, while such a general power is outstanding, the property subject to the power is includible in the beneficiary's estate for estate tax purposes.[157] Further, the release of such a power by the beneficiary is potentially a gift back to the trust which can consume a portion of the beneficiary's gift tax applicable exclusion (or, in extreme cases, give rise to a gift tax).[158] Even if (as discussed in more detail below) the trust agreement has provisions, such as a power of appointment held by the beneficiary, that cause the lapse of the withdrawal power to be an "incomplete gift," such a gift can become "complete" not only if the beneficiary dies before the trust assets are distributed to him or her, but if trust property previously subject to one beneficiary's withdrawal right is later distributed to a different beneficiary. Further, if a beneficiary dies while holding a power of appointment over a trust that was funded with gifts subject to that beneficiary's lapsed withdrawal rights, upon the beneficiary's death, all or a portion of the trust assets (possibly far exceeding the value of the lapsed withdrawal amounts if the trust assets have appreciated), could be taxable in the beneficiary's estate. There are also generation skipping transfer (GST) tax implications to the beneficiary when he or she becomes the deemed transferor of property to the trust for estate or gift tax purposes as a result of a *Crummey* power. Finally, as a deemed donor to the trust, a beneficiary with a lapsed or unlapsed *Crummey* power could be treated as the owner of all or a portion of the trust for income tax purposes under Sections 671-678 of the Code (the "grantor trust" rules). All of these

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157 I.R.C. § 2041

158 I.R.C. § 2514(b).

consequences need to be considered in drafting the *Crummey* provisions of a trust and are addressed briefly below.

B. The Gift Tax Consequences of *Crummey* Powers on the Power Holder

(1) Generally. Since a *Crummey* power is a general power of appointment, the release or lapse of a Crummey power will be a gift to the trust by the releasor.[159] The gift by the releasor is a gift of a future interest to the other trust beneficiaries and, therefore, the gift tax annual exclusion will not apply. Absent an exception to this gift tax treatment, the releasor will be required to file a gift tax return to report the release, thereby consuming a portion of the releasor's gift tax applicable exclusion or even resulting in the payment of gift tax if the releasor has fully utilized his or her applicable exclusion.

(2) Limiting Withdrawals to the "*Five or Five*" Amount. Under Section 2514(e) of the Code, the release of a general power of appointment that does not exceed the greater of $5,000 or 5% of the aggregate value (at the time of lapse) of the trust assets subject to the power (the "*five or five*" amount) is disregarded for gift tax purposes. Therefore, if a beneficiary's *Crummey* withdrawal right is limited to the *five or five* amount, the lapse of the power will not result in gift tax consequences to the beneficiary.

Five or five powers are restrictive in that the $5,000 limit cannot be replicated among multiple trusts. On the other hand, the 5% limitation is determined on the basis of the aggregate value of all trusts to which the limit applies.[160]

For example, if a beneficiary has the power to withdraw $26,000 from the corpus of one trust arising from gifts made to the trust by two donors, and the power lapses on June 1, 2012 when the trust corpus is worth $300,000, and if the same beneficiary has a second noncumulative power to withdraw $26,000 from the corpus of the same trust arising from gifts made to the trust by two different donors, and such power lapses on December 1, 2012 when the value of the trust corpus has appreciated to $400,000, then the maximum amount of trust assets subject to the beneficiary's withdrawal power at the time of any lapse during the calendar year would be $400,000, and the beneficiary's *five or five* amount for the year would be $20,000 (5% x $400,000). The remaining $32,000 subject to the beneficiary's withdrawal power in that calendar year would be a gift to the trust by the beneficiary.[161]

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[159] I.R.C. § 2514(b).
[160] Rev. Rul. 85-88, 1985-2 CB 201
[161] *Id.*

On the other hand, if the beneficiary has the power to withdraw $26,000 from the corpus of one trust, and the power lapses on June 1, 2012 when the trust corpus is worth $300,000, and if the same beneficiary has a second power to withdraw $26,000 from the corpus of a *different* trust, and such power lapses on December 1, 2012 when the value of the trust corpus is $400,000, then the maximum amount of trust assets subject to the beneficiary's withdrawal power for the year would be $35,000 (5% X $700,000). The remaining $17,000 subject to the beneficiary's withdrawal powers in that calendar year would be a gift to the trusts by the beneficiary.[162]

Despite the limitations of a *five or five* power, restricting *Crummey* withdrawal powers to the *five or five* amount should always be considered, particularly if the value of the trust assets is likely to be sufficient to allow full use, or nearly full use, of the gift tax annual exclusion amount for all donors. For example, if a married couple is funding a trust for the collective benefit of children and grandchildren, so long as the value of the trust assets is at least $520,000, the full annual exclusion amount for both spouses can be used for each of the trust beneficiaries even though the *Crummey* powers are limited to the *five or five* amount.

> ***Comment:*** *It is important to be cautious about coordinating the lapse of a Crummey power when reliance is placed upon the five or five exception to avoid adverse gift tax consequences. Specifically, the five or five power is determined on the basis of a calendar year, and therefore should lapse in the year that gift it made to the trust. (See the discussion at Section VI of this Outline, above.) This may conflict with the desire to provide a Crummey holder a "reasonable opportunity" (generally 30-60 days) to withdraw contributions to the trust. For gifts made late in the calendar year, it might be appropriate to postpone the lapse, including the determination of the five or five amount, to the next calendar year, even though that could limit the availability of the five or five amount to shelter the next year's contributions.*

(3) Postponing the Lapse of *Crummey* Power in Excess of the "*Five or Five*" Amount ("*Hanging Powers*"). Limiting *Crummey* powers to the *five or five* amount may not be practical if the full annual exclusion amount is required to accomplish the donor's objectives (such as to fund premiums on a life insurance policy) and the value of the trust is not sufficient for the 5% limitation to support full use of the gift tax annual exclusion. In that case, adverse gift tax consequences to the beneficiary might be deferred or even avoided entirely by providing under the trust instrument that (a) the withdrawal right will only lapse in any calendar year up to the *five or five* amount, and (b) the balance will remain subject to the beneficiary's

[162] *Id. See, also*, GCM 3937 and PLR 903005.

right of withdrawal until, if ever, the assets of the trust have appreciated sufficiently to allow the unexercised power to lapse under the *five or five* rule (a "*hanging power*"). Such a hanging power is particularly useful if it is expected that the assets of the trust will spring in value in the future. For example, if a trust holds a life insurance policy, upon the payment of the policy proceeds to the trust when the insured dies, the value of the trust assets should be sufficient to "lapse out" the hanging powers.[163]

There are several potential disadvantages of hanging powers, including estate and GST tax consequences, which are discussed in this Section of the Outline below. There is also the practical disadvantage associated with the fact that a hanging power can be exercised at any time by the trust beneficiary. This needs to be explained to the settlor of the trust. To limit the risks to the trust in this regard, once the normal period for the lapse of the Crummey power has expired (such as 30 or 60 days), it should be permissible for the trust instrument to provide that the hanging power may only be exercised with the consent of a non-adverse party.[164] Note that even if the consent of a non-adverse party is required to exercise a hanging power, the assets subject to that power could remain subject to creditors' claims. (See the discussion on *Crummey* powers and asset protection at Section X of this Outline, below.)

(4) Creating an Incomplete Gift

(a) Inclusion of Trust Property in *Crummey* Holder's Estate. If a beneficiary holding a *Crummey* power is the sole beneficiary of the trust and if the trust property will be payable to his or her estate if he or she dies before receiving full distribution of the trust assets, the lapse of the beneficiary's *Crummey* power will be an incomplete gift.[165] Further, if a beneficiary holding a *Crummey* power also holds a general power of appointment over the trust, the lapse of the *Crummey* power will be an incomplete gift.[166]

(b) Special Power of Appointment. Another option to avoid adverse gift tax consequences for a beneficiary upon the lapse of his or her *Crummey* power would be to provide the beneficiary a testamentary special power of appointment over the portion of the trust funded with his or her lapsed withdrawal right (or the portion exceeding the *five or five*

[163] Importantly, if the beneficiaries holding hanging powers and the ultimate beneficiaries of a trust are not the same, then division and distribution of the trust should be delayed sufficiently for all hanging powers to lapse out (and/or the trust should prohibit distribution of any amounts subject to unlapsed withdrawal rights). Otherwise, the non-beneficiary power holders will make a gift of their unlapsed withdrawal powers to the ultimate beneficiaries.

[164] Rev. Rul. 82-156, 1982-2 C.B. 216; I.R.C. Section 2041(b)(1)(c). *See, also*, Zeydel, *How to Create and Administer a Successful Irrevocable Life Insurance Trust*, 34 Estate Planning 3, 12-13 (June 2007).

[165] PLR 8142061.

[166] PLRs 8517052, 8545076 and 8142061.

power).[167] Because the beneficiary maintains "dominion and control" over the disposition of the assets he or she has "gifted" to the trust as the consequence of the lapse, the gift is incomplete. If the trust property is ultimately distributed to the beneficiary during his or her lifetime, the gift will never be complete.

Unfortunately, sheltering lapsed *Crummey* powers from becoming immediately taxable gifts through the use of powers of appointment is inherently complex when there are multiple trust beneficiaries with withdrawal rights over a single trust fund. Rather, this approach to the issue is best suited for trusts administered as entirely separate shares for the trust beneficiaries. Such an approach would potentially limit the ability to add beneficiaries to the trust in the future (such as future born or adopted children) and would also limit the grantor's ability to use the annual exclusion for some beneficiaries and not for others. For example, the donor may have used annual exclusion for one of the beneficiaries outside of the trust. This would be difficult to adjust for in a separate share structure, particularly if the beneficiaries are collectively and proportionately invested (such as in a life insurance policy). In that case, the trustee risks a breach of the trustee's fiduciary duties if the trustee uses funds gifted to one beneficiary's trust to invest in an asset (such as a life insurance policy) that creates value for a different beneficiary's trust.

