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Crummey Trusts: An Exploitation of the Annual Exclusion

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I. INTRODUCTION

The imposition of taxes generally fosters an intense ambition on the part of those individuals adversely affected by such taxes to seek means of avoidance. Tax practitioners, wishing to capitalize on such desires, search for and discover loopholes within the tax law that can be utilized for the purpose of tax avoidance. One loophole commonly used to avoid the imposition of estate and gift tax is a "Crummey Trust."[1] This Comment will explore the nature of such trusts, their consistency with policies underlying the estate and gift tax laws, and their harmony with controlling precedent. Furthermore, this Comment will test the boundaries of the utility of such trusts. Finally, this Comment will undertake an analysis of the gift and estate tax ramifications on the beneficiaries of such trusts in order to ascertain the usefulness of this device as an effective loophole.

A. *Background*

1. Evolution of Estate and Gift Tax Laws

The estate tax is the common method by which the federal government imposes a tax on the transfer of property upon an individual's death.[2] Contrary to previous methods of estate taxation, the present

1. This device is named after the case in which the technique was initially recognized: Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). A Crummey Trust is created when the settlor of a trust grants the beneficiary a right to demand all or part of the trust's income or corpus. *See infra* notes 32-34 and accompanying text.

2. Section 2001 of the Internal Revenue Code (the Code) imposes a tax on the

estate tax is levied upon the estate of the decedent rather than upon the recipient of the estate.[3] This tax is computed by multiplying the taxable estate by the applicable tax rate.[4]

Social and fiscal policies were the underlying incentives for the enactment of the estate tax laws.[5] Society profited from the imposition of such taxes through the prevention of the undue accumulation of wealth.[6] Fiscal objectives were fulfilled by utilizing estate tax revenues to finance government expenditures, such as military exigencies.[7] However, the revenues raised from estate taxes remain insignificant in comparison to revenues raised from other forms of taxation.[8] Thus, since

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transfer of the taxable estate of a decedent who is a citizen or resident of the United States. I.R.C. § 2001(a) (West 1992). The federal estate tax is considered an excise tax because it is imposed upon the occurrence of a specified event—the transfer of property upon death. RICHARD B. STEPHENS & THOMAS L. MARR, THE FEDERAL ESTATE AND GIFT TAXES 1 (1959). An excise tax is distinct from a direct tax, which is levied on a particular piece of property without regard to the occurrence of a specific transaction. *Id.*

3. I.R.C. § 2001(a) (West 1992); *see also* DOUGLAS A. KAHN ET AL., FEDERAL TAXATION OF ESTATES, GIFTS AND TRUSTS ¶ 1.102 (1970). If such a tax were imposed on the recipient of the property it would be considered an inheritance tax as opposed to an estate tax. *Id.*

4. Section 2051 of the Code provides that "the taxable estate shall be determined by deducting from the value of the gross estate [applicable] deductions." I.R.C. § 2051 (West 1992). The tax liability can be determined by applying the rate schedule provided in subsection (c) of § 2001 of the Code. I.R.C. § 2001(c) (West 1992). The tax rate is progressive, thus the larger the taxable estate the higher the tax rate. *Id.*; *see also* STEPHENS & MARR, *supra* note 2, at 7.

5. Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 224 (1956). The constitutionality of estate taxation was confirmed by the Supreme Court in New York Trust Co. v. Eisner, 256 U.S. 345 (1921).

6. *See* Larry W. Gibbs, *Basic Federal Estate and Gift Taxation*, 17 ST. MARY'S L.J. 809, 811 (1986). Gibbs states that the "[f]ear of the great fortunes and the perpetuation of family dynasties was a striking feature of the late nineteenth century. This fear gave rise to legislative action . . . [of taxing] away the large estates." *Id.*; *see also* Eisenstein, *supra* note 5, at 224, 252-55 (discussing social objectives of estate taxation).

7. The first death transfer tax was adopted in 1797 when the new nation faced a possible military predicament due to its crumbling relations with France. Eisenstein, *supra* note 5, at 225. In 1862, an inheritance tax was levied in order to raise revenues for financing the Civil War. *Id.* at 225-26; *see also* Gibbs, *supra* note 6, at 810. The present estate tax laws were enacted in 1916 to assist in the financing of the First World War. Eisenstein, *supra* note 5, at 225-26; *see also* KAHN, *supra* note 3, at 3. For a detailed discussion on the fiscal objectives underlying estate tax laws, see Eisenstein, *supra* note 5, at 238-52.

8. Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969*

fiscal objectives have scarcely been met by estate taxes, social policies appear to be the dominant force motivating the taxation of estates.

