Title

The *Crummey* trust: Keeping both the IRS and the creditors at bay is taking some fancy footwork

Summary

Since *Crummey v. Commissioner* was decided in 1968, the IRS has been making life difficult for the settlors of *Crummey* trusts. Only recently the parties again skirmished, this time over whether an *in terrorem* clause in the governing trust instrument *per se* renders withdrawal rights illusory. See *Mikel v. Commissioner*, T.C. Memo, 2015-64. It does not. Chalk up another victory for the taxpayer. While the *Crummey* trust continues to be an effective tax avoidance vehicle, the very feature that makes it effective potentially exposes the underlying property to the reach of the creditors of the holders of the withdrawal rights, namely the withdrawal rights themselves. In California and New York most notably the risk appears to be a serious one. Charles E. Rounds, Jr. discusses the *Crummey* trust generally, and these specific tax-avoidance and creditor-access issues in particular, in §9.18 of *Loring and Rounds: A Trustee's Handbook*. The entire section, with some post-publication enhancements, is reproduced in its entirety below.

The Text

§9.18 The Crummey Trust [Reproduced from the 2015 Edition of *Loring and Rounds: A Trustee's Handbook*, with post-publication enhancements]

The annual gift tax exclusion.[1] In 1998, *X* could make gifts with a combined value of $12,000 or less to *Y* without having to file a federal gift tax return.[2] This $12,000-per-donee annual exclusion from taxable gifts was subject to upward cost-of-living adjustments for gifts made after 1998.[3] The exclusion increased to $13,000 for 2009, and $14,000 for 2013, 2014, and 2015.

For a gift to be "nontaxable," however, it must be of a "present" interest.[4] A donative transfer of property to the trustee of an irrevocable discretionary trust with multiple permissible beneficiaries, for example, would not qualify either in whole or in part for the exclusion.[5] Either the donor's credit equivalent/applicable exclusion amount[6] would be tapped or a gift tax would be owed with respect to the entire amount.[7] What if the present permissible beneficiaries—let us say adult and minor issue of the transferor—had the right to withdraw pro rata portions of the gift for a limited period of time after the transfer to the trustee and were given a timely notice of that right? What if, at the expiration of the period, withdrawal rights would then cease? Would the annual exclusion be available then?

In a similar case, *Crummey v. Commissioner*,[8] the Federal Court of Appeals for the Ninth Circuit held that it would. These limited rights of withdrawal would be enough to qualify the gift as a "present" interest transfer for purposes of the annual exclusion. Hence the name *Crummey* trust.

Since the Ninth Circuit case, the IRS has ceased challenging the general concept of the Crummey

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[1]*See generally* Lischer, 845 T.M., Gifts A-115.
[2]I.R.C. §2503(b) (the annual exclusion); I.R.C. §6019(1) (a gift tax return need not be filed).
[3]I.R.C. §2503(b)(2).
[4]I.R.C. §2503(b)(2); Treas. Reg. §25.2503-3(a).
[5]Treas. Reg. §25.2503-3(c).
[6]*See* §8.9.1.1 of this handbook (the unified credit).
[7]Treas. Reg. §25.2502-1(a).
[8]397 F.2d 82 (9th Cir. 1968).

trust.[9] It has, however, tussled with taxpayers over such issues as what constitutes adequate notice of withdrawal rights;[10] what is a reasonable time in which those rights may be exercised;[11] how notice is to be given to minors;[12] whether the gift tax annual exclusion is available to the transferor when those with the withdrawal rights otherwise have only remote successive, contingent,[13] or even nonexistent beneficial interests under the trust itself;[14] and whether the presence of an *in terrorem* clause in the governing trust instrument renders the right of withdrawal illusory.[1]

A typical Crummey trust is funded with an insurance contract on the life of the settlor.[15] The idea is that holders of withdrawal rights will decline to exercise those rights, thus freeing up the trustee to apply the gift toward payment of the insurance policy's annual premium.