C. The Estate Tax Consequences of *Crummey* Powers on the Power Holder. Because a *Crummey* power is a general power of appointment, if a beneficiary dies holding an unlapsed *Crummey* power, including a hanging power, then the amount of the unlapsed power is includable in his or her taxable estate.[168] If, however, all of a beneficiary's *Crummey* powers lapsed prior to his or her death, and if the lapse of the *Crummey* power in any given year never exceeded the *five or five* amount, no portion of the trust assets will be includible in the beneficiary's estate solely by virtue of the lapsed withdrawal power.[169]

Where the gift tax consequences of a lapsed Crummey power are deferred by virtue of a testamentary power of appointment, however, whether general or special, the estate tax consequences are more complicated. Under such circumstances, estate tax inclusion results either under Section 2036(a) of the Code if the beneficiary retained an economic interest in the trust property funded with his or her lapsed withdrawal right, and/or under Section 2038 of the Code due to the beneficiary's retention of control over the use and enjoyment of the trust property until his or her death. Under these provisions, the fraction of the value of the trust property funded by the lapsed withdrawal right in excess of the *five or five* amount, determined as of the date of the beneficiary's death (that is, factoring in appreciation and depreciation in

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[167] Treas. Reg. § 25.2511-2(b). *See, also,* PLR 8229097.
[168] I.R.C. § 2041(a)(2).
[169] I.R.C. § 2041(b)(2).

trust property), will be includible in the beneficiary's estate for estate tax purposes, not just the value of the lapsed withdrawal amounts.[170] This can be a particularly troublesome calculation, if, for example, a trust holds a life insurance policy, the proceeds of which were received before the beneficiary died, or if the trust invested the gifted property in assets that substantially appreciated in value before the beneficiary died.[171]

D. The GST Tax Implications to the Beneficiary Holding a *Crummey* Power[172]

(1) Identity of the Transferor. Because (a) the GST tax is imposed on certain transfers to skip persons, and (b) the definitions of "skip persons"[173] and "non-skip persons"[174] are defined by reference to the transferor, the identification of a transferor for every transfer is necessary to ascertain the GST tax implications of that transfer. The identity of the transferor is also critical in determining who can or should apply GST tax exemption to a particular transfer.[175]

A "transferor" for GST tax purposes includes any individual who transfers property in a manner that is subject to estate or gift tax.[176] If multiple individuals have been subject to estate or gift tax on the transfer of a particular property, the individual with respect to whom the transferred property was most recently subject to estate or gift taxation is the transferor.[177] Thus**,** an intervening event that subjects an individual other than the original transferor to taxation under any other principles of estate or gift taxation will change the identity of the transferor for GST tax purposes.

(2) *Crummey* Withdrawal Power Can Change the Transferor. A *Crummey* power may be considered an intervening event that changes the identity of the transferor for GST tax purposes. The effect of a *Crummey* withdrawal power on the identity of a transferor depends on the extent of the withdrawal power.

(a) "*Five or Five*" Power. To the extent that a beneficiary holds a "*five or five"* power (see the discussion regarding the gift tax consequences of *Crummey* powers,

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[170] Treas. Reg. § 20.2041(d)(4); *see, also,* PLR 200022035.

[171] For a more detailed discussion this issue*, see* Whitty, *Crummey Trust Computations*, 9 Probate & Property 35 (Jan/Feb 1995).

[172] ***The Author wishes to recognize the contribution of time and talent by her associate, Brian P. Tsu, who was instrumental in the development of this Section of the Outline addressing the generation skipping transfer tax considerations in granting Crummey powers.***

[173] I.R.C. § 2613(a).

[174] I.R.C. § 2613(b).

[175] I.R.C. §§ 2631(a) and 2632(a).

[176] I.R.C. § 2652(a)(1).

[177] Treas. Reg. § 26.2651-1(a)(1).

above), a lapse of that power will not change the transferor as the lapse of a *five or five* power does not result in a transfer for gift tax purposes.[178] However, if the beneficiary dies before the power lapses, the property subject to the power will be included in the beneficiary's gross estate and subject to estate tax.[179] This would make the beneficiary the transferor of such property at the beneficiary's death for GST tax purposes. This possibility may be mitigated by limiting the withdrawal power to 30 days.

(b) <u>Hanging Power in Excess of *Five or Five* Power</u>. A beneficiary holding a withdrawal power in excess of *a five or five* power will be treated as the transferor of the amount in excess of the five or five amount to the extent the power lapses and the lapse is a completed transfer.[180] If, however, there is no lapse of the power because the power "hangs," the beneficiary would not be subject to gift taxation and the grantor would remain the sole transferor for GST tax purposes. If the beneficiary dies while a withdrawal power in excess of the *five or five* amount is still hanging, the property subject to the power will be included in the beneficiary's gross estate and subject to estate tax. The beneficiary would then become the transferor of the amount in excess of the *five or five* amount for GST tax purposes. To maintain GST tax exempt status for the trust, if that is desired, the beneficiary's GST tax exemption must be applied to the formerly hanging power. Because the grantor will remain the transferor for GST tax purposes of the previously lapsed *five or five* amount (as well as any other portion of the trust that was not subject to a withdrawal right), the trust will have two transferors for GST tax purposes. Each portion will be treated as a separate trust for GST tax purposes.[181]

(c) <u>Lapsing Power in Excess of *Five or Five* Power</u>. Alternatively, if a power to withdraw an amount in excess of the *five or five* amount lapses and the lapse is a completed transfer, the beneficiary will become the transferor of this amount for GST tax purposes. To maintain GST tax exempt status for the trust, if that is desired, the beneficiary's GST tax exemption must be applied to the amount of the lapsed withdrawal power in excess of the *five or five* amount.[182] Each portion will be treated as a separate trust for GST tax purposes.[183] Similarly, if the beneficiary dies while holding a withdrawal power in excess of a *five or five* power, the subject property, including the *five or five* amount if it has not yet lapsed,

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[178] Treas. Reg. § 26.2652-1(a)(5), Ex. 5 and I.R.C. 2514(e).
[179] I.R.C. § 2041(a).
[180] Treas. Reg. § 26.2652-1(a)(5), Ex. 5. The lapse of a power over an amount in excess of the 5 or 5 amount may not be a completed transfer for federal gift tax purposes. For example, if a beneficiary holds a power of appointment over the lapsed amount in excess of the 5 or 5 power, the gift of the lapsed amount would be an incomplete transfer.
[181] I.R.C. § 2654(b)(1) and Treas. Reg. § 26.2654-1(a)(2)(i).
[182] *Id*.
[183] I.R.C. § 2654(b)(1) and Treas. Reg. § 26.2654-1(a)(2)(i).

will be included in the beneficiary's gross estate for estate tax purposes.[184] In each case, because the grantor will remain the transferor for GST tax purposes of the previously lapsed 5 or 5 amounts (as well as any other portion of the trust that was not subject to a withdrawal right), the trust will have two transferors for GST tax purposes.

(3) Gift-Splitting. If the donor's spouse makes an election under Section 2513 to treat the gift as made one-half by the spouse,[185] the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor and the donor is treated as the transferor of one-half of the value of the entire property for GST tax purposes.[186]

(4) Estate Tax Inclusion Period. An important part of GST tax planning relates to the allocation of GST tax exemption to transfers that are subject to, or will be subject to, GST tax. Even where the transferor is properly ascertained, the GST tax exemption cannot be allocated until the close of the estate tax inclusion period ("ETIP") with respect to that transferor.[187] The ETIP is the period during which the value of the transferred property would be includible in the gross estate of the transferor *or the spouse* of the transferor.[188]

(a) Spousal *Crummey* Powers. Because the ETIP includes the period during which the value of transferred property would be includible in the gross estate of the spouse of the transferor, a *Crummey* power held by the spouse of a transferor could prevent the transferor from allocating GST tax exemption until the lapse of the power. However, an exception to the ETIP rule is available if the spouse of the transferor holds a withdrawal power no greater than the *five or five* amount and such withdrawal power terminates no later than 60 days after the transfer to the trust.[189] Because the withdrawal power must terminate within 60 days the spouse of the transferor cannot hold a hanging power without running afoul of the ETIP rule.

(b) Other *Crummey* Powers. To the extent that a beneficiary holds a *Crummey* power in excess of a *five or five* power, or permits a *Crummey* power in excess of a *five or five* power to lapse, that beneficiary will be the transferor of the amount in excess of the *five or five* amount for GST tax purposes. Accordingly, if the trust is a dynasty or multi-generational trust, both the original grantor (to the extent of the *five or five* amount) and the beneficiary (for the amount in excess of the *five or five* amount) must allocate GST tax

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184 I.R.C. § 2041(a).
185 Discussed above at Section V.C of this Outline above.
186 I.R.C. § 2652(a)(2) and Treas. Reg. § 26.2652-1(a)(4) & (5), Ex. 9.
187 I.R.C. § 2642(f).
188 Treas. Reg. § 26.2632-1(c)(2).
189 Treas. Reg. § 26.2632-1(c)(2)(ii)(B).

exemption to their respective transfers. However, as a power to withdraw in excess of a *five or five* power results in inclusion under Section 2041(a)(2), the beneficiary will be unable to allocate GST tax exemption until death because of the ETIP rule.