Upon the enactment of the estate tax laws, many individuals commenced a search for avenues of circumventing the imposition of such taxes. A traditional avoidance technique was to diminish one's gross estate subject to taxation through inter vivos transfers.[9] In order to obstruct such avoidance techniques, a federal tax was imposed on gifts made during one's lifetime.[10] The gift tax liability is calculated by multiplying the taxable gifts made during the calendar year by the applicable rate.[11]

Treasury Proposals, the Criticisms, and a Rebuttal, in ESTATE AND GIFT TAXATION 163, 164 (Practising Law Inst., 1971). In 1969, the revenues raised from gift and estate taxation were less than 2% of the total tax revenue raised. *Id.* In 1975, gift and estate tax revenues were 1.7% of the total tax revenue raised. Gibbs, *supra* note 6, at 811.

9. Jeffrey G. Sherman, *'Tis a Gift to be Simple: The Need for a New Definition of "Future Interests" for Gift Tax Purposes*, 55 U. CIN. L. REV. 585, 589 (1987). The estate tax is reduced by inter vivos transfers because "but for the transfer, [the property] would have been subject to the estate tax at the donor's death." *Id.*

10. Section 2501 of the Internal Revenue Code provides in relevant part: "A tax . . . is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or non resident." I.R.C. § 2501(a)(1) (West 1992). The donor of the gift is primarily liable for payment of this tax. Treas. Reg. § 25.2511-2(a) (as amended in 1983). Although the Code states that a gift tax is imposed on individuals, when the grantor of a gift is a corporation, the gift tax may be imposed on the individual shareholders. Treas. Reg. § 25.2511-1(h)(1) (as amended in 1986). A gift has been defined as an "irrevocable transfer by a donor, competent to make a gift, and clearly and unmistakably intending to divest himself of title, dominion, and control over the subject matter of the gift, to a donee capable of accepting a gift, or to someone acting as trustee or agent for the donee in accepting it." JACOB RABKIN & MARK H. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION § 51.04[1] (1992); *see also* Rev. Rul. 57-315, 1957-2 C.B. 624. Donative intent is not a factor taken into consideration when determining whether a gratuitous transfer of property has taken place for the purpose of gift tax laws. Treas. Reg. § 25.2511-1(g)(1) (as amended in 1983). Rather, a gift is made to the extent that "property is transferred for less than an adequate and full consideration in money or money's worth." I.R.C. § 2512 (West 1992). Under § 2511, a gift tax applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." I.R.C. § 2511(a) (West 1992).

11. Section 2503 of the Code provides that "taxable gifts [are] the total amount of gifts made during the calendar year, less [applicable] deductions." I.R.C. § 2503(a) (West 1992). The rates to be applied are the progressive tax rates provided in § 2001(c). I.R.C. § 2001(c) (West 1992). The method of computing the gift tax is set forth in § 2502, which states that the tax rates are progressive, not just with respect to the current year's gifts, but upon the cumulative amount of taxable gifts made by the donor during his lifetime. I.R.C. § 2502 (West 1992); *see also* KAHN, *supra* note 3, ¶ 2.101, at 177.

2. The Annual Exclusion

Currently, a taxpayer is permitted a $10,000 annual exclusion per donee for gifts made after December 31, 1981.[12] In the case of married individuals, the annual exclusion increases to $20,000 per donee, provided that the donor's spouse consents to having made one-half of the gift.[13] Furthermore, the number of donees for whom a taxpayer can claim an annual exclusion is unlimited.[14] Thus, if a married taxpayer was to make a gift of $25,000 to A and $25,000 to B, he would not have a gift tax liability for the first $20,000 of gifts made to each donee, but a gift tax would be imposed for the remaining $5,000.

a. *The purpose of the annual exclusion*

The purpose of the annual exclusion is "to obviate the necessity of keeping an account of and reporting numerous small gifts, and yet to

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12. Section 2503 of the Code provides: "In case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such persons shall not, for the purpose of subsection (a), be included in the total amount of gifts made during such year." I.R.C. § 2503(a) (West 1992). In the case of a transfer of property to a trust, a trust beneficiary is considered a donee for the purpose of the annual exclusion. Helvering v. Hutchings, 312 U.S. 393, 396 (1941); *see also* Treas. Reg. § 25.2503-(2)(a) (as amended in 1984). In the case of a transfer of property to a corporation, the shareholders of the corporation are considered to be the donees. *See* Chanin v. United States, 393 F.2d 972, 980 (9th Cir. 1968); Treas. Reg. § 25.2511-1(h)(1) (as amended in 1986); Rev. Rul. 71-443, 1971-2 C.B. 337.

13. Section 2513 of the Code provides in relevant part:

> A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States . . . . [This] paragraph . . . shall apply only if both spouses have signified . . . their consent to the application of [this] paragraph in the case of all such gifts made during the calendar year by either while married to the other.

