

## **Avoiding Crummey Power Mistakes in Drafting Trust Documents**

Protecting Against IRS Challenges to Gifts to Irrevocable Trusts

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# Introduction and Overview

- *Crummey v. Commissioner*, 397 F.2d 83 (9<sup>th</sup> Cir. 1968)
  - Seminal (and namesake) case
  - Since, numerous court cases, revenue rulings, PLRs and TAMs have developed contours of “best practices” for planning with crummey powers

# Introduction and Overview

- What is at stake if IRS successfully challenges crummey power?
  - Lose benefit of IRC § 2503(b) annual exclusion
- Where is IRS likely to focus its challenges?
  - Identity of power holder
  - Time period during which power is exercisable
  - Required notice to power holder

# Drafting Requirements in Trust Instruments

- Best practice – include necessary provisions in trust instrument
- **But**, requirements may be satisfied in contribution agreement instead
  - Additional care needed to mitigate risk of mistake
  - Maintain careful contemporaneous records

# Identity of Power Holder

- Multiple power holders permitted
  - Donor may exclude on a transfer-by-transfer basis
  - Beware of “naked” powers
- Avoid reciprocal powers
- Minor beneficiaries
  - Trust instrument (or transfer instrument) should expressly permit exercise of withdrawal power on behalf of minor
  - No impediment to appointment of guardian
- Special generation-skipping transfer tax considerations

# Time Period During Which Power Is Exercisable

- Trust instrument (or transfer instrument) should identify specifically
- Must be “reasonable”
  - No bright line guidance on what is reasonable
  - Be careful with contribution date if period drafted to expire with end of calendar year (or other specified date)
- May extend into a calendar year beyond the year of contribution

# Amount Over Which Power Is Exercisable

- Be aware of potential income and transfer (estate, gift and generation-skipping transfer) tax consequences
  - Consider limiting power to a “5&5” power, but take care in drafting
- Spouse as a power holder
  - Spousal ETIP
- Gift-splitting considerations



# Notice Requirements to Beneficiaries

- Trust instrument at issue in *Crummey v. Commissioner* did **not** include provisions requiring notification to beneficiary of a contribution over which beneficiary had a withdrawal power
- **However,** IRS position has been otherwise

# Notice Requirements to Beneficiaries

- Form
  - Actual versus formal
- Recipient (and minor beneficiaries)
- Timing
  - Advance waivers?
- Curing past practice

# Steps to Protect Against IRS Challenge

- Scope of Annual Exclusion.
  - The annual exclusion is only available for gifts of present interests.
    - A present interest is an unrestricted right to the immediate use, possession or enjoyment of property or the income from property.

# Steps to Protect Against IRS Challenge

- Two specific requirements must be met to assure qualification for the annual exclusion. Power holder must:
  - Be given notice of the existence of the power; and
  - Be given a reasonable time to exercise the power.

# Steps to Protect Against IRS Challenge

- Notice does not have to be in writing (see *Estate of Carolyn W. Holland v. Comm'r*, T.C. Memo 1997-302.)
  - 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.

# Steps to Protect Against IRS Challenge

- To provide maximum evidentiary effect *Crummey* Letters should include:
  - A statement that a gift was made to the trust for the benefit of the beneficiary;
  - The amount of the gift subject to the beneficiary's demand right;
  - The demand right exercise period; and
  - A request that the beneficiary notify the trustee if the beneficiary wishes to exercise the demand right.

# Steps to Protect Against IRS Challenge

- Additional content of *Crummey* Letters.
  - The *Crummey* Letter may also include an attached acknowledgment with instructions that the beneficiary sign and return the acknowledgement.
    - Note: The acknowledgment should not contain language effectuating a waiver by the beneficiary of the demand right.

# Steps to Protect Against IRS Challenge

- Reasonable Opportunity.

- The IRS has determined that a 3 day period to exercise withdrawal power is illusory.
- 30 days has consistently been held to be a reasonable length of time.
  - Note, in *Cristofani* the beneficiaries were afforded only a 15 day exercise period, and the court found that the transfer qualified for the annual exclusion. However, the length of the exercise period was not litigated in that case.

# Steps to Protect Against IRS Challenge

- Exercise Period:
  - Important to make sure that the exercise period begins immediately upon the date of the transfer, rather than on the date of notice, as any delay in the beneficiary's ability to exercise the withdrawal right might create a future interest.
  - It is also important to make sure that the exercise period is not contradicted by the terms of the trust (e.g. a statement in the trust that rights automatically lapse on December 31 of each year.)

# Steps to Protect Against IRS Challenge

- Minor Beneficiaries:

- Notice should be given to beneficiaries' legal guardians.
- If no legal guardian, should be given to the beneficiaries' parents.

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# Additional Steps to Protect Against IRS Challenge

- Withdrawal powers held by persons with little or no interest in trust.
  - The IRS has been consistently hostile toward the use of contingent beneficiaries, or worse, persons with no interest in a trust at all, to increase the number of annual exclusions that can be used to fund a trust.
    - *Cristofani v. Comm'r*, 97 T.C. 74 (1991).
    - *Kohlsaas v. Comm'r*, T.C. Memo 1997-212.
    - *Estate of Holland v. Comm'r*, TC Memo. 1997-302.

# Additional Steps to Protect Against IRS Challenge

- Waiver or Lapse of Withdrawal Right.
  - Withdrawal right is a general power of appointment. I.R.C. § 2514(c).
    - Although 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.
    - However, a waiver of a general power of appointment does not constitute a release.

# Five or Five Amount

- Lapse of a withdrawal power is treated as a gift by powerholder to the trust.
  - The gift is of a future interest and therefore, the powerholder is not entitled to the annual exclusion.
  - However, 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. I.R.C. § 2514(e).

# Five or Five Amount

- Ways to deal with issues caused by lapse of withdrawal power:
  - Limit gifts to five or five amount.
  - Create an incomplete gift.
    - Make the beneficiary the sole beneficiary with trust payable to his or her estate if he or she dies before receiving full distribution.
    - Give beneficiary power of appointment over trust.
  - Use hanging withdrawal powers.

# Hanging Powers

- Hanging Powers.

- Withdrawal power lapses only to the extent of the five or five amount each year and the balance remains subject to the withdrawal power.
- Purpose of hanging power is to postpone the lapse of the power until another five or five amount is available to reduce the amount of the lapse and thus reduce the adverse gift tax consequences of the lapse

# Hanging Powers

## ■ Hanging Powers Concerns.

- If a beneficiary dies while holding Crummey withdrawal powers, the aggregate value of those powers is includible in the beneficiary's estate.
  - If included in the beneficiary's estate, then the beneficiary would become the transferor for GST tax purposes.
- Practical disadvantage that the hanging power can be exercised at any time by the beneficiary.

# Thank You

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# Thank You

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