E. **The Income Tax Implications of Granting *Crummey* Powers**[190]

(1) Generally. The existence of a *Crummey* power may affect the income taxation of a trust. Specifically, a beneficiary holding a *Crummey* power may be treated as an owner of a portion of the trust under Section 678 of the Code.[191]

(2) Section 678. Section 678 provides that a person other than the grantor shall be treated as the owner, for purposes of the "grantor trust" rules, of any portion of trust with respect to which the (i) person has a power exercisable solely by that person to vest the corpus or income to themselves,[192] or (ii) such person has partially released or otherwise modified such power and after the release or modification retains such control that would result in that person being treated as an owner of the trust under Sections 671 through 677 of the Code.[193]

(a) Effect of a Withdrawal Power. A beneficiary's withdrawal power constitutes a power exercisable solely by that person to vest the corpus or income to themselves, as described in Section 678(a)(1) of the Code.[194] As a result, such beneficiary may be treated as an owner of the trust under Section 678.

(b) Effect of a Lapsed Power. Section 678(a)(2) makes clear that it will treat a beneficiary as an owner of the trust under the grantor trust rules if the beneficiary releases a power exercisable solely by that person to vest the corpus or income to themselves (i.e. a withdrawal power) to the extent the beneficiary would be an owner under Sections 671-677 of the Code. It is less clear whether a "lapse" constitutes a "release" for purposes of Section 678(a)(2). The IRS has treated a lapse of a withdrawal power as a release for such purposes in a number of rulings.[195] However, neither Section 678, nor its attendant Treasury Regulations, defines a "release" to include a lapse. Presumably the position of the IRS stems from the language of Sections 2041(b)(2) and 2514(b) of the Code, which expressly provide that the

[190] ***The Author wishes to recognize the contribution of time and talent by her associate, Brian P. Tsu, who was instrumental in the development of this Section of the Outline addressing the income tax considerations in granting Crummey powers.***

[191] Rev. Rul. 81-6, 1981-1 C.B. 385.

[192] I.R.C. § 678(a)(1).

[193] I.R.C. § 678(a)(2).

[194] Rev. Rul. 81-6, 1981-1 C.B. 385.

[195] PLRs 200022035, 8517052 and 8142061. In PLR 8839008, the IRS ruled a right over corpus can affect income, so that a right over either corpus or income falls within Section 678(b).

"lapse" of a general power of appointment shall be considered a release of that power for estate and gift tax purposes.

(c) **No De Minimis Exception.** Although Sections 2041, 2514 and 678 respectively address the estate, gift and income tax consequences of holding a general power of appointment over trust property, unlike Section 2041 and 2514, Section 678 does not carve out a de minimis exception. In other words, there is no analog to the "*five or five* amount" for purposes of Section 678.

(3) **Amount Owned Under Section 678.** If a beneficiary is treated as an owner of a trust under Section 678, the beneficiary will include in his or her taxable income and credits, a pro rata portion of all income, deductions, and credits of the trust. The portion allocated to the beneficiary's taxable income and credits is equal to a fraction, the numerator of which is the amount subject to withdrawal and the denominator of which is the fair market value of the trust property at the date the withdrawal becomes effective.[196] Further, as most withdrawal powers exist for a limited period (e.g. 30 days), the fraction allocating the income, deductions, and credits of the trust will be further reduced by the portion of the year during which the withdrawal power was not effective.[197]

(4) **Section 678 is Inapplicable to a Grantor Trust.** If the original grantor is the owner of the trust under the grantor trust rules, a beneficiary holding a *Crummey* power generally will not be subject to the grantor trust rules (i.e. Section 678). Section 678(b) provides that a person will not be treated as the owner under Section 678(a) in regard to a power over *income* if the original grantor is already treated as the owner of the trust under the grantor trust rules.

(a) **Scope of Section 678(b).** Although this rule appears to be of limited applicability at first glance, as a *Crummey* power is a withdrawal power over *corpus*, the Congressional Committee Report indicates that the exception applies to the grantor's power over both income and corpus.[198] The IRS has consistently ruled accordingly in various private letter rulings.[199] Several rulings do rely on Treas. Reg. § 1.671-2(b), which provides for purposes of the grantor trust rules,[200] the word "income" refers to taxable income and not trust or fiduciary accounting income. This Regulation further provides that for such purposes, it is immaterial

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[196] Treas. Reg. § 1.671-3(a)(3).
[197] PLR 8142061.
[198] H.R. Report No. 1337, 83rd Congress, 2nd Session 340 (1954).
[199] PLRs 200730011, 200603040 and 9309023.
[200] Contrast this with Treas. Reg. § 1.643(b)-1, which provides that "income" refers to trust or fiduciary accounting income unless modified with the words "taxable," "distributable net," "gross" or "undistributed net."

whether the income involved constitutes income or corpus for trust accounting purposes. If "income" as it is referred to in Section 678(b) means both items of income allocable to principal and those allocable to income, it would seem that the rulings are consistent with both the Congressional intent and regulatory authority.

(b) Duration of Section 678(b). Does the death of the original grantor open the door to Section 678? Neither Section 678 nor its attendant Treasury Regulations specify whether Section 678(b) continues to prevent a *Crummey* beneficiary or holder of a withdrawal power from becoming an owner of the trust after the death of the original grantor. Historically, the IRS has held that a *Crummey* beneficiary or holder of a withdrawal power would become an owner of the trust at the death of the grantor even if the grantor was originally treated as the owner of the trust under the grantor trust rules.[201] However, in PLR 9321050 the IRS concluded that the death of the original grantor of a grantor trust did not make a beneficiary holding a withdrawal power an owner of the trust even though the beneficiary held a withdrawal power after the death of the original grantor. Interestingly, in that private letter ruling the IRS specifically references an earlier private letter ruling, PLR 9026036 (as opposed to a general statement reversing its position), and expressly reverses its previous position with respect to this particular issue in that ruling. Presumably, a trust that ceases to be treated as a grantor trust with respect to the grantor (e.g. upon the grantor's death) will be treated as a separate taxpayer for income tax purposes and any *Crummey* beneficiaries or holders of a withdrawal power will not be treated as the owner of the income of the trust for federal income tax purposes.

X. Asset Protection Considerations in Granting *Crummey* Powers[202]

A. During the *Crummey* Withdrawal Period. Under traditional common law, assets subject to a power of withdrawal by a beneficiary are not subject to the claims of the beneficiary's creditors or his estate. [203] Additionally, the donee's creditors cannot compel the donee to exercise the power of withdrawal, nor can the creditors acquire the power. [204] However, under the UTC and *Restatement Third*, during the period of time that a power of withdrawal may be exercised, the assets subject to withdrawal are subject to the claims of the

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[201] PLRs 9034004 and 9026036.

[202] ***The Author wishes to recognize the contribution of time and talent by her associate, David P. Jones, II, who was instrumental in the development of this Section of the Outline addressing the asset protection considerations in granting Crummey powers.***

[203] *Restatement (Second) of Property: Donative Transfers*, Section 13.2, noting that some state statutes provide an exception to this rule.

[204] *Scott on Trusts*, at Section 147.3. *See, also, University Nat'l Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. 1991), *cert. denied*, 1992 Colo. LEXIS 269 (March 23, 1992) (debtor's unexercised right to withdraw up to $5,000 from a trust was not a property right that was subject to garnishment).

beneficiary's creditors, the same as the beneficiary's other assets. [205] If the beneficiary retains the withdrawal power until death, the property subject to the power may be liable for claims against the beneficiary's estate.[206] For withdrawal powers limited either in time or amount, such as a right to withdraw a $13,000 annual exclusion contribution within 30 days, the UTC limits the creditor to the $13,000 contribution and requires the creditor to take action before the expiration of the 30-day period.[207] Because there are no statutes corresponding to the UTC and *Restatement Third* under California law, it is unclear whether assets subject to a *Crummey* withdrawal right and hanging powers would be subject to the claims of a *Crummey* power holder's creditors.

B. <u>After the Withdrawal Period Ends</u>. Generally, if a trust instrument includes a spendthrift clause, a beneficiary's interest under the trust may not be restrained.[208] However, in cases where the settlor is a beneficiary of a trust he or she created, any spendthrift clause in the trust instrument is deemed to be invalid against the settlor's transferees or creditors.[209] Although no California court has ruled specifically on the issue, it appears there is no exemption of *Crummey* trusts from California's prohibition against self-settled spendthrift trusts set forth in California Probate Code §15304. Consequently, the creditors of a *Crummey* power holder could arguably reach any assets within a trust that were subject the *Crummey* withdrawal power even after it expires by a lapse, release, or waiver.

For states that follow the UTC, trust property that was previously subject to a beneficiary's withdrawal right that has lapsed, released or been waived are subject to the claims of the beneficiary's creditors only to the extent that the value of the property subject to the power when the stated time frame expires exceeds the greater of: (1) the "*five-or-five*" amount, and (2) the gift tax annual exclusion amount.[210] For example, assume a trust holds $25,000 and the beneficiary has the right to withdraw $15,000 of that amount for 30 days, after which time the withdrawal right lapses. The beneficiary does not exercise the withdrawal power, and the 30-day withdrawal period ends. The *five-or-five* amount is $5,000, since 5 percent of $25,000 is only $1,250. The gift tax annual exclusion amount is $13,000. Therefore the greater of: (1) the five-by-five amount, and (2) the gift tax annual exclusion amount is the gift tax exclusion amount

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205 *See* comment to UTC Section 505; and *Restatement Third*, Section 56, comment b.
206 *Ibid.*
207 *See* Comment to UTC Section 505. For an in-depth discussion on the impact of withdrawal rights under the UTC, see Jonathan Gopman and James Flick, "UTC Section 505(b)-Withdrawal Rights May Expose Trust Assets to Beneficiaries' Creditors," Steve Leimberg's *Asset Protection Planning Newsletter* #91 (Nov. 1, 2006), at www.leimbergservices.com.
208 Cal. Prob. Code §15300.
209 Cal. Prob. Code §15304.
210 UTC Section 505(b)(2). *See also Restatement Third*, Section 56, Reporter's Note to comment b (*citing* UTC Section 505(b)(2).)