I.R.C. § 2513(a)(1)-(2) (West 1992). This process is known as "gift splitting." *See* Treas. Reg. § 25.2513-1 (as amended in 1983). A gift tax return must be filed if a husband and wife wish to split a gift. *Id.*

14. Section 2503(b) of the Code states that the first $10,000 of gifts to any person is not a taxable gift. I.R.C. § 2503(b) (West 1992); *see also* Louis S. Harrison, *The Strategic Use of Lifetime Gifting Programs to Reduce Estate Taxes in Light of Recent Congressional and Internal Revenue Service Antipathy Towards Transfer Tax Reduction Devices*, 40 DEPAUL L. REV. 365, 376 (1991) (stating that no limitations are imposed on the number of donees eligible for the gift tax exclusion).

fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."[15] Thus, based on the express language of the legislative history the exclusion is intended to relieve taxpayers of the burden of accounting for myriad immaterial gifts made during the course of the taxable year. This language unequivocally repudiates the contention that donors can uninhibitedly utilize the annual exclusion to shift their estate to members of their family free of estate and gift tax.

The purpose of the annual exclusion can also be inferred from actions undertaken by Congress subsequent to its enactment. On several occasions, Congress has taken affirmative steps to reduce the amount of gift tax exclusion available.[16] Decreases in the amount of the exclusion in 1939 and again in 1942 were prompted by Congress' recognition that donors were exploiting the exclusion by transferring their estate to members of their family free of estate and gift taxation.[17] Therefore, based on the actions taken by Congress, it is clear that the annual exclusion was not intended to be utilized as an estate tax avoidance device.

b. *Limitations of the exclusion*

The availability of the annual exclusion is not without limitations. In order for the exclusion to be applicable, the transfer cannot be construed as a transfer of a future interest.[18]

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15. S. REP. NO. 708, 72d Cong., 1st Sess. 41 (1932).

16. Between 1932 and 1938, the amount of the annual exclusion was set at $5,000. *See* S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932). In 1938, the amount of the exclusion was decreased to $4,000. *See* H.R. REP. NO. 1860, 75th Cong., 3d Sess. 61 (1938) (recommending reduction to $3,000); H.R. REP. NO. 2330, 75th Cong. 3d Sess. 17 (1938) (settling on reduction to $4,000). In 1942, the amount of the exclusion decreased to $3,000. *See* H.R. REP. NO. 2333, 77th Cong., 2d Sess. 37 (1942). In 1981 the exclusion was increased to $10,000. *See* STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 273 (Comm. Print 1981) [hereinafter GENERAL EXPLANATION].

17. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 61 (1938); H.R. REP. NO. 2333, 77th Cong., 2d Sess. 37 (1942). The increase in the amount of the exclusion in 1981 was made due to "the substantial increases in price levels" since the law was originally enacted. GENERAL EXPLANATION, *supra* note 16, at 273.

18. Under § 2503 of the Code, the annual exclusion is available only for gifts other than gifts of future interests. I.R.C. § 2503(b) (West 1992). A "future interest" has been defined as a "legal term, and includes reversions, remainders, and 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." Treas. Reg. § 25.2503-3(a) (as amended in 1983). In Fondren v. Commissioner, 324 U.S. 18, 20 (1945), the Supreme Court stated that it is the postponement of enjoyment that makes an interest in property a future

The Supreme Court initially addressed the issue of whether a particular type of transfer qualifies as a transfer of a present interest in *United States v. Pelzer.*[19] In *Pelzer*, the taxpayer created a trust for the benefit of his living and unborn grandchildren and provided for the accumulation of income for a ten year period.[20] The Court stated that since "[t]he 'use, possession, or enjoyment' of each donee is . . . postponed to the happening of a future uncertain event," the transfer constituted a transfer of a future interest.[21] Thus, in determining whether a transfer qualifies for the annual exclusion, the fundamental issue to be addressed is whether a transfer of a present interest has taken place.[22] The following factual situation illustrates the distinction between present and future interests. Assume A transfers property to B for life with remainder to C. B has the right to present enjoyment of property and thus has received a present interest. On the other hand, C's use and enjoyment of the property are to commence in the future; C has received a future interest.

There are two apparent reasons for the imposition of such restric-

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interest. *See also* Estate of Kolker v. Commissioner, 80 T.C. 1082, 1085 (1983) (stating that "the entire value of any gift of a future interest in property must be included for the calendar quarter in which the gift is made"); Quatman v. Commissioner, 54 T.C. 339, 341 (1970) (stating that "the mere fact that the distribution of corpus is postponed is enough to make that gift a future interest"). The donor has the burden of proving that the transfer does not constitute a future interest. Commissioner v. Disston, 325 U.S. 442, 449 (1945); Herrmann's Estate v. Commissioner, 235 F.2d 440, 444 (5th Cir. 1956); Kniep v. Commissioner, 172 F.2d 755, 758 (8th Cir. 1949); Commissioner v. Sharp, 153 F.2d 163, 164 (9th Cir. 1946).

