Contingent Beneficiaries and Crummey Powers: The Battle Lines Are Drawn

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Abstract: *The IRS has withdrawn its acquiescence in* Estate of Cristofani v. Commissioner *and begun aggressively contesting cases where it believes grantors have engineered Crummey transfers solely to obtain annual exclusions without the requisite intent to make bona fide gifts. Focusing upon gifts to contingent beneficiaries, the IRS now asserts a "substance over form" argument. Where facts and circumstances indicate a "prearranged understanding" that Crummey withdrawal rights will not be exercised, the IRS will disallow use of the annual exclusion. This article highlights potential pitfalls and outlines potential solutions to this dilemma.*

After almost 30 years of relative calm, the Internal Revenue Service (IRS) has begun aggressively questioning the viability of "Crummey powers." A Technical Advice Memorandum (TAM) issued by the IRS in August 1995 served as a diplomatic warning that less than meticulous compliance would render "Crummey gifts" ineffective.[1] An Action on Decision (AOD) and another TAM, both issued in July 1996, constitute a full-fledged declaration of war against Crummey gifts (meticulous or otherwise) made to "contingent" trust beneficiaries.[2] In light of these combative rulings, this article offers guidance for utilizing Crummey powers in connection with irrevocable trusts.

Back to Basics

A transfer by an individual to an irrevocable trust constitutes a taxable gift.[3] Fortunately, an annual gift tax exclusion (the "annual exclusion") can shelter gifts made by the grantor to the trust of up to $10,000 per beneficiary per year.[4] Married grantors have the additional option to "split" gifts: a gift by one spouse to an irrevocable trust will be considered to have been made one half by the grantor and one half by the grantor's spouse (as long as the spouse consents) even if the trust is a single grantor trust.[5] Through such split gifts, a couple may gift $20,000 per beneficiary per year free of gift tax.[6]

A Gift Must Be A Present Interest

Grantors may only take advantage of the annual exclusion if they gift "present interests" in property.[7] Under existing law, a "Crummey power" is such a present interest. It gives the power holder an unrestricted and immediate right (during a specified time period) to withdraw property that has been transferred to a trust.[8]

In the 1968 case of *Crummey v. Commissioner*, the taxpayers (the Crummeys) created an irrevocable trust for the benefit of their four children.[9] Each beneficiary had the right to withdraw (from any additions made that year to the trust) an amount less than or equal to the annual exclusion. If a beneficiary failed to exercise his or her withdrawal right prior to December 31, such right lapsed as to that year.

The taxpayers made their additions to the trust during the last two weeks of December. Therefore, the beneficiaries technically had less than two weeks each year to exercise their withdrawal rights. Further, the beneficiaries, three of whom were minors, never actually exercised their withdrawal rights (and likely did not even know they existed). Nonetheless, the Ninth Circuit Court of Appeals ruled that because the beneficiaries were "legally and technically capable of immediately enjoying the property," the taxpayers had gifted "present interests."

Not surprisingly, there have been many "clarifications" of the Crummey power concept since 1968. The IRS has consistently focused upon the adequacy of notice to Crummey power beneficiaries and the availability of trust assets (over which the power may be exercised). Subsequent revenue rulings, technical advice memoranda, and private letter rulings have established the following protocol, which must be followed for Crummey gifts to effectively qualify for the annual exclusion under existing law:

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... in July 1996, the IRS reconsidered its position and issued a revised AOD categorically opposing the Cristofani court findings.

(1) Each year the beneficiary must receive a "Crummey letter," notifying him or her of the withdrawal right.[10]

(2) Notification by Crummey letter must be given to the beneficiary within a reasonable amount of time before the power lapses. Thirty days has been deemed sufficient.[11]

(3) The power holder's withdrawal right may be limited in any year to the lesser of the amount of the annual exclusion or the greater of $5,000 or 5 percent of the value of the trust corpus.[12]

(4) The notice should provide that if the Crummey power beneficiary is under a legal disability of any kind, the withdrawal right may be exercised by a parent or guardian.[13]

(5) Generally the withdrawal right is noncumulative and will lapse after expiration of the notice period (e.g., 30 days).[14]

(6) The power to withdraw by a beneficiary should be superior to any power of a trustee.[15]

Illusory Powers Held by Contingent Beneficiaries

The issue of contingent Crummey beneficiaries came to the forefront in 1991 courtesy of *Estate of Cristofani v. Commissioner.*[16] The grantor, Maria Cristofani, established a trust for the benefit of her two children. If either of her children predeceased the grantor, that child's share of the trust would pass to the grantor's grandchildren. Thus, the IRS maintained the five grandchildren were merely "contingent" beneficiaries.