($13,000). After the expiration of the 30-day withdrawal period, $2,000 of the trust property ($15,000 minus $13,000) will continue to be subject to the beneficiary's creditors.

C. Practical Considerations. In light of the foregoing concerns, the trust instrument should be drafted to allow the donor to exclude a beneficiary who has current creditor or spousal problems from withdrawing trust assets. Otherwise, the creditor or spouse may be able to obtain a court order compelling the beneficiary to exercise such powers and make the trust funds available for division in a divorce, bankruptcy, or other similar action. Unfortunately, this restriction may preclude the use of a *Crummey* withdrawal power to create a present interest in the trust assets and qualify gifts in trust for the gift tax annual exclusion. When the beneficiary's time frame for exercising a withdrawal power expires by a lapse, release, or waiver, the property formerly subject to the *Crummey* power may be subject to the beneficiary's creditors. It is reasonable to give a *Crummey* withdrawal power to a beneficiary who has no current problems, because such withdrawal powers exist only briefly as to any particular gift. The donor can cease making transfers to the trust if the beneficiary's financial or marital situation worsens to the point at which the creditor or divorcing spouse is seeking assets upon which to make a claim Furthermore, the donor may wish to retain an express power to terminate the operation of the withdrawal power as to future contributions.

XI. Alternatives to *Crummey* Trusts for Securing the Annual Exclusion

As noted in the previous sections of this Outline, *Crummey* powers, while widely used and accepted, have their distinct disadvantages, including potential gift, income and estate tax consequences to the power holder, the risk of subjecting trust assets to claims of the power holder's creditors, as well as the actual risk to the donor that the power holder (or the guardian acting for a minor power holder) will exercise his or her withdrawal rights. It is therefore important to be aware of other means pursuant to which gifts in trust may qualify, in whole or part, for the gift tax annual exclusion and other exclusions that do not involve the consumption of a donor's applicable exclusion or the filing of a gift tax return.

A. Beneficiary's Income Interest Can Qualify for the Annual Exclusion. It is possible to create a trust in which the beneficiary's income interest qualifies for the annual exclusion (without the need for a *Crummey* power) although the principal interest does not.[211] For gifts made after April 30, 1989, the value of such a qualifying income interest is determined under the valuation rules of Section 7520 of the Code. The valuation tables are contained in IRS Pubs. 1457 and 1458, which are revised every 10 years. Under these tables, if the income

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[211] Treas. Reg. § 25.2503-3(b); *Herr v. Comm'r*, 35 T.C. 732 (1961), *aff'd*, 303 F.2d 780 (3d Cir. 1962); *Pettus v. Comm'r,* 54 T.C. 112 (1970).

interest is for a substantial period of time (such as for the life of a younger income beneficiary), the value of the income interest in the gifted property could represent a substantial portion of the entire gift, and this portion of the gift will qualify for the annual exclusion even if the beneficiary's right to principal is limited or even non-existent.

(1) Elements of a Present Interest in Trust Income. In order for a gift of an income interest in a trust to qualify as a present interest, three elements must be satisfied. These elements are: (a) the trust will receive income; (b) some portion of that income will flow steadily to the beneficiary; and (c) the portion of the income flowing out to the beneficiary can be ascertained.[212] On this basis, if a gift of income-producing property is made to a trust that provides for the payment of all of the net income annually to the beneficiary for a term of years, and if principal can be paid to no person other than the income beneficiary during that term, the income interest will be a present interest for purposes of the gift tax annual exclusion.[213] If the foregoing requirements are met, the presence of a spendthrift clause will not cause an otherwise qualifying income interest to fail to qualify as a present interest.[214]

(2) Trustee with Discretion to Distribute Income. If income is payable to the beneficiary only in the event of a contingency, such as when the trustee deems necessary, the income interest will not be a present interest.[215] Similarly, if a trust agreement gives the trustee the discretion to allocate receipts to income or principal or to charge expenses to income or principal,[216] or if the trustee has the discretion to credit income with capital gains or charge income with capital losses,[217] the value of the income interest will be unascertainable and, therefore, it will not qualify as a present interest. Further, if a trustee has the discretion to allocate trust income among several beneficiaries, the value of the income interest as to any one of the beneficiaries is unascertainable and therefore fails to qualify as a present interest.[218] If the trust requires the payment of income to a beneficiary, but there is a clause in the trust permitting the trustee to withhold income distributions to a beneficiary who is suffering from a substance abuse or other negative or self- destructive behaviors, the income interest likely will not qualify as a present interest.

(3) Trustee with Discretion to Distribute Principal. If a beneficiary's income interest in a trust otherwise qualifies as a present interest, it will not fail to so qualify

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212 *Calder*, 85 T.C. at 727-28 (*citing Disston*, 325 U.S. at 449; *Blasdel*, 478 F.2d 226 (5th Cir. 1973)).
213 Treas. Reg. § 25.2503-4(c).
214 Rev. Rul. 54-344, 1954-2 C.B. 319.
215 *Fondren*, 324 U.S. 18 (1945); *Street v. Comm'r,* 29 T.C. 428 (1957), *aff'd*, 261 F.2d 666 (5th Cir. 1958); *see, also,* Treas. Reg. § 25.2503-3(c) Ex. 1.
216 *Van Den Wymelenberg v. U.S.,* 397 F.2d 443, 446 (7th Cir. 1968).
217 Rev. Rul. 77-358, 1977-2 C.B. 342.
218 Rev. Rul. 55-303, 1955-1 C.B. 471; *see, also,* Treas. Reg. § 25.2503-3(c) Ex. 3.

because the trustee has the power to distribute principal to that beneficiary, even though such a distribution will in effect, reduce the amount of income generated by the trust. If, however, during the term of a beneficiary's income interest, the trustee can distribute principal to *another* beneficiary, the value of the income interest will indeterminable to the extent of that power.[219] On the other hand, at least one court has held that where a trustee's discretion to invade principal for beneficiaries other than the income beneficiary is limited by an ascertainable standard, and if by applying that standard, the possibility of a principal invasion is so remote as to be negligible, the value of the income interest is not necessarily indeterminable.[220]

(4) Delay in Distribution of Income. As a general rule, any delay imposed by a trust instrument upon the distribution of trust income to the income beneficiary will cause the income interest to fail to qualify as a present interest.[221] However, the requirement that income be distributed at such times as the trustee deems practical, but in all events at least annually, will not cause the beneficiary's income interest to fail to qualify as a present interest because income is not paid by the trustee as received.[222] Delaying the distribution of trust income until all trust liabilities have been paid by the trustee will, however, cause the income interest to be treated as a future interest.[223]

(5) Trust Holding Unproductive Property. The Treasury Regulations under Section 7520 of the Code provide that the valuation of an income interest in a trust holding unproductive property may not be based upon standard valuation principles unless the trustee may be required to make the property productive.[224] On this basis, the IRS may challenge the characterization of a beneficiary's income interest in a trust as a present interest that is susceptible of valuation if the gift to the trust involves non-income producing property,[225] particularly if that property is not easily converted into productive property or if the trust agreement restricts either the trustee's ability to sell the gifted property or the beneficiary's right to require the trustee to make the trust property productive.

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219 Rev. Rul. 58-307, 1958-1 C.B. 206; *Schayek v. Comm'r,* 33 T.C. 629 (1960); *Brody v. Comm'r,* 19 T.C. 126 (1952); *Evans v. Comm'r,* 17 T.C. 206 (1951), *aff'd*, 198 F.2d 435 (3d Cir. 1952); *Riter v. Comm'r,* 3 T.C. 301 (1944).

220 *Jones v. Comm'r,* 29 T.C. 200, 211-12 (1957).

221 Rev. Rul. 75-415, 1975-2 C.B. 374 (income distributions delayed until the earlier of the beneficiary's college enrollment or three years after the trust's creation).

222 *Edwards v. Comm'r,* 46 B.T.A. 815 (1942), *aff'd*, 135 F.2d 574 (7th Cir. 1943).

223 Treas. Reg. § 25.2503-3(c) Ex. 5.

224 Treas. Reg. § 25.7520-3(b)(2)(v) Exs. 1-2.

225 *See Calder*, 85 T.C. at 728 (annual exclusion denied for income in a trust where artwork in trust unlikely to produce rental or other income susceptible of valuation); *see, also, Stark v. U.S.,* 345 F. Supp. 1263 (W.D. Mo. 1972), *aff'd*, 477 F.2d 131 (8th Cir. 1973), *cert. denied*, 414 U.S. 975 (annual exclusion denied where no reasonable possibility that income would be forthcoming from gift of stock in closely held corporation that had paid no dividends for more 15 years before gift).

B. 2503(c) Trusts. A gift to a trust that meets the requirements of Section 2503(c) of the Code will be a gift of a present interest for which the annual exclusion applies although such trust does not contain *Crummey* powers. Section 2503(c) provides as follows:

> "(c) Transfer for the Benefit of Minor. No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom
>
> (1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and
>
> (2) will to the extent not so expended
>
> (A) pass to the donee on his attaining the age of 21 years, and
>
> (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in Section 2514(c)."