19. 312 U.S. 399 (1941); *see also* Ryerson v. United States, 312 U.S. 405, 408 (1941). The *Ryerson* court held that since the trustee's power to terminate the trust was a contingency which might never occur, the gift was a future interest. *Id.*

20. *Pelzer*, 312 U.S. at 400.

21. *Id.* at 404.

22. A present interest has been defined as 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)." Treas. Reg. § 25.2503-3(b) (as amended in 1983). In *Fondren*, the Court stated that a transfer of present interest has occurred where the donee has a "right to substantial present economic benefit." 324 U.S. at 20; *see also* Commissioner v. Disston, 325 U.S. 442, 447 (1945). However, if a beneficiary's "right to receive the income payments is subject to the trustee's discretion, it is not a present interest and no exclusion is allowable with respect to the transfer in trust." Treas. Reg. § 25.2503-3(c)(1) (as amended in 1983); *see also* Hamilton v. United States, 553 F.2d 1216, 1219 (9th Cir. 1977) (stating that, if based on the trust instrument the trustee has excessive discretion in management and distribution of income, the beneficiary has not received a present interest).

tions on the availability of the annual exclusion. First, restricting the exclusion to transfers of a present interest is necessary to avoid difficulties associated with determining the identity of donees and the value of gifts made to such donees.[23] However, commentators have noted that the restriction on the applicability of the exclusion is implicit in the stated goals underlying the gift tax laws.[24] Second, as previously stated, the exclusion was permitted to avoid the necessity of keeping records of minor gifts exchanged between friends and family. While gifts of present interests usually consist of minor gift exchanges, a gift of a future interest is usually made with the intent to avoid taxes and not with the intent to make a routine gift.[25] Thus, limiting the exclusion to conveyance of a present interest was another method by which Congress sought to ensure that taxpayers did not use inter vivos transfers as a tax avoidance device.

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23. H.R. REP. NO. 708, 72d Cong., 1st Sess. 29 (1932); S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1932). The identity of the donee and the value of the gift made to the donee are necessary factors in determining whether the donor is entitled to a gift tax exclusion. For instance, assume a taxpayer transfers $100,000 in trust naming A, B, and C as beneficiaries. Also assume that the taxpayer gives the trustee the power to distribute income to beneficiaries as he sees fit. Under § 2503(b), the donor gets a $10,000 exclusion per donee. I.R.C. § 2503(b) (West 1992). Given the above factual situation, it is not possible to determine the ultimate number of donees and the ultimate value that each donee may receive. Since the exclusion is permitted on a per-donee basis, it would not be possible to calculate the exclusion. *See* Sherman, *supra* note 9, at 588; *see also* United States v. Pelzer, 312 U.S. 399, 403 (stating that "[t]he exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts").

24. Sherman, *supra* note 9, at 589. In many instances, an annual exclusion has been unavailable on the basis that the transfer constituted a conveyance of a future interest, even though the identity of the donees was ascertainable. *Id.*; *see also* Commissioner v. Glos, 123 F.2d 548, 549-50 (7th Cir. 1941) (holding that although the identity of the ultimate beneficiary was not at issue, the gift constituted a gift of a future interest because possession was postponed). Thus, the characteristics of the gift must be taken into consideration in identifying the type of interest transferred. Sherman, *supra* note 9, at 589.

25. Sherman, *supra* note 9, at 590.

> One seldom makes a gift of a future interest without the advice and intervention of an attorney or other professional. If a gift is in the form of future interest, it is likely to have been made as much from tax-reduction motives as from a simple desire to make the kind of gift that Congress sought to exempt through section 2503(b). Accordingly, Congress chose, rather than requiring an investigation into the motives prompting each gift of a future interest, to disqualify such gifts altogether from the annual exclusion.

Id.

II. CRUMMEY TRUSTS: AN ABUSE OF THE ANNUAL EXCLUSION

Although Congress has attempted to prevent estate tax avoidance by imposing gift taxes on inter vivos transfers and by placing restrictions on the applicability of the gift tax exclusion, estate planners have developed new and more creative avoidance devices. A common estate planning strategy is the use of the annual exclusion to transfer significant amounts of wealth while escaping estate and gift taxes.[26] Even though the annual exclusion usually applies to outright transfers of property,[27] many individuals wishing to utilize the exclusion are hesitant to surrender control of assets to their children.[28] Rather, these individuals prefer to defer the beneficiaries' possession and enjoyment of the corpus and income of gifts in trust.[29] Since the beneficiary does not have immediate access to the funds, the transfer is considered to be a conveyance of a future interest, and thus does not qualify for the annual exclusion.[30]

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26. Owen G. Fiore et al., *Probate Avoidance and Other Uses of Trusts*, *in* ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (ALI-ABA Course of Study, August 20, 1992), *available in* Westlaw, File No. C771 ALI-ABA 469, at *12 (stating that "[a]nnual exclusion gifts can be effective estate planning tool[s]"). This device also assists in the avoidance of generation skipping tax. Under § 2642(c), inter vivos transfers that qualify for the present interest gift tax exclusion under § 2503(b) are not subject to generation skipping tax. I.R.C. § 2642(c) (West 1992).