The $5,000 or 5 percent exception.[16] While the person who is making the gift to a Crummey trust is affected by the $14,000 gift tax exclusion limitation of Code Section 2503(b), those beneficiaries with rights of withdrawal are affected by the "5 and 5" limitation of Code Section 2514(e). There is a tension here. Section 2514(e) provides as follows: The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeds in value the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value at the time of the lapse[17] of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

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[9] Rev. Rul. 73-405, 1973-2 C.B. 321; Rev. Rul. 75-415, 1975-2 C.B. 374.

[10] *See, e.g.*, Priv. Ltr. Rul. 8008040. *See generally* Sebastian V. Grassi, Jr., A Practical Guide to Drafting Irrevocable Life Insurance Trusts (2d ed., 2007, ALI-ABA); Sebastian V. Grassi, Jr., *Selected Issues in Drafting the Irrevocable Life Insurance Trust After the 2001 Tax Act*, 28 ACTEC J. 277, 291–292 (2003) (advising against having beneficiaries waive being notified each year of their Crummey withdrawal rights). *See also* TAM 9532001 (Apr. 12, 1995) (discouraging the use of "once for all time" Crummey notifications).

[11] Priv. Ltr. Rul. 8004172 (withdrawal periods in the range of thirty, forty-five, or sixty days would seem to be the norm). *See* TAM 9141008 (suggesting that a twenty-day withdrawal period was unreasonable).

[12] *See, e.g.*, Priv. Ltr. Rul. 8133070 (suggesting that notice to parent of minor donee may be sufficient notice). *See also* Priv. Ltr. Rul. 9030005 (providing that trustee and guardian of minor Crummey power-holder need not give notice to self).

[13] *See, e.g.*, Cristofani v. Comm'r, 97 T.C. 74 (1991) (allowing the present interest exclusion in the context of a Crummey trust, though some beneficiaries with present withdrawal rights possessed, in addition to those rights, mere contingent future interests under the trust itself).

[14] *See, e.g.*, TAM 9141008, TAM 9045002, TAM 9628004 (suggesting that the IRS will challenge annual exclusion eligibility when those with withdrawal rights otherwise have remote or nonexistent equitable interests).

[1] *See* Mikel v. Comm'r, T.C.Memo. 2015-64 ("Assuming arguendo that the beneficiaries' withdrawal rights must be enforceable in State court, we conclude that this remedy, which respondent concedes was literally available, was also practically available because the in terrorem provision, properly construed, would not deter beneficiaries from pursuing judicial relief.").

[15] *See generally* §9.2 of this handbook (the irrevocable life insurance trust).

[16] *See generally* Cline, 825-2nd T.M., Powers of Appointment—Estate, Gift, and Income Tax Considerations.

[17] Treas. Reg. §25.2514-3.

The problem is that when a power-holder through nonexercise (lapse) or otherwise *releases* a general inter vivos power of appointment (and that is what a Crummey withdrawal right is) the *power-holder* could be making a taxable gift to the extent the property subject to the power exceeds in value that which is subject to the "5 and 5" exception. Therefore, in order to avoid adverse gift tax consequences *for the power-holder* at the time of lapse, the typical Crummey Trust will provide that in any given year, there is a $5,000/5 percent limitation on what a power-holder may release. Excess withdrawal rights, referred to as "hanging" powers, are then carried over to later years. On the other hand, if someone releases a withdrawal right but retains some beneficial interest under the trust, the release may not be deemed a completed gift for tax purposes.