(1) Requirement that Property and Income Be Expended for the Beneficiary. The first requirement of Section 2503(c) is that trust property and the income therefrom may be expended by the trustee, or applied by the trustee for the benefit of, the beneficiary before his attaining the age of 21 years. To satisfy this requirement, the trust instrument must not impose any substantial restriction upon the exercise of the trustee's discretion to make distributions to or for the benefit of the beneficiary while he or she is a minor.[226] Any limitation upon the trustee's distribution powers could result in the loss of the annual exclusion if that limitation is deemed to exceed that imposed upon a guardian under applicable state law.[227] Trust provisions that limit distributions to those necessary in the event of an accident, illness, infirmity, disability or other emergency affecting the trust beneficiary are substantial restrictions on the trustee's discretion to make distributions and will cause a gift to the trust to fail to qualify as a present interest under Section 2503(c).[228] Further, if the trustee

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[226] Treas. Reg. § 25.2503-4(b)(1).

[227] *U.S. v. Baker,* 236 F.2d 317 (4th Cir. 1956); *Ill. Nat'l Bank of Springfield v. U.S.,* 756 F. Supp. 1117 (C.D. Ill. 1991) (*citing Heidrich v. Comm'r,* 55 T.C. 746 (1971); *Williams v. U.S.,* 180 Ct. Cl. 417 (1967)); *see, also,* Rev. Rul. 59-78, 1959-1 C.B. 690 (*citing Baker*, 236 F.2d 317).

[228] *Ill. Nat'l Bank*, 756 F. Supp. 1117 (C.D. Ill. 1991); *Faber v. U.S.,* 439 F.2d 1189 (6th Cir. 1971); *Pettus*, 54 T.C. 112 (1970).

may only make distributions upon the demand of another person on the beneficiary's behalf, the trustee's discretion to make distributions is subject to a substantial restriction.[229]

Not all distribution standards will be deemed substantial restrictions upon the trustee's discretion to make distributions for purposes of 2503(c). A general standard that is reflective of need is not so restrictive as to cause a gift to the trust to be a gift of a future interest.[230] The Service has ruled that a trustee's discretionary power to use principal and income for the beneficiary's support, care, education, comfort and welfare is not a substantial restriction upon the trustee's discretionary powers and will not cause the trust to fail to qualify under Section 2503(c).[231] Similarly, a gift to a trust has qualified as a gift of a present interest under Section 2503(c) where the trust instrument directed the trustee to make distributions as may be necessary for the education, comfort and support of the beneficiary, and to accumulate any income not so needed under this standard,[232] and also where a trust instrument authorized the trustee to make distributions in such amounts and at such times as the trustee in his or her sole discretion deemed necessary for the proper care, support, maintenance and education of the beneficiary.[233] The fact that the trustee may not make such distributions in a manner that will serve to discharge the grantor's legal obligation to support the trust beneficiary will not be considered a substantial restriction, as such a statement merely duplicates the rights of the minor under state law.[234] On the other hand, limiting distributions based upon the beneficiary's other financial resource may create a future interest.[235]

(2) <u>Requirement that Property Pass to Donee at Age 21</u>. The second requirement of Section 2503(c) is that trust property and the income therefrom that is not distributed to, or applied for the benefit of, the beneficiary before he or she attains the age of 21 years must pass to the beneficiary upon attaining that age. To satisfy this requirement, the trust estate must either be distributed to the beneficiary, or distributable in the beneficiary's discretion, no later than when the beneficiary is age 21.

Initially, the IRS interpreted this requirement to prohibit any trust provision that would cause a trust to continue after the beneficiary's 21st birthday, even if the beneficiary possessed the power to withdraw the trust property or to elect to have it continue in

[229] *Wood v. Comm'r,* 16 T.C. 962 (1951).
[230] *Heidrich*, 55 T.C. 746 (1971).
[231] Rev. Rul. 67-270, 1967-2 C.B. 349.
[232] *Id.*
[233] *Craig v. Comm'r,* T.C. Memo 1971-254.
[234] *Ill. Nat'l Bank*, 756 F. Supp. at 1120; *Upjohn v. U.S.*, 72-2 USTC 12,888 (W.D. Mich. 1972).
[235] Rev. Rul. 69-345, 1969-1 C.B. 226.

trust for distribution at a later date.[236] This position was not followed by the Tax Court, however,[237] and the IRS subsequently adopted and broadened the Tax Court's position, ruling in Rev. Rul. 74-43[238] that a trust would qualify under Section 2503(c) so long as, upon reaching the age of 21, the beneficiary has the right to compel distribution from the trust, even if that right is limited to a specific period of time and must be exercised in writing, and, if not exercised, the trust property will remain in trust subject to the terms of the trust agreement.[239]

As with *Crummey* withdrawal powers, there should be a reasonable time frame during which the beneficiary can exercise his or her right to withdraw trust property from a 2503(c) trust. Although there is no clear indication of what would constitute a reasonable time frame, in private rulings the IRS has approved time periods of 30 and 60 days.[240]

(3) Requirement that Undistributed Property Be Paid to Donee's Estate or Be Subject to Donee's General Power of Appointment. The third and final requirement of Section 2503(c) is that, in the event of the beneficiary's death before attaining age 21, trust property and the income therefrom that has not been distributed to, or applied for the benefit of, the beneficiary must be payable to the estate of the beneficiary or as he may appoint under a general power of appointment as defined in section 2514(c) of the Code. A beneficiary's general power of appointment will be effective for this purpose even if, under local law, the donee lacks testamentary capacity or the capacity to exercise a power of appointment.[241] Care must be taken, however, to be certain that the trust instrument does not define capacity in a manner that exceeds state law definitions. For example, a trust which limited a minor's ability to exercise her power of appointment before the age of 19, the normal age of testamentary capacity under applicable state law (Texas), nevertheless failed to qualify under Section 2503(c) because applicable state law granted testamentary capacity to a married beneficiary who is at least 18 years of age.[242] Similarly, the requirement that trust property be paid to a beneficiary's estate is strictly construed. For example, where a trust agreement provided for the distribution of trust property at the beneficiary's death to his heirs at law, the trust failed to qualify under Section 2503(c).[243]

Although the language of Section 2503(c) is unclear on this issue, the Service has interpreted the requirement for disposition at death to be read in the alternative; that

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236 *See* Rev. Rul. 60-218, 1960-1 C.B. 378. This ruling was subsequently revoked by Rev. Rul. 74-43, 1974-1 C.B. 285.
237 *Heidrich*, 55 T.C. 746 (1971).
238 Rev. Rul. 74-43, 1974-1 C.B. 285.
239 *Se, also*,Treas. Reg. § 25.2503-4(b)(2).
240 PLRs 8521089, 7824035, 7805037.
241 Treas. Reg. § 25.2503-4(b).
242 *Gall v. U.S.*, 521 F.2d 878 (5th Cir. 1975), *cert. denied*, 425 U.S. 972 (1976).
243 *Ross v. Comm'r*, 652 F.2d 1365 (9th Cir. 1981), *aff'g* 71 T.C. 897 (1979).

is, the beneficiary must either have a general power of appointment or the trust property must be payable to the beneficiary's estate, the goal being to ensure estate tax inclusion for property that received the benefit of the gift tax annual exclusion. For example, the IRS has allowed a gift to a trust to qualify for the annual exclusion under Section 2503(c) where the beneficiary held a special power of appointment rather than a general power of appointment, but in the absence of a valid exercise of that power, the trust property would be payable to the beneficiary's estate.[244] Similarly, if a beneficiary holds a general power of appointment over the trust, the trust agreement may provide for the disposition of the remainder to alternate beneficiaries in the event that the beneficiary does not validly exercise his general power of appointment.[245]

(4) <u>A Trust Can Qualify Under 2503(c) as to Income Only</u>. Consistent with the general principles discussed earlier in this Outline, a gift in trust can qualify for the annual exclusion under Section 2503(c) as to a portion or all of the beneficiary's income interest even if it does not so qualify as to the beneficiary's interest in trust corpus.[246] In order for a beneficiary's income interest in a trust to qualify as a present interest under Section 2503(c), the requirements of Section 2503(c) must be met as to trust income; that is, (a) all of the income generated by the trust property may be expended by the trustee, or applied by the trustee for the benefit of, the beneficiary before he or she attains the age of 21 years; (b) any accumulated trust income must pass to the beneficiary upon attaining the age of 21; and (c) in the event of the beneficiary's death before he or she attains the age of 21 years, any accumulated trust income must be payable to the estate of the beneficiary or as he may appoint under a general power of appointment as defined in section 2514(c) of the Code. If these requirements are met as to income but not as to principal (as, for example, where trust principal is not fully distributable at age 21), the beneficiary's income interest will be a present interest that qualifies for the gift tax annual exclusion, but the gift of trust principal will be a gift of a future interest that does not so qualify.[247]

C. <u>Gifts Under the UTMA and the UGMA</u>. Uniform laws have been adopted in every state and the District of Columbia to facilitate gifts to minors without the use of trusts. These laws are generally either a complete adoption, or an adaptation, of the Uniform Transfers to Minors Act ("UTMA"), or its ancestors, the Uniform Gifts to Minors Act ("UGMA") and the Model Gifts of Securities to Minors Act ("MGSMA"). Gifts that are made to a custodian for the benefit of a minor (which is considered to be a person under age 21 for purposes of the UTMA

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[244] TAM. 8320007 (*citing Ross*, 652 F.2d 1365 (9th Cir. 1981)).

[245] Treas. Reg. § 25.2503-4(b)(3).

[246] *Comm'r v. Herr,* 303 F.2d 780 (3d Cir. 1962), *aff'g* 35 T.C. 732 (1961); *Pettus*, 54 T.C. 112 (1970); *Quatman v. Comm'r,* 54 T.C. 339 (1970); *see, also,* Rev. Rul. 68-670, 1968-2 C.B. 413.