27. Rev. Rul. 54-400, 1954-2 C.B. 319. "In the case of an outright and unrestricted gift to a minor, the mere existence or nonexistence of a legal guardianship does not of itself raise the question whether the gift is of a future interest." *Id.*; *see also* STANLEY S. SURREY ET AL., FEDERAL WEALTH TRANSFER TAXATION 670 (2d ed. 1982). There are many practical disadvantages associated with making an outright gift to a minor. Frederick W. Whiteside, *Giving Gifts to Minors Can Still Result in Significant Income and Estate Tax Savings*, 8 TAX'N FOR LAW. 282-83 (1980). When a minor holds title to property, the court's permission must be obtained in order to dispose of the property. *Id.* Additionally, upon a minor's death, the property reverts back to the parents, thereby abrogating some of the tax benefits. *Id.*

28. Richard W. Harris & Steven W. Jacobson, *Maximizing the Effectiveness of the Annual Gift Exclusion*, TAXES, Mar. 1992, at 205.

29. *Id.* According to the article, such taxpayers wish to transfer the property in order to avoid the imposition of estate taxes, yet they wish to retain control over such property. *Id.* A donor's desire to defer access to the trust's funds was typified in a Private Letter Ruling where a parent delayed final distribution of the trust property until the beneficiary reached age 60. Priv. Ltr. Rul. 82-29-097 (Apr. 22, 1982).

30. Gibbs, *supra* note 6, at 842; *see also* Burke A. Christensen, *Defective Income Tax Powers, Crummey Clauses and the IRS*, 119 TR. & EST. 68-69 (1980). "A gift to a trust does not usually convey a present interest in the gift to the trust beneficiary, because the donee's enjoyment of the property is subject to the will of another person—the trustee." *Id.*; *see supra* note 18 and accompanying text.

To avoid the unfavorable tax consequences of such transfers, practitioners have developed an ingenious device that qualifies a transfer as a present interest while permitting the deferral of distribution to the intended beneficiary. The device employed by estate planners to avoid the adverse tax consequences of an inter vivos transfer is known as a Crummey Trust.[31]

Even though the policies underlying the gift tax laws appear to be quite clear, Crummey Trusts have been used for the purpose of avoiding such taxes. These trusts have prevented the gift tax laws from providing a safeguard against estate tax avoidance as originally contemplated by enactment of the laws.

A. *What Is a Crummey Trust?*

To establish a Crummey Trust, the grantor contributes property to a trust and grants the beneficiary a lapsing power to withdraw a specific amount.[32] This power of withdrawal gives the beneficiary the power to obtain "immediate use, possession or enjoyment of the property," thus converting the transfer to that of a present interest qualifying for the annual exclusion.[33] The power to compel distribution qualifies as a

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31. This device is named after the case in which the technique was recognized: Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). An alternative device that can be used to transfer property to minors free of gift tax is a statutory trust for minors provided for under § 2503(c) of the Code. Under this section a transfer of property to a person under the age of twenty-one is considered a gift of a present interest if the following requirements are satisfied: (1) the trust corpus and income from the trust property may be consumed by the donee or for the benefit of the donee before the age of twenty-one, (2) any amount not expended for the donee's benefit shall pass to the donee at the age of twenty-one, and (3) if the donee passes away prior to reaching the age of twenty-one, the remaining trust property must be distributed to the donee's estate. I.R.C. § 2503(c) (West 1992). However, § 2503 trusts are not as attractive as the Crummey Trust because they require the property to be distributed to the beneficiary when he or she reaches the age of twenty-one. *See Demand Period of 30 Days Okayed for Crummey Trust*, 53 J. TAX'N 34-35 (1980).

In order to better comprehend the operation of Crummey Trusts, the reader must be familiar with fundamental trust terminology. A trust is defined as a "fiduciary relationship in which one person is the holder of the title to property subject to an equitable obligation to keep or use the property for the benefit of another." GEORGE G. BOGERT & GEORGE T. BOGERT, LAW OF TRUSTS § 1, at 1 (5th ed. 1973). A trustee is "the person who holds title for the benefit of another." *Id.* A settlor is "the person who intentionally causes the trust to come into existence." *Id.* A beneficiary is "the person for whose benefit the trust property is to be held or used by the trustee." *Id.* at 2.