The grantor made Crummey gifts to the trust on behalf of her children and grandchildren (seven gifts of fractional shares of real property valued at $10,000 each for a total of $70,000 per year). The IRS disallowed five of the seven annual exclusions claimed by the grantor, who paid no gift tax on these gifts, on the grounds that they were illusory because the grandchildren might never receive present enjoyment of the trust property. The Tax Court rejected the IRS's argument holding that gifts to beneficiaries who do not have a vested present interest or vested remainder interest in the trust corpus or income may nonetheless qualify for the annual exclusion. According to the Tax Court, the determinative factors should be the ability of the beneficiaries, in a legal sense, to exercise their rights to withdraw corpus and the trustee's right to legally resist such demands for payment, rather than the likelihood that the beneficiaries will actually receive present enjoyment of the property.[17]

In *Estate of Cristofani,* the IRS also argued that the grantor was not entitled to utilize her annual exclusions because she never intended to benefit her grandchildren, as evidenced by their status as contingent beneficiaries and their total failure to actually exercise their withdrawal rights. The Tax Court firmly repudiated this argument.[18] The IRS, however, continues to focus on the intent of the grantor when evaluating the viability of annual exclusions.

The Illusory AOD and the Dummy Crummey TAM

The IRS initially acquiesced in the *Cristofani* result but noted that extending withdrawal rights to contingent beneficiaries "would invite flagrant abuse in the future."[19] However, in July 1996, the IRS reconsidered its position and issued a revised AOD categorically opposing the *Cristofani* court's findings. The IRS concluded that it would deny annual exclusions where no bona fide gift was intended:

"To extend the benefit of the annual exclusion to illusory gifts of present interests would undermine the unified system of estate and gift taxation. Accordingly, IRS will continue to litigate cases whose facts indicate that the substances of the transfers were merely to obtain annual exclusions and that no bona fide gift of a present interest was intended."[20]

Warming to its "substance over form" approach, the IRS issued a Technical Advice Memorandum simultaneously with its revised AOD.[21]

In the TAM, the grantor established three irrevocable trusts from which her three children, seven grandchildren, two great grandchildren, and certain spouses had the right to make Crummey withdrawals prior to December 31 of each year. Upon the grantor's death, the beneficiaries were certain of her issue. The trusts did not require withdrawal notices. Those that were sent were routinely sent only a few days prior to the end of the calendar year, and frequently the trusts were not actually funded until after the withdrawal rights expired.

The IRS looked to the highly unfavorable facts and circumstances underlying the grantor's actions and determined that none of the transfers were present interests sufficient to qualify for the annual exclusion. Significantly, the grantor's compliance with Crummey power protocol was less than meticulous. In several instances, the grantor transferred property to the trusts after the beneficiaries' brief withdrawal period had already expired. Moreover, several beneficiaries were so-called "dummy Crummeys" — they had no interests in the trust other than their withdrawal rights.[22]

Yet even though the IRS had a surfeit of technical violations on which to base denial of the grantor's annual exclusions, it took pains to further expand its more subjective "substance over form" analysis. The IRS found that evidence that the beneficiaries failed to exercise their withdrawal rights supported only one logical conclusion — the grantor and the beneficiaries had a prearranged understanding. "[T]he beneficiaries knew that their rights were paper rights

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only, or that exercising them would result in unfavorable consequences." The IRS ruled that where the facts and circumstances indicate a "prearranged understanding" that the Crummey withdrawal rights will not be exercised, or that exercising such rights will result in undesirable consequences to the power holder, there is no bona fide unrestricted gift of a present interest in property.[23]

In support of its analysis, the IRS cites three cases: *Gregory v. Helvering*,[24] *Heyen v. Commissioner*,[25] and *Deal v. Commissioner*.[26] (The revised AOD also cites *Estate of Joseph Cidulka v. Commissioner*[27] for the same proposition.) In *Gregory*, the taxpayer entered into a corporate reorganization for the sole purpose of reducing taxes. In *Heyen*, the taxpayer gifted blocks of stock to intermediaries (to gain multiple annual exclusions) who then immediately gifted the stock to the taxpayer's family. In *Deal*, the taxpayer entered into a "sale" of property to her daughters in exchange for demand notes which she proceeded to "forgive" in succeeding years. In all of these cases, the taxpayer orchestrated a "series" of transactions that resulted in favorable tax consequences, retaining direct control throughout.[28]