[247] *Herr*, 303 F.2d 780 (3d Cir. 1962); *Weller v. Comm'r,* 38 T.C. 790 (1962); *Konner v. Comm'r,* 35 T.C. 727 (1961).

and under 18 for the purposes of the UGMA and the MGSMA) under any of these Acts generally qualify as gifts of present interests.[248]

The advantage of such custodial arrangements as compared to 2503(c) trusts or other trust structures is simplicity, cost effectiveness, and the ability to act quickly when time is of the essence to complete a transfer (such as a deathbed transfer, discussed later in this Outline, or a last minute annual exclusion gift made at year end). There are several disadvantages of gifts under the UTMA or UGMA, however.

First, because the custodian's power to make distributions to the minor or for the minor's benefit is not limited to a reasonably definite standard for purposes of Section 2038 of the Code, if the donor serves as custodian and dies while in that capacity, the assets in the account will be includible in the donor's estate.[249] On the other hand, the IRS has ruled that where a donor makes a gift to a UTMA or UGMA account with his or her separate property, his or her spouse can serve as custodian without risk of estate tax inclusion, even if the spouse makes a gift splitting election under Section 2513 of the Code.[250]

Naming the parent of the beneficiary (such a donor's child as custodian of the donor's grandchild) can also be problematic. Under the UTMA and the UGMA, the custodian can make distributions that would serve to discharge the parent's support obligation to the beneficiary. As a result, it is the position of the Service that a parent acting as custodian for his or her minor child holds a general power of appointment over the account.[251]

A significant non-tax disadvantage of custodial arrangements, however, is that the assets in the account are distributable to the beneficiary at age 18 (or, under the UTMA only, as late as age 21 if so specified in the original instrument of transfer). When annual exclusion gifts are made to a custodial account on a regular and continuous basis, particularly if they start when the beneficiary is an infant, the combination of $13,000 (or more) annual gifts and good investing can result in the accumulation of several hundred thousand dollars in a minor's account by the time he or she is age 18 or 21. As discussed above, when such gifts are made to a 2503(c) trust, the trust agreement can require the beneficiary to take some affirmative action to withdraw the trust assets within a relatively short period of time after reaching the age of 21 (commonly within 30-60 days), after which time those assets will be irrevocably transferred to a trust that will continue until the beneficiary is substantially older and more financially mature. A beneficiary of a UTMA or UGMA account, however, has the absolute right to withdraw the

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[248] Rev. Rul. 59-357, 1959-2 C.B. 212.
[249] *Id.*; *Est. of Prudowsky v. Comm'r,* 55 T.C. 890 (1971), *aff'd*, 465 F.2d 62 (7th Cir. 1972).
[250] Rev. Rul. 74-556, 1974-2 C.B. 300.
[251] GCMs 37299 and 37590; *see, also,* Rev. Rul. 57-366, 1957-2 C.B. 618.

assets from the account at anytime after the age specified for termination (age 18 or 21). Further, if the beneficiary is disabled when the account terminates, a guardianship or custodianship may be required in order to access the funds for the beneficiary's benefit.

To replicate the benefits of a 2503(c) trust, in advance of the beneficiary's reaching the age of majority, donors and their attorneys will often prepare an irrevocable trust to which the beneficiary will be asked by the donor to transfer the assets in the custodial account. However, unlike the 2503(c) trust, where an affirmative act is required by the beneficiary within a relatively short time frame to withdraw the trust assets, the beneficiary of a custodial account must take an affirmative action for the assets to be placed in a trust. Where there are several hundred thousand dollars accumulated in a custodial account, the minor may not be a willing participant in this plan and, unlike a 2503(c) trust, he or she will have an unlimited time to consider the alternatives. In addition, whereas the donor/client is the settlor of a 2503(c) trust, and the attorney who prepared the trust is rarely consulted by the beneficiary upon reaching the age of majority, the beneficiary of the custodial account will be the settlor of the continuation trust. Typically, the donor's lawyer is asked by the donor to draft the trust that will receive the custodial assets. A lawyer in this situation needs to exercise great care to address the inherent conflict of interest between the donor on the one hand and the beneficiary on the other. It should come as no surprise that beneficiaries who are advised by the donor's attorney to place custodial assets in an irrevocable trust could later question the wisdom of having voluntarily taken hundreds of thousands of dollars out of his or her control. This could result in unfortunate backlash to the drafting attorney, particularly if the term of the continuation trust is very long or there is a loss to the trust fund due to mismanagement or self-dealing by the trustees. The donor's lawyer might therefore be well advised to instruct the minor to seek his or her own legal counsel to explain the benefits and burdens of an irrevocable transfer of assets to the proposed trust before committing to such a transfer.

D. Incomplete Gift Trust

(1) Basic Concept. Depending upon a donor's goal in establishing a trust, an alternative to creating a *Crummey* trust and sending annual withdrawal notices to trust beneficiaries is to establish a trust to which transfers are incomplete gifts for federal gift tax purposes. Assets transferred to such a trust would not be considered gifts for gift tax purposes until distributions are made to the trust beneficiaries.

The clear disadvantage of such a vehicle is that the trust assets will not be removed from the settlor's estate for estate tax purposes. Nevertheless, this trust structure would be appropriate in circumstances where the settlor wishes to have an intermediary (the Trustee) between the settler and adult children or other family members who have become dependent

upon the settler for maintaining their standard of living, for funding their educations, for health care, or for other reasons. The trust agreement can establish the parameters by which the Trustee will make such distributions and the settlor can focus on his or her non-monetary relationship with the trust beneficiaries.

(2) **When is a Gift in Trust "Incomplete?"** A gift in trust is "incomplete" unless and until the donor has so parted with dominion and control of the trust property as to leave the donor no power to change its disposition, whether for the donor's own benefit or for the benefit of another person.[252] In general, a gift in trust is incomplete if the donor has either of the following powers:

(a) **Power of Revocation.** A gift in trust is incomplete if the donor retains the power to revoke the trust and revest beneficial title to the trust property in the donor[253] whether such power is retained by the donor under the trust agreement or is implied under state law.[254]

(b) **Power of Amendment.** A gift in trust is also incomplete if the donor retains the power to amend the trust to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.[255] For example, when a settlor retained a testamentary power to appoint the remaining balance of the trust at his death to any person other than himself, his estate, his creditors, or the creditors of his estate, the IRS ruled privately that the donor's gifts to the trust were incomplete.[256]

(c) ***Testamentary Power of Appointment by Grantor Does NOT Create an Incomplete Gift of Term Interest.*** In CCA 201208026, the IRS concluded that the retention by a grantor of a trust of a testamentary power of appointment was not enough to cause the gift of the term interest in the trust to be incomplete. Rather, the testamentary power of appointment was sufficiently only to render incomplete the gift of the *remainder interest* in the trust. To add insult to injury, however, the IRS further determined that the value of the remainder interest is ignored under IRC §2702, meaning that the full value of the property transferred to the trust was the value of the gift without any reduction of the value of the remainder.

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[252] Treas. Reg. § 25.2511-2(a)

[253] Treas. Reg. § 25.2511-2(c); *Burnet v. Guggenheim*, 288 U.S. 280 (1933); *Comr. v. Allen*, 108 F.2d 961 (3d Cir. 1939), *cert. denied*, 309 U.S. 680 (1940).

[254] *See, e.g.*, Cal. Prob. Code §15400, which provide that, "Unless a trust is expressly made irrevocable by the trust instrument, the trust is revocable by the settlor."

[255] Treas. Reg. § 25.2511-2(e)

[256] PLR 200502014. *See, also,* PLRs 200715005 and 200731019.

(3) When Does an Incomplete Gift Become Complete? A gift to an "incomplete gift trust" becomes "complete" when the donor has so parted with dominion and control over the trust property as to leave the donor no power to change its disposition.[257] This can occur because the donor has effectively released the power to revoke or amend a trust. It will also occur when a donor dies. However, because the gift tax imposed by §2501 applies only to transfers by living donors, the death of a settlor holding a power or revocation over a trust or the power to change the interests of the trust beneficiaries will not give rise to gift tax.[258] Rather, the trust property subject to the settlor's power of revocation, amendment or appointment, whether or not exercised prior to the settlor's death, will be included in the settlor's federal taxable estate under Section 2038 of the Code.

A gift to an incomplete gift trust also becomes complete for federal gift tax purposes if and to the extent the Trustee of the trust actually distributes the trust property to or for the benefit of someone other than the settlor.[259] Importantly, so long as such distributions are limited to (a) distributions that discharge a legal obligation of the settlor; (b) distributions that do not exceed the gift tax annual exclusion amount (taking into consideration gifts made to the beneficiary by the donor outside of the trust in the year of the distribution); (c) outright distributions to the settlor's U.S. citizen spouse or charity; or (d) payments for qualified tuition and medical expenses within the meaning of Section 2503(e) of the Code, no portion of the Settlor's lifetime applicable exclusion or GST tax exemption will be utilized, nor is any gift tax reporting required, absent other gifts made outside of the trust that give rise to such a reporting requirement. Importantly, trust distributions made within the scope of Section 2503(e) of the Code to skip-persons are also excluded from the imposition of GST tax under Section 2611(b)(1) of the Code.

The balance of this Section of the Outline focuses on the scope of distributions that can be made from an incomplete gift trust for tuition and medical expenses within the meaning of Section 2503(e) of the Code.

