Crummey Powers
Annual Gift Tax Exclusion

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Congress' intent in enacting the gift tax statute was to prevent taxpayers from depleting their estates through gifts and as a consequence avoiding the estate tax. In application, however, the gift tax presents some problems. A blanket gift tax on all gifts would present administrative difficulties at both the IRS and taxpayer levels. As a practical matter, there would be no way the IRS could enforce a blanket gift tax (imagine trying to enforce a tax on the cash that a grandparent places inside a birthday card to a grandchild). Furthermore, placing a largely unenforceable provision into the Internal Revenue Code (which undergirds a tax system largely based on voluntary compliance) would promote contempt among taxpayers which would be damaging to the raising of revenue in the United States. To avoid these difficulties, Congress employed an annual exclusion to the gift tax.[14]

Section 2503(b) provides for taxpayers to make gifts free from gift tax to any person during any single calendar year in an amount up to $14,000.[15] The amount of the annual exclusion under Section 2503(b) is adjusted for inflation (by multiplying $10,000 by the cost of living adjustment).[16]

A crucial limitation to the use of the annual gift tax exclusion provided by IRC § 2503(b)(2) is that the gift must be of a "present interest." Gifts of future interests (such as gifts in trust) are specifically excluded by the statute (thus subjecting such gifts to gift tax). Since much of estate planning is driven by the non-tax goal of protecting beneficiaries from wasting gifted assets, the exclusion of gifts of future interests from the annual exclusion presented a real obstacle to using the annual exclusion as a method to reduce a taxpayer's gross estate.

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[14] *Id*. at 926.
[15] Current as of 2016.
[16] IRC § 2503(b)(2).

The Key Issue: Gift of a Present Interest

Pursuant to IRC § 2503(b), only gifts of "present interest" qualify for the gift tax annual exclusion. Thus, the donee must have the unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property.[17] The key issue of whether or not a particular gift will qualify under the annual exclusion ultimately is determined by how the IRS will characterize the transfer – whether or not the gift is deemed by the Service to be of a present interest. The ramifications of the characterization are direct: if the gift is a present interest, the annual exclusion will apply (no tax); if the gift is deemed to be a future interest, the exclusion does not apply and the taxpayer must pay gift tax on the transfer (or utilize their lifetime unified gift/estate tax credit amount).[18] By limiting the annual exclusion to present interest transfers, Congress intended to ensure that the exclusion would apply only to those transfers for which it was originally intended, i.e., routine, ordinary gifts.[19]

Notwithstanding the decisive importance of the characterization of a gift as one of either a future interest or a present interest, neither term is defined in the Internal Revenue Code. The applicable Treasury Regulations have defined future interest as including reversions, remainders and other interests or estates, whether vested or contingent and whether or not supported by a particular interest or estate which is limited to commence in use, possession or enjoyment at some future date or time. The courts have not clarified the distinction, rather they have interpreted the distinction in a manner that is vague and contradictory, leaving taxpayers without a consensus as to what truly qualifies as a future interest for the purposes of the annual exclusion.[20]

[17] Treas. Reg. §25.2503-3(b).
[18] Neil, *supra* note 3, at 927.
[19] *Id*. at 927-928.
[20] *Id*. at 927.

The most prominent standard to determine whether a gift of a present interest has been made is the "right to enjoy" or the "legal right test."[21] The type of interest transferred to the donee of a gift is critical in the distinction between whether such an interest is considered present or future.[22] Transfers in trust are almost always intended to provide for a beneficiary's future welfare and often contain restrictions that strictly prohibit a beneficiary's immediate enjoyment of such gift. It follows that, generally, gifts in trust will be treated as a future interest.[23] The United States Supreme Court acknowledged that the annual exclusion cannot apply simply because a donee has "vested rights."[24] Rather, the donee must receive a right to a substantial present economic benefit as determined by the present right to use, possess or enjoy the property.[25]