32. Thomas W. Abendroth, *Grantor Trusts are Now Useful Planning Tools*, 20 TAX'N FOR LAW. 81-84 (1991); *see also* Gibbs, *supra* note 6, at 842-43.

33. Gibbs, *supra* note 6, at 842-43; *see also* Treas. Reg. § 25.2503-3(b) (as amended in 1983).

present interest if the beneficiary is not required to take any action other than making the demand.[34] However, upon the creation of such a trust, the donor must satisfy several additional requirements in order to realize the benefit of the annual exclusion.

B. *Requirements of Notice and Opportunity to Exercise*

In order for the transfer to the Crummey Trust to qualify for the annual exclusion, the withdrawal right must be accompanied with sufficient notice of such right to the powerholder, as well as adequate time for the right to be exercised.[35] The Internal Revenue Service (the Ser-

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34. Rev. Rul. 75-415, 1975-2 C.B. 374. In this Revenue Ruling, the donee's right of withdrawal was contingent upon him terminating his college education. The ruling stated that a transfer of a present interest had not occurred if the donee's enjoyment of the trust was subject to some contingency which is of "independent significance." *Id.*; *see also* Kent Mason, *An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573, 577-78 (1982) (discussing the impact of prerequisites on the donee's ability to exercise withdrawal power).

35. Mason, *supra* note 34, at 577-78. In *Crummey*, the Ninth Circuit did not impose notice requirements as a prerequisite to the validity of such trusts. *Crummey*, 397 F.2d at 82. In fact, the court stated that it was unlikely that the powerholders had any notice of transfers to the trust. *Id.* at 87. However, the Service has imposed such restrictions in Revenue Ruling 81-7 which states:

> A trust provision which gives a legally competent adult beneficiary the power to demand corpus does not qualify a transfer to the trust as a present interest eligible for gift tax annual exclusion under section 2503(b) of the Code, if due to the donor's conduct, the beneficiary lacks knowledge of the power and does not have a reasonable opportunity to exercise it before it lapses.

Rev. Rul. 81-7, 1981 C.B. 474.

The beneficiaries must generally receive actual notice of their withdrawal power. Tech. Adv. Mem. 79-46-007 (July 26, 1979) (denying a taxpayer the benefit of the annual exclusion because the grantor failed to take the imperative step of actually notifying the beneficiary). This requirement applies to both minor and adult beneficiaries of such trusts. Malcolm A. Moore, *Tax Consequences and Uses of "Crummey" Withdrawal Powers: An Update*, 1988 INST. ON EST. PLAN., ¶ 1102.1 (1988). If the beneficiary is a minor, notice should be given to the person's guardian or natural parents. *Id.*; *see also* Priv. Ltr. Rul. 82-29-097 (Apr. 22, 1982); Priv. Ltr. Rul. 81-43-045 (July 29, 1981); Priv. Ltr. Rul. 81-43-024 (July 28, 1981). Oral or written notice will be sufficient to satisfy the notice requirement. Moore, *supra*, at ¶ 1102.2. However, for evidentiary reasons, written notification is the preferred mode of informing beneficiaries of their power of withdrawal. *Id.* If the trustee giving the notice is also the parent of the beneficiary, the trustee's actual knowledge may render written notice unnecessary. Priv. Ltr. Rul. 80-08-040 (Nov. 28, 1979); Priv. Ltr. Rul. 90-30-005 (July 27, 1990).

In cases involving multiple transfers during the year, a single annual notice letter to each beneficiary containing the original contribution, the terms of the demand rights, vice) has stated that the failure to comply with these requirements makes the demand right "illusory," thus depriving the donor of the ability to utilize the annual exclusion.[36] In a number of private letter rulings, the Service has held that the reasonable time requirement is satisfied if donees receive a minimum of thirty days in which to exercise their demand power.[37] However, in a recent tax court decision, a fifteen day withdrawal period was not contested by the Service.[38] Finally, for evidentiary purposes, the beneficiary of the trust should recognize the receipt of the notice in writing.[39] Once the donor satisfies the requirements of notice and opportunity to exercise, the donor can avail himself of the benefit of the annual exclusion if he assures the availability of the proper assets in the trust.

C. *Requirement of Availability of Liquid Assets*

Generally, any type of property may be transferred to a trust, including cash, bonds, stocks, life insurance policies, or real estate.[40] However-

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and the amounts contributed satisfies the notice requirements. Priv. Ltr. Rul. 80-03-033 (Oct. 23, 1979); Priv. Ltr. Rul. 80-03-152 (Oct. 29, 1979); *see also* Richard S. Rotherberg, *Crummey Powers Enhance the Usefulness of Trusts for Minors and Life Insurance Trusts*, 15 EST. PLAN. 322-23 (1988) ("An initial notice can . . . satisfy the notice requirement so long as the transfers conform to the description in the initial notice.")