On the other hand, in the Crummey gift setting, the grantor creates an irrevocable trust; makes gifts to that trust for the benefit of the trust beneficiaries; and, in so doing, gives up control over the gifted assets. If the beneficiaries fail to exercise their withdrawal rights, their Crummey powers lapse and the gift is administered by the trustee as required by the terms of the trust. Without explicit evidence that the grantor continues to control the assets (as in *Gregory* and *Deal*) or has asked that the beneficiaries refrain from exercising their rights over the property (as in *Heyen*), it seems a bit of a stretch for the IRS to rule conclusively that failure by "contingent" beneficiaries to withdraw funds evinces a prearranged plan. As long as the grantor does not restrict the beneficiaries' powers, the beneficiaries' decisions to exercise (or not exercise) their powers should be irrelevant. After all, a property right is created by the existence of the withdrawal power, not its exercise.[29]

The Illusory Future

The IRS has yet to persuade the Tax Court that its *Crummey* analysis has merit. Most recently, in *Estate of Lieselotte Kohlsaat v. Commissioner*,[30] the tax court repudiated the IRS's "substance over form" approach, refusing to infer an understanding between the grantor and her 16 contingent beneficiaries[31] that their Crummey rights would remain unexercised.

In 1990, Ms. Kohlsaat transferred a commercial building to an irrevocable trust, granting each trust beneficiary the right (for 30 days) to demand an immediate distribution of the property in an amount not to exceed $10,000. Although properly notified, none of the Kohlsaat trust beneficiaries exercised their withdrawal rights and none requested notification of future transfers of property to the trust. On audit, the IRS denied the 16 annual gift tax exclusions claimed by Ms. Kohlsaat on the grounds that the contingent beneficiaries did not hold present interests in the trust.

The Tax Court held to the contrary. The court found no evidence of a prearranged understanding, and concluded that by virtue of their unrestricted rights to demand immediate distribution of trust property the contingent beneficiaries had received gifts of present interests.

Assuming, however, that the IRS is not quite ready to shelve its "substance over form" argument, what can be done? For one, trusts can be drafted to provide that the trustee may make discretionary distributions of income and/or principal to all Crummey power holders. This removes the issue of "contingent" beneficiaries. Grantors and trustees should also make certain that they have followed proper Crummey protocol by mandating annual Crummey letters explaining a beneficiary's withdrawal rights, adequate notice periods, and sufficient availability of trust assets.

Of course, if the Crummey power holders occasionally exercise their withdrawal rights, the "illusory" argument is further weakened.[32] Finally, assuming that the IRS will continue to investigate and analyze the grantor's intent, grantors must walk a fine line of explaining to beneficiaries the advantages of leaving annual gifts in trust without falling over into the abyss of "prearrangement." J

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(1) Tech. Adv. Mem. 95-32-001 (Aug. 11, 1995). Technical Advice Memoranda and Actions on Decision, like Private Letter Rulings, may not be

cited as precedent. IRC §6110(j)(3). Nevertheless, they reveal IRS thinking on the subject.

(2) Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *action on decision*, 1996-010 (July 15, 1996).

(3) IRC §§2501(a) and 2511(a). All section citations are to the Internal Revenue Code.

(4) IRC §2503(b). Helvering v. Hutchings, 312 U.S. 393, 61 S. Ct. 653, 85 L. Ed. 909, (1941).

(5) IRC §2513.

(6) Form 709 must be filed to indicate consent to the gift by the spouse.

(7) Treas. Reg. §25.2503-3.

(8) "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property." Treas. Reg. §25.2503-3(b).

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

(10) Tech. Adv. Mem. 95-32-001 (Aug. 11, 1995).

(11) Fifteen days was held reasonable in Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991).