(4) Distributions for Tuition and Medical Expenses

(a) General Rule. I.R.C. § 2503(e) provides an exclusion from gift taxation for amounts paid on behalf of any individual to an educational organization for tuition

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[257] Treas. Reg. § 25.2511-2(a)
[258] Treas. Reg § 25.2511-2(f) (gift tax imposed by §2501 applies only to transfers by living donors).
[259] Treas. Reg. § 25.2511-2(f); *Goldstein v. Comr.*, 37 T.C. 897, 905-06 (1962), *acq*. 1964-2 C.B. 5.

related to the education and training of that individual, or for payments made to any person providing medical care to that individual.[260]

(b) Definition of "Educational Organization". For purposes of the exclusion for tuition payments under I.R.C. § 2503(e)(2)(A), the payee must be an "educational organization" within the meaning of IRC § 170(b)(1)(A)(ii). As described in I.R.C. § 170(b)(1)(A)(ii), an organization must maintain a regular faculty and curriculum and have a regularly enrolled body of students in attendance at the place where its educational activities are regularly held. Further, its primary function must be the presentation of formal instruction to its students. While the organization may engage in non-educational activities, those activities must be merely incidental to the organization's educational activities.[261]

The Regulations define educational organizations as those which provide primary, secondary, preparatory and high school education, as well as colleges and universities.[262] This leaves open the question whether nursery schools and pre-schools can qualify as educational organizations. In Revenue Ruling 78-446, 1978-2 C.B. 257, the I.R.S. considered whether an organization was a "nonprofit educational organization" within the meaning of I.R.C. § 501(c)(3), and, by reference, I.R.C. § 170(b)(1)(A)(ii), for the purpose of determining that organization's qualification for certain excise tax exemptions. In the ruling, the I.R.S. examined two different scenarios. In the first scenario, the organization provided day care and instructional services to children between the ages of 4 months and 6 years. These services were provided in a group setting in the homes of staff members trained in childcare and licensed and monitored by the state. In addition to providing childcare, these staff members involved the children in reading and projects involving science, art, letters, and numbers. The I.R.S. determined that, with regard to this program, education was merely incidental to the primary purpose of providing custodial care to the children. The second program examined in the ruling was oriented toward children between the ages 3 and 6 years who attended for a full day, in some cases 5 days each week. Educational activities offered in this program included exercises in listening skills, exposure to numbers, letters, concepts, mathematics and science, problem solving, and arts and crafts. The program had a head teacher who met state teacher qualification standards and at least two teacher assistants in each classroom. Under these facts, the I.R.S. concluded that this program demonstrated a regular educational curriculum with on-site instructors and an enrolled student body at the designated place of instruction and therefore was a qualified nonprofit educational organization.

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[260] I.R.C. § 2503(e)(2).

[261] Treas. Reg. § 1.170A-9(b)(1).

[262] *Id.*

A few additional points are worth mention on the qualified tuition exclusion. First, although I.R.C. § 2503(e)(2)(A) incorporates by reference I.R.C. § 170(b)(1)(A)(ii) to define an "educational organization," there is no requirement that the organization actually qualify for the income tax charitable deduction provided under § 170.[263] Therefore, tuition payments made to a foreign educational organization will qualify for the gift tax exclusion even though no income tax deduction would be available for a gift to the organization.[264] Second, the exclusion applies only to tuition and cannot be applied to the payment of such expenses as room and board, books, or equipment.[265] Finally, the donor must in all cases make the tuition payments directly to the educational institution and not as a reimbursement to the student.[266] Payments made to a trust will not qualify, even if distributions are limited to tuition payments;[267] nor will payments made to a 529 Plan qualify for the exclusion.[268] On the other hand, the I.R.S. has issued a Technical Advice Memorandum providing that payments made for future years of private school tuition qualified for the exclusion under I.R.C. § 2503(e)(2)(A) where those prepayments were made for designated individuals then enrolled at the school and were non-refundable if the student ceased to be enrolled at the school.[269]

(c) <u>Definition of "Medical Care" and Allowable Medical Expenses</u>. I.R.C. § 2503(e)(2)(B) provides an exclusion from gift taxation for amounts paid by an individual directly to persons providing medical care on behalf of another individual. For this purpose, "medical care" is defined by reference to I.R.C. § 213(d), pertaining to the individual income tax deduction for medical expenses. The Regulations provide that medical expenses include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease; or for the purpose of affecting any structure or function of the body; or for transportation primarily for and essential to medical care; as well as amounts paid for medical insurance.[270] The exclusion is not available, however, for payments made for medical care that is reimbursed by a medical insurance company.[271] Further, as with tuition payments, to be excludable from gift taxation, expenses for medical care must be paid directly to the service provider.[272] Beyond this general guidance, most of the case law and I.R.S. rulings that are relevant to the medical expense

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263 Rev. Rul. 82-143, 1982-2 C.B. 220.
264 *Id.*
265 Treas. Reg. § 25.2503-6(b)(2).
266 Treas. Reg. § 25.2503-6(c) Ex. 1.
267 Treas. Reg. § 25.2503-6(c) Ex. 2; PLR 200602002
268 I.R.C. § 529(c)(2)(A)(ii).
269 TAM 19941013.
270 Treas. Reg. § 25.2503-9(b)(3).
271 *Id.*
272 Treas. Reg. § 25.2503-6(c) Ex. 1.

exclusion under § 2503(e) arise in the context of defining an income tax deductible medical expense under I.R.C. § 213(d).

The gift tax exclusion for medical care can be particularly useful in several situations: for example, when clients have elderly relatives who require special support services due to diminishing physical or mental capabilities, younger relatives who cannot afford health insurance, those who have uninsured (or uninsurable) health care expenses, or those who have special needs arising from physical or developmental disabilities. While the exclusion for medical expenses is broad and there is a fairly extensive amount of case law and I.R.S. rulings, the focus of the following discussion will be largely upon issued related to these particular planning situations.

One question that frequently arises is whether the medical expense exclusion permits a client to pay for personal assistants to provide for the home care of a disabled relative. The definition of a medical expense does, in fact, include expenses incurred for personal attendants for qualified long term care services as defined in I.R.C. § 7702B(c) (pertaining to the tax treatment of payments received under a long term care insurance contract).[273] The exclusion for the cost of such an attendant will include his or her salary and the employer's share of any employment taxes.[274] In addition, if the attendant lives in the home, the expenses can include the additional out-of-pocket costs incurred for the attendant's lodging and meals in excess of the normal costs of maintaining the home.[275] The attendant's expense can even be indirect. For example, if an attendant previously held an essential position in her family's business and a replacement needed to be hired in order for the attendant to care for the disabled family member, the cost of hiring the replacement can potentially qualify as an excludable medical expense.[276]

I.R.C. § 7702B(c) defines long term care services as necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance and personal care services, which are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner. For this purpose, a chronically ill individual is any individual that has been certified by a licensed health care practitioner as being unable to perform (without substantial assistance from another individual) at least two of the six activities of daily living listed in I.R.C. § 7702B(c)(2)(B)(i) for a period of at least 90 days due to a loss of functional capacity; or alternatively, a condition as

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[273] I.R.C. § 213(d)(1)(C).
[274] Rev. Rul. 57-489, 1957-2 C.B. 207.
[275] Rev. Rul. 76-106, 1976-1 C.B. 71.
[276] *Ungar v. Comm'r,* 22 T.C.M. (CCH) 766 (1963).

determined under the Regulations that carries a similar level of disability.[277] The daily activities listed in I.R.C. § 7702B(c)(2)(B)(i) include eating, toileting, transferring, bathing, dressing, and continence. An individual is also chronically ill for this purpose if he or she has been certified by a licensed health care practitioner as requiring substantial supervision to be protected from threats to health and safety due to a severe cognitive impairment.[278] Note that, for services rendered after 1996, the medical expense exclusion for qualified long term care services is not available if the paid attendant is the spouse of the chronically ill person or a relative, within the definition provided by IRC § 152(d)(2), of the chronically ill person, unless the attendant is professionally licensed to perform the provided services.[279] The exclusion is also not available for payments made to a partnership or corporation that is related to the chronically ill person within the definitions provided in I.R.C. §§ 267(b) or 707(b).[280] If, however, the attendant is not a spouse or related person to the chronically ill individual, there is no requirement that the individual be a nurse or have other special qualifications, the focus of the issue being the nature of the services rendered not the qualifications of the service provider.[281]

Expenses for an attendant may be excludable even if the services provided to the ill or disabled individual does not satisfy the above definition of qualified long-term care services. However, only the portion of the cost of the attendant's services related to medical care will be excludable. Services related to such activities as cooking, housekeeping, driving, or running errands are not generally considered related to medical care.[282]

In addition to paying for personal attendants, excludable medical expenses can include all or a portion of medically necessary capital expenditures.[283] These expenditures may qualify for an exclusion due to medical necessity if they relate to a permanent improvement of property; however, the expense is excludable only to the extent that it is not offset by a corresponding increase in the value of the property.[284] Importantly, as with all medical expenses, to be excludable, a capital expenditure must be medically necessary and not simply related to the general improvement of the patient's health.[285]

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[277] I.R.C. § 7702B(c)(2)(A)(i).
[278] I.R.C. § 7702B(c)(2)(A)(iii).
[279] I.R.C. § 213(d)(11)(A).
[280] I.R.C. § 213(d)(11)(B).
[281] *See, e.g.*, *Est. of Marantz,* 39 T.C.M. (CCH) 516, 517 (1979); *Bye v. Comm'r,* 31 T.C.M. (CCH) 238, 240 (1972); *Est. of Dodge,* 20 T.C.M. (CCH) 1811, 1814 (1961).
[282] Rev. Rul. 76-106, 1976-1 C.B. 71; Rev. Rul. 58-339, 1958-2 C.B. 106; *Westbrook v. Comm'r,* 49 T.C.M. (CCH) 981 (1985); *Van Vechten v. Comm'r,* 32 T.C.M. (CCH) 1363, 1365 (1973); *Borgmann v. Comm'r*, 28 T.C.M. (CCH) 678, 680-81 (1969), *aff'd per curiam* 438 F.2d 1211 (9th Cir. 1971).
[283] Treas. Reg. § 1.213-1(e)(1)(iii).
[284] *Id.*
[285] Treas. Reg. § 1.213-1(e)(1)(ii); Rev. Rul. 54-57, 1954-1 C.B. 67, *modified by* Rev. Rul. 83-33, 1983-1 C.B. 70 (1983) (cost to install an elevator merely improved patient's general health and was not