36. Rev. Rul. 81-7, 1981 C.B. 474. Private Letter Ruling 79-46-007 sets forth an illustration of an illusory demand right due to lack of notice. Priv. Ltr. Rul 79-46-007 (July 26, 1979). There, a donor created an irrevocable trust on December 29, 1976, naming his grandson as beneficiary of the trust. Additionally, the trust instrument stated that the beneficiary had the power to demand trust assets up to December 31, 1976. In considering the circumstances under which the gift was made, the Service noted the donee's ignorance of his power to demand the trust corpus and the short period of time in which he could exercise such power. The Service stated that the donee had not received a present interest in the property because the donee's right to immediate use of the property was dependent upon his knowledge of the right. The ruling further stated that the donor's conduct was an indication of his intent to transfer a future interest in the property. Thus, the gift could not qualify for an annual exclusion. *Id.*; *see also* Rev. Rul. 81-7, 1981 C.B. 474 (holding that the donee's ignorance of the existence of his or her withdrawal powers "makes the demand right illusory and effectively deprives the donee of the power," thereby preventing the applicability of the annual exclusion).

37. Priv. Ltr. Rul. 80-03-152 (Oct. 29, 1979); Priv. Ltr. Rul. 80-24-084 (Mar. 21, 1980); Priv. Ltr. Rul. 80-04-172 (Nov. 5, 1979); Priv. Ltr. Rul. 90-30-005 (July 27, 1990).

38. Cristofani v. Commissioner, 97 T.C. 74 (1991).

39. Rotherberg, *supra* note 35, at 323. (stating that written acknowledgement of the receipt of the notice will protect the taxpayer in any future audit).

40. Whiteside, *supra* note 27, at 284 (stating that the types of property that can be transferred in trust are "almost unlimited."); *see also* Rotherberg, *supra* note 35, at 325-27. Crummey powers are primarily utilized in connection with life insurance trusts. *Id.* Such trusts hold life insurance policies during the life of the insured and the proceeds are distributed to the beneficiaries of the policies upon death of the

er, in establishing Crummey Trusts the applicability of the annual exclusion is further conditioned upon the availability of sufficient liquid assets.[41] These assets include cash or assets convertible to cash which may be used in the event that the beneficiary chooses to exercise his withdrawal rights.[42] Assets that do not pose any problems include cash and marketable securities.[43] Assets such as real estate and art works are not clearly divisible and thus fail the nature of assets test unless the trust instrument provides for a clear means of partition and withdrawal.[44] The requirement of availability of liquid assets may also be satisfied by permitting a trustee's sale, encumbrance, loan, mortgage, or other distribution in order to satisfy the exercise of the demand right.[45] If non-liquid assets are contributed to the trust, the demand right may be considered illusory, rendering the transfer that of a future interest.[46]

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insured. *Id.* The assets transferred to the trust consist of the cash necessary for the premium payments. *Id.* Although these premium payments are considered to be a gift to the beneficiary, granting the withdrawal rights to the beneficiary permits the payments to go untaxed as present gifts. *Id.* Furthermore, settlors of such trusts can transfer enormous portions of their wealth without incurring estate taxes, since the value of life insurance proceeds is not included within their taxable estate. *Id.* However, for the transfer to be considered a present gift, the donee must be able to withdraw the contract or a partial interest in the contract. *Id.*

41. Priv. Ltr. Rul. 81-18-051 (Feb. 9, 1981); Priv. Ltr. Rul. 81-03-074 (Oct. 23, 1980); Tech. Adv. Mem. 84-45-004 (June 27, 1984); *see also* Moore, *supra* note 35, at § 1101.1. The withdrawal right may be exercised with reference to both newly transferred property and existing trust assets, in order to qualify for the annual exclusion. *Id.*

42. Moore, *supra* note 35, at § 1101.1; *see also* Tech Adv. Mem. 84-45-004 (June 27, 1984); Priv. Ltr. Rul. 81-18-051 (Feb. 9, 1981); Priv. Ltr. Rul. 81-03-074 (Oct. 23, 1980).