To the extent a Crummey Trust contains income-producing assets, both the settlor/donor and the one with the withdrawal rights, *i.e.*, the power-holder, may be liable for some portion of the resulting income tax liability.[18] If the settlor has retained at least one of the powers specified in Sections 671 through 679 of the Internal Revenue Code such that the trust is a grantor trust for income tax purposes and if a beneficiary at the same time possesses a Crummey withdrawal right over the same income, it is the settlor, not the beneficiary, who is taxed as the owner of the trust income.[19]

While a Crummey Trust may facilitate the avoidance of estate taxes upon the settlor/donor's death, it is certain that property subject to withdrawal at the time of the power-holder's death will be subject to the federal estate tax.[20] Prior taxable releases can also result in estate tax liability at the power-holder's death.[21] Finally, annual exclusion gifts to a Crummey Trust under which there are multiple permissible beneficiaries can have generation-skipping tax implications if one or more of those with withdrawal rights are skip persons.[22]

Creditor-access issues. When it comes to Crummey Trusts, potential tax traps are not the only concern. So also is creditor accessibility. Under the Uniform Trust Code, see §505(b)(2), a lapse, release, or waiver of a power of withdrawal will cause the holder to be treated as the settlor of the trust for creditor accessibility purposes to the extent the value of the property affected by the lapse, release, or waiver exceeds the Crummey or "5 and 5" power.[23] In §5.3.3.1 of this handbook, we explain why being deemed the settlor of a trust under which one is, say, a discretionary beneficiary of principal will likely render the principal reachable by the deemed settlor's creditors. The following states either have fallen in line with the UTC, or are even less creditor friendly, when it comes to the lapse, release, or waiver of general powers: Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, D.C., Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Vermont, Virgina, Washington, and Wisconsin. It is significant that California and New York are not on this list. Massachusetts case law, arguably, suggests that a lapse, release, or waiver of a general inter vivos power incident to a non-self-settled trust relationship does *not* in and of itself render the former holder a deemed

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[18]As to the potential income tax liability of the power-holder, *see* I.R.C. §678. *See also* §9.1 of this handbook (The Grantor Trust) and §10.1 of this handbook (Introduction to the Fiduciary Income Tax). If trust income is used to pay premiums for insurance on the life of the settlor/donor or the settlor/donor's wife, then such income is taxable to the settlor/donor under the grantor trust rules (I.R.C. §677(a)(3)).

[19]*See generally* Sebastian V. Grassi, Jr., A Practical Guide to Drafting Irrevocable Life Insurance Trusts (2d ed., 2007, ALI-ABA).

[20]*See* I.R.C. §2041(a)(2). *See also* Treas. Reg. §20.2041-3(d)(3).

[21]*See* I.R.C. §2041(a)(2).

[22]*See* I.R.C. §2642(c)(2). *See generally* §8.9.2 of this handbook (the generation-skipping transfer tax).

[23]Uniform Trust Code §505(b)(2) (available on the Internet at <http://www.uniformlaws.org/Act.aspx?title=Trust%20Code>).

settlor of the trust to the extent of the value of the affected property.[2] Colorado case law would seem more or less in accord.[3] As would Indiana's case law.[4]

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[2] *Cf.* State St. Trust Co. v. Kissel, 302 Mass. 328, 19 N.E.2d 25 (1939) (property subject to a general *testamentary* power of appointment is accessible to the postmortem creditors of the power-holder *only to the extent the power is actually exercised*). Of course, all bets are off if it turns out that under Massachusetts common law as enhanced by equity, the lapse, release, or waiver of a general inter vivos power of appointment is a constructive exercise of the power. The Massachusetts legislature enacted subsection (a) of § 505 of the Uniform Trust Code, but expressly declined to enact subsection (b), leaving the "current law" in place. No explanation was furnished in the commentary accompanying the MUTC, specifically the commentary accompanying Mass. Gen. Laws ch. 190B, §505(a), as to what that "current law" might be or how that "current law" would have been changed by the enactment of §505(b). All the commentary does is confirm that the omission of §505(b) from the MUTC was intentional.

[3] *See* University National Bank v. Rhoadarmer, 827 P.2d 561 (Colo. App. 1991).

[4] *See* Irwin Union Bank and Trust Co. v. Long, 312 N.E.2d 908 (Ind. App. 1st Dist. 1974).