Examples of excludable capital expenditures that do *not* permanently improve property include, but are not limited to, the acquisition of specially trained dogs, wheelchairs and inclinators;[286] mobility scooters ("autoettes");[287] phone equipment for the hearing impaired;[288] televisions specially equipped for the hearing impaired (but only to the extent the cost of the television exceeds the cost of a regular television);[289] even special reclining chairs to mitigate a physical infirmity on the advice of a physician.[290]

Capital expenditures that permanently improve property for the primary purpose of medical care are excludable only if they are an essential element of treatment and would not otherwise have been incurred for non-medical reasons.[291] As noted above, capital expenditures that permanently improve property, even if medically necessary, are only excludable to the extent that the expenditure is not offset by a corresponding increase in the value of the property.[292] Generally, the burden will be on the taxpayer to prove that such an expense is excludible. However, certain expenses incurred to improve real property to accommodate a disabled person are presumed to be fully deductible.[293] These expenses include: constructing exit and entrance ramps to a residence; widening doorways and hallways to accommodate wheelchairs; installing railings, support bars and other similar modifications to bathrooms; lowering cabinets; altering the location of outlets and fixtures; installing porch lifts (but not home elevators); modifying smoke alarms and other warning systems; modifying stairs; adding handrails and grab bars; modifying door hardware; and grading the grounds to provide access.[294] The cost of installing a home elevator will only be excludable if it is medically necessary (as compared to a convenience or lifestyle accommodation or merely to improve a patient's generally health) and then only to the extent that its cost is not offset by a corresponding increase in the value of the property.[295] The cost of installing a pool can be an excludable expense under the same principles, provided that the pool is medically necessary, such as to treat arthritis or emphysema.[296] However, to the extent the cost of the pool exceeds

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deductible under I.R.C. § 213); *Evanoff v. Comm'r,* 44 T.C.M. (CCH) 1394, 1396 (1982) (same, swimming pool).

[286] Treas. Reg. § 1.213-1(e)(1)(iii).
[287] Rev. Rul. 67-76, 1967-1 C.B. 70.
[288] Rev. Rul. 73-53, 1973-1 C.B. 139; *see, also,* Rev. Rul. 71-48, 1971-1 C.B. 99.
[289] Rev. Rul. 80-340, 1980-2 C.B. 81.
[290] Rev. Rul. 58-155, 1958 C.B. 156.
[291] *Jacobs v. Comm'r,* 62 T.C. 813 (1974); *see, also,* Rev. Rul. 76-80, 1976-1 C.B. 71.
[292] Treas. Reg. § 1.213-1(e)(1)(iii).
[293] Rev. Rul. 87-106, 1987-2 C.B. 67.
[294] *Id.*
[295] Rev. Rul. 54-57, 1954-1 C.B. 67, *modified by* Rev. Rul. 83-33, 1983-1 C.B. 70 (1983).
[296] Rev. Rul. 83-33, 1983-1 C.B. 700; *Cherry v. Comm'r,* T.C. Memo 1983-470.

the needs of the individual, or relates to aesthetic or architectural considerations, the exclusion will not apply.[297]

(d) Specific Applications

(i) Alternative Care/Alternative Living Arrangements. When an individual can no longer reside at home, even with personal attendants, or if residing at home is not economically feasible, it is generally possible to exclude all or a portion of the cost of alterative living arrangements from gift taxation under § 2503(e)(2)(B). On the one extreme is the cost of inpatient hospital care. The cost of such care is entirely excludable as related to the patient's medical care, even though it will involve the provision of meals, lodging and other expenses that would have been incurred by the patient if not hospitalized.[298] The entire cost of inpatient care in a facility other than a hospital is similarly excluded if its principal purpose is to secure medical care,[299] or if the patient requires constant supervision.[300] In all other circumstances, however, an allocation must be made between the costs of inpatient care that are related to medical care and the costs that are not so related, such as food and lodging.[301]

(ii) Direct Payment of Medical Insurance. Paying for family members' medical insurance can provide another means to make excludable gifts. Generally, the exclusion covers premiums paid for insurance covering medical services and pharmaceuticals, hospitalization insurance, cooperatives, and "free choice" medical service plans.[302] Also excluded from gift taxation are payments for supplemental medical insurance under Part B of Title XVIII of the Social Security Act.[303] Payments for qualified long-term care insurance contracts, within the meaning of I.R.C. § 7702B(b)(1) of the Code, are also excluded, provided the annual cost limits defined in I.R.C. § 213(d)(1) of the Code are not exceeded. For example, in 2012, the annual long-term care insurance premium cost for an individual between the ages of 61 and 70 is limited to $3,500, and the cost for an individual over age 70 was limited to $4,370.[304]

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[297] *Ferris v. Comm'r,* 582 F.2d 1112, 1117-18 (7th Cir. 1978), *rev'g* 36 T.C.M. (CCH) 765 (1977).
[298] Treas. Reg. § 1.213-1(e)(1)(v).
[299] Treas. Reg. § 1.213-1(e)(1)(v)(a).
[300] *Counts v. Comm'r,* 42 T.C. 755, 765-66 (1964).
[301] Treas. Reg. § 1.213-1(e)(1)(v)(b); *see, also,* I.R.S. Info. Ltr. 2002-0169; *Estate of Smith v. Comm'r,* 79 T.C. 313, 321-22 (1982).
[302] I.R.C. § 213(d)(1)(D); Treas. Reg. § 1.213-1(e)(4)(ii).
[303] I.R.C. § 213(d)(1)(D); Treas. Reg. § 1.213-1(e)(4)(i)(a).
[304] *See* I.R.C. § 213(d)(10)(B).

(iii) Prescription Drugs. Only payments for prescribed drugs (or insulin, if not prescribed) are covered by the exclusion.[305] Illegal drugs (such as laetrile or medical marijuana, even if prescribed) are not covered by the exclusion.[306] Similarly, following the 2003 Medicare Act, expenses related to the importation of prescription drugs from other countries, such as Canada or Mexico, are not excludable.[307]

(iv) Cosmetic Surgery. Expenses related to cosmetic surgery are not excludable unless it is to ameliorate the effects of a congenital abnormality, a personal injury, or a disfiguring disease.[308] Further, in CCA 200603025, the IRS took the position that gender reassignment surgery was akin to cosmetic surgery and, therefore, the cost of such surgery was not deductible for purposes of I.R.C. § 213 (and, therefore, will not be excludible for gift tax purposes). On the other hand, expenses incurred for corrective laser eye surgery are excludable.[309] Payments made for acupuncture services are also excludable.[310]

(v) Fertility and Contraceptive Treatments. The IRS has ruled privately that expenses related to fertility treatments are deductible under I.R.C. § 213, and are therefore excludable for gift taxation purposes. Such treatments include fees related to reversing male sterilization (vasectomies), in-vitro fertilization, and costs associated with securing an egg donor.[311] However, payments to a surrogate mother are not deductible under I.R.C. § 213 and therefore are not excludable medical expenses for gift taxation purposes.[312] Costs associated with birth control, including surgery and legal abortion, are excludable.[313]

(vi) Rehabilitation and Psychological Services. Generally, the entire cost of inpatient treatment of drug or alcohol abuse is an excludable medical expense,[314] as is the cost of a program to stop smoking.[315] The cost of a weight loss program as a treatment for a specific disease (such as obesity) is excludable, but the cost of any foods provided through the program is not.[316]

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305 I.R.C. § 213(b).
306 Rev. Rul 97-9, 1997-1 C.B. 77, *clarifying* Rev. Rul. 73-603, 1973-2 C.B. 76.
307 I.R.S. Info. Ltr. 2005-0011.
308 I.R.C. § 213(d).
309 Rev. Rul. 2003-57, 2003-22 I.R.B. 959.
310 Rev. Rul. 82-111, 1982-1 C.B. 48.
311 PLR 2003182007.
312 I.R.S. Info. Ltr. 2002-0291.
313 Rev. Rul. 73-603, 1973-2 C.B. 76, *clarifying* Rev. Rul. 73-201, 1973-1 C.B. 140.
314 Rev. Rul. 72-226, 1972-1 C.B. 96; Rev. Rul. 73-325, 1973-2 C.B. 75.
315 Rev. Rul. 99-28, 199-25 I.R.B. 6, *revoking* Rev. Rul. 79-162, 1979-1 C.B. 116.
316 Rev. Rul. 2002-19, 2002-6 I.R.B. 778.

The cost of counseling services by qualified psychiatrists and psychologists are usually excludable.[317] On the other hand, the cost to visit a religious shrine following a serious illness for spiritual purposes is not excludable.[318] Also non-excludible is the cost of purchasing new clothing, furniture, and appliances as a recommended therapy for a neurotic disorder.[319] Further, and most unfortunately, the cost of traveling to play golf, even if recommended by a physician, is not an excludible expense.[320]

<u>Circular 230 Notice</u>: In accordance with IRS Treasury Regulations, we are required to notify you that any tax advice given herein (including attachments) is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding any penalties that may be imposed by any governmental taxing authority or agency or (2) promoting, marketing or recommending to another person any tax related matter.

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[317] Rev. Rul. 55-261, 1955-1 C.B. 307.
[318] *Ring v. Comm'r,* 23 T.C. 950, 954 (1955).
[319] *Rabb v. Comm'r,* 31 T.C.M. (CCH) 476, 479 (1972).
[320] *Altman v. Comm'r,* 53 T.C. 487, 490 (1969).