43. Rotherberg, *supra* note 35, at 323.

44. *Id.*

45. Ernest Szarwark, *Drafting Crummey Powers: The Current Rulings Scene*, 5 NOTRE DAME EST. PLAN. INST. 483, 491 (1983) (stating that if liquid funds are not available, the beneficiary may be deprived of the power to withdraw unless the trustee is empowered to sell or borrow against the trust assets); *see also* Priv. Ltr. Rul. 78-26-050 (Mar. 29, 1978). In cases where life insurance policies are the assets of the trust, the "nature of assets" test is satisfied if the trustee can satisfy a beneficiary's exercise of his demand power by borrowing against the value of the policies and conveying to the beneficiary either cash or an interest in the policies. *Id.*; *see also* Priv. Ltr. Rul. 84-45-004 (June 27, 1984) (stating that asset availability is ensured if the trust instrument gives the trustee power to sell or encumber the trust property to satisfy the beneficiaries' demand).

46. *See* Priv. Ltr. Rul. 81-18-051 (Feb. 9, 1981); Priv. Ltr. Rul. 81-03-074 (Oct. 23, 1980); Tech. Adv. Mem. 84-45-004 (June 27, 1984); *see also* Pamela H. Benya, *How to Qualify Gifts In Trust As Present Interests for the Gift Tax Exclusion*, 7 EST. PLAN.

Once a donor drafts a trust instrument containing a power of withdrawal, and once the requirements of notice, opportunity to exercise, and availability of assets are satisfied, the donor may avail himself of the benefits of the annual exclusion. However, courts have constantly wrestled with the legitimacy of a trust established with the primary motive of avoiding estate and gift taxes.

D. *Case History*

As estate planners developed this innovative tax avoidance technique, an important issue before the courts was whether such transfers in trust constituted transfers of a present interest. This issue was of primary importance in cases involving minors as the beneficiaries of the trust since they were not likely to exercise their withdrawal power.[47]

1. Supreme Court Precedent

On several occasions the United States Supreme Court has been asked to determine whether a gift in trust qualifies for the annual exclusion. In *Fondren v. Commissioner*,[48] the Supreme Court was called upon to determine whether a transfer to a trust in conjunction with granting withdrawal powers to the trustee constituted the transfer of a present interest.[49] The Court stated that the concept of present interest does not refer solely to having a "vested interest;" rather the donee must obtain a "substantial present economic benefit" evidenced by "the right to presently use, possess, or enjoy the property."[50] The *Fondren* Court further stated that in determining whether a transfer of a present interest has occurred, one must consider the surrounding circumstances

194, 198 (1980) (stating that "it is possible that a trustee's ability to invest illiquid or non-transferable assets could be viewed as creating a defeasible demand right incapable of valuation . . . and therefore [creating] a future interest.).

47. Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968). The *Crummey* court stated that in cases involving minors as beneficiaries of the trust, it is extremely doubtful that a demand for funds will be made. *Id.*

48. 324 U.S. 18 (1945).

49. In *Fondren*, the trustors created a trust for the benefit of their seven grandchildren. *Id.* at 18. The trust provided that the trustee could distribute the corpus and income of the trust to the beneficiaries during their minority upon a showing of need on the part of the beneficiary. *Id.* at 22. The settlors claimed that an annual exclusion was applicable for the transaction because the trustee's power to apply the funds for the benefit of the children qualified the transaction as a transfer of a present interest. *Id.* at 23-24. The Tax Court held that the transfer constituted a transfer of a future interest. *Id.* at 19. The circuit court affirmed the Tax Court's decision. *Id.* The Supreme Court affirmed.

50. *Id.* at 20; *see also* Ryerson v. United States, 312 U.S. 405 (1941); United States v. Pelzer, 312 U.S. 399 (1941).

as well as the specific terms of the trust.[51] The circumstances surrounding the trust in *Fondren* revealed that the parents of the minor beneficiaries were quite capable of providing financial support for the beneficiaries, and thus the contingency triggering the distribution of the trust's funds was not likely to occur.[52] Because the surrounding circumstances demonstrated that such withdrawal was unlikely, the Court held that the beneficiaries did not in essence have the right to use, possess or enjoy the property, and thus did not receive a present interest.[53]

The Supreme Court next addressed this issue in *Commissioner v. Disston*,[54] where it reaffirmed *Fondren*.[55] The *Fondren* and *Disston* Courts adopted a substance over form analysis to ascertain whether a transfer would be characterized as a transfer of a present interest. These decisions were consistent with the Court's long standing policy favoring the substance of a transaction over its legal form.[56]

2. Circuit Court Decisions

Following the *Fondren* and *Disston* decisions, the circuit courts continued to hand down contradictory and irreconcilable holdings with respect to the use of Crummey Trusts as a vehicle for tax avoidance.[57] This divergence of opinion was based on the controversy over whether

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51. *Fondren*, 324 U.S. at 21-22.
52. *Id.* at 22.
53. *Id.* at 22-25.
54. 325 U.S. 442 (1945).
55. In *Disston*, the Court encountered a trust similar to the one created in *Fondren* and reaffirmed its decision by holding that