In the *Crummey* case, the Ninth Circuit's definition of a present interest was based upon the beneficiary's right to enjoy the property. The Court, through its adoption of the right to enjoy test, rejected the IRS' argument that the grantor's intent should control. Therefore, despite the fact that a grantor might expect that a withdrawal right will not be exercised, there is nevertheless a present interest when the grantor lacks the legal means to prevent the withdrawal right from being exercised.[26]

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[21] Christopher Steenson, *A Reluctant Stance by the IRS: The Uncertain Future of the Use of Section 2503(b) Annual Gift Exclusion Following Crummey*, 38 SANTA CLARA L. REV. 589, 592 (1998).
[22] Neil supra note 3, at 927.
[23] *Id*. at 928-929.
[24] *Fronden v. Commissioner*, 324 U.S. 18, 20 (1945).
[25] *Id.*
[26] Wilson, *supra* note 2, at 305.

Crummey v. Commissioner: Analysis

The *Crummey* case turned on an interpretation of the definitions of "future interest" and "present interest." The taxpayers in *Crummey* created a trust for the benefit of their four grandchildren. The operative feature in the trust instrument provided that each of the four beneficiaries of the trust could demand, at any time up until December 31 of a given year, up to $4,000 or the amount transferred into the trust during such year, whichever was less. What distinguished the *Crummey* case from other cases was that the demand power granted to the beneficiaries did not continue for the life of the trust, but rather lapsed at the end of each year it was given. To protect the annual exclusions the taxpayers had taken on their gift tax return pursuant to the trust gifts, they had to show evidence that the minor beneficiaries of a trust could have effectively demanded whatever trust property they were entitled to (thus meeting the definition of a present interest).[27] In order to do so, the taxpayers in *Crummey* relied on the trust language that provided the beneficiaries a right to demand immediate distribution of certain trust funds within a specified period of time, arguing that such a withdrawal right effectively qualified the gifts as present interest.[28] The IRS countered that the likelihood of the beneficiaries' exercising a demand right and the intent of the trust settlor in granting the power should be considered when determining whether a gift is of a present or future interest.

The court held that the rights provided in the *Crummey* trust instrument, which granted a power of withdrawal over contributions to any revocable trust, did qualify such contributions as gifts of a present interest eligible for the annual exclusion. The court noted that the right of withdrawal present in the *Crummey* trust gave the beneficiaries an unrestricted right to the immediate use, possession and enjoyment of the property contributed to the trust. Further, the

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[27] Michael J. Savinelli, *Three Strikes and the IRS is Out?: Crummey, Cristofani, and Kohlsaat: Firmly Entrenched Crummey Powers*, 12 QUINNIPIAC PROB. L. J. 67, 69-70 (1997)
[28] Neil, *supra* note 3, at 934.

court noted that the right of withdrawal need not be exercised in order for the beneficiaries to have a present interest in property contributed to the trust.[29] Essentially, the withdrawal power formed the basis for a judicially created "present interest."[30]

Moreover, the Ninth Circuit expressly declined to entertain the IRS argument concerning settlors' intent or the likelihood of beneficiaries exercising their power. Instead, the court noted the inconsistency and unfairness to the taxpayer that could result from the IRS implementing such an approach due to the arbitrary nature of trying to interpret the subjective intent behind each decision to allow a demand power to lapse.[31]

The legacy of the *Crummey* case is that taxpayers were afforded a mechanism by which to make a gift to trust for the benefit of a minor child, maintain some control over the funds in trust via the language in the trust instrument and still claim the transfer under the annual exclusion.[32] Although the *Crummey* case can be seen as having served an important and justifiable policy/tax goal, it has also provided estate planners with a broad method whereby the gift tax can be avoided and gross estates for estate tax purposes can be incrementally reduced. Ultimately, *Crummey* has become an effective estate planning tool that affords taxpayers the ability to legally and systematically deplete the value of their estates while avoiding transfer tax consequences.[33]

[29] James Spallino, Jr., *Drafting and Administering Irrevocable Life Insurance Trusts: The basics and Beyond*, 20 OHIO PROB. L. J. 91, 95 (2009).
[30] Wilson, *supra* note 2, at 301.
[31] Neil, *supra* note 3, at 936.
[32] *Id*. at 937.
[33] *Id*.