(12) This limitation is to avoid a gift of an amount in excess of the 5 or 5 power deemed made by a power holder beneficiary to the other beneficiaries, under IRC §2514(e). Such a gift would be a future interest, unavailable for the annual exclusion, decreasing the power holder's unified credit. If a power holder has a special power to appoint the excess over the 5 or 5 limit, since control is retained, arguably no gift results. Treas. Reg. 25.2511-2(b). A portion of the trust property attributable to the power, however, is included in the power holder's estate for estate tax purposes. Treas. Reg. 20.2041-3(d)(4).

(13) Naumoff v. Commissioner, 46 T.C.M. (CCH) 852 (1983).

(14) Powers that cumulate, or hang, lapse only to the extent of the greater of $5,000 or 5 percent of value each year. The IRS is critical of this procedure. See Howard M. Zaritsky and Stephan R. Leimberg, Tax Planning with Life Insurance, 5-38 (1992).

(15) Tech. Adv. Mem. 81-07-009 (Oct. 31, 1980).

(16) 97 T.C. 74 (1991).

(17) "Based upon the provisions of the Children's Trust, we believe that decedent intended to benefit her grandchildren. Their benefits, as remaindermen, were contingent upon a child of decedent's dying before decedent or failing to survive decedent by more than 120 days. We recognize that at the time decedent executed the Children's Trust, decedent's children were in good health, but this does not remove the possibility that decedent's children could have predeceased decedent.... Although decedent's grandchildren never exercised their respective withdrawal rights, this does not vitiate the fact that they had the legal right to do so...." Id.

(18) Id.

(19) *Cristofani*, 97 T.C. 74 (1991), *action on decision*, 1992-09 (Apr. 6, 1992).

(20) *Cristofani*, 97 T.C. 74 (1991), *action on decision*, 1996-010 (July 15, 1996).

(21) Tech. Adv. Mem. 96-28-004 (July 12, 1996).

(22) Priv. Ltr. Rul. 87-27-003 (Mar. 16, 1987) already stands for the proposition that the IRS will disallow annual exclusions for gifts of "naked powers" — powers given to beneficiaries who have no interest in the trust other than their Crummey withdrawal rights.

(23) While the IRS maintains that it will not contest annual gift exclusions for Crummey powers held by current income beneficiaries or vested remainder beneficiaries, "...where nominal beneficiaries enjoy only discretionary income interests, remote contingent rights to the remainder or no rights whatsoever in the income or remainder, their nonexercise indicates that there was some kind of prearranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences or both." Tech. Adv. Mem. 96-28-004.

(24) Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

(25) Heyen v. United States, 945 F.2d 359 (10th Cir. 1991).

(26) Deal v. Commissioner, 29 T.C. 730 (1958).

(27) Annual exclusions were disallowed for stock transfers to a daughter-in-law and grandchildren. These beneficiaries never received any benefits from the stock, did not receive their pro rata distribution when the company was sold, and were never shown as stockholders in the corporate records. Estate of Joseph Cidulka v. Commissioner, 71 T.C.M. (CCH) 2555 (1996).

(28) Clearly, the taxpayers in *Gregory* and *Deal* controlled the reorganization and controlled the demand notes. In *Heyen*, the court determined that the taxpayer's actions were sufficient for a jury to conclude that she never really gave up control of the shares of stock to the intermediary recipients.

(29) Estate of Alperstein v. Commissioner, 613 F.2d 1213 (2nd Cir. 1979); *cert denied*, 446 U.S. 918, 100 S. Ct. 1852 (1980); Rev. Rul. 75-351, 1975-2 C.B. 368. See also Estate of Kurz v. Commissioner, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995) for the proposition that the value of a withdrawal power that is outstanding (but not exercised) at death is included in the decedent's estate and subject to estate taxes. See also IRC §2514(e) and Treas. Reg. §25.2514(b)(1) for the proposition that to the extent that a withdrawal power exceeds the greater of $5,000 or 5 percent of the value of the trust assets (from which the withdrawal could be satisfied), lapse of such power will constitute a taxable transfer to the other trust beneficiaries.

(30) 1997 Tax Ct. Memo LEXIS 247, T.C. Memo 1997-212.

(31) The primary beneficiaries of the trust were Ms. Kohslaat's two children. The court specifically noted that the contingent beneficiaries were also all family members: 7 grandchildren, 8 great-grandchildren, and one daughter-in-law.

(32) While implementation of these suggestions may soften scrutiny by the IRS, care should be taken that they do not simultaneously frustrate the grantor's intent.