Expanding Crummey Powers: *Cristofani v. Commissioner*

Cristofani v. Commissioner was a Tax Court decision that affirmed not only the *Crummey* decision, but also the widespread use of Crummey powers as a trust planning device.[34] The issue in the *Cristofani* case was the propriety of annual exclusions taken for gifts made to the grantor's two children and five grandchildren, all of whom were minors. The two children and five grandchildren were each given a lapsing power to demand up to $10,000 of the trust income in the year it was given. The key fact in *Cristofani* was that only the two children of the grantor were named as primary beneficiaries of the trust and the five grandchildren retained contingent remainder interests in the trust. (The five grandchildren's interests would vest only if their parent failed to outlive the grantor by 120 days).[35]

In *Cristofani*, the IRS attacked the notion that the contingent remainder beneficiaries held a present interest because it was not certain that their interest would ever vest, and they would have no interest in the trust if their parents survived the settlor. The Tax Court, however, disagreed with the IRS and, siding with the taxpayers, found the demand power held by each of the grandchildren was indeed a present interest and, therefore, subject to the annual exclusion. According to the Tax Court, the key factor for determining a present interest is whether the beneficiaries are able, in a legal sense, to exercise their right to withdraw the trust corpus and the trustee's right to resist that demand.[36]

The *Cristofani* trust document explicitly authorized the right of withdrawal by the five grandchildren. Although the grandchildren never exercised such right, the key legal right to do so was still present and hence they received a gift of a present interest. Accordingly, the gift tax

[34] Savinelli, *supra* note 27, at 71.
[35] Neil, *supra* note 3, at 941.
[36] Savinelli, *supra* note 27, at 71.

exclusions were allowed for all five grandchildren. The unanimous *Cristofani* decision not only accepted the use of Crummey powers, but also expanded such use.[37]

Cristofani allows taxpayers to increase the amount that can be conveyed to a trust gift tax free by increasing the number of beneficiaries that are granted Crummey powers. With *Cristofani*, the Tax Court has approved the use of a trust in which contingent beneficiaries possess Crummey powers as an effective method to increase the availability of the annual exclusion from estate and gift taxes. Although the IRS acquiesced in the result of the *Cristofani* case, it did not concur with the Court's broad interpretation of the annual exclusion and indicated that it would challenge the validity of Crummey rights where a beneficiary had no current or vested remainder interest in the trust or where there was a prearranged understanding that the withdrawal rights would not be exercised. However, the IRS has not been successful in advocating this position.[38] The IRS approach with Crummey powers would be to distinguish between vested and contingent beneficiaries. The IRS believes that, as to contingent beneficiaries, the grant of a Crummey power may be merely a cohesive device to gain extended annual exclusions with no meaningful present interest transferred to the contingent beneficiary.[39] Some commentators have noted that the *Cristofani* decision expanded the class of eligible Crummey beneficiaries far beyond what was contemplated by the Ninth Circuit.[40] Affording a grantor the opportunity to take advantage of the annual exclusion in a situation where the beneficiary of the Crummey power has little or no opportunity to receive a share of the trust corpus (other than the annual withdrawal power), and thus little or no reason for allowing the

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[37] *Id*.
[38] Duncan E. Osborne and Elizabeth Morgan Schurig, Domestic Asset Protection, DOM. & INT'L L. & TACTICS § 14:32.
[39] James C. Magner, Linda R. Getzen and Edward F. Koren, *Preparation and Use of Trusts*, 2 EST. TAX & PERS. FIN. PLAN. § 19:58 (2011).
[40] Neil, *supra* note 3, at 941.

power to lapse, is a subversion of both the policy rationale behind *Crummey* and the general purpose of allowing an annual exclusion in the first place.[41]

[41] Neil, *supra* note 3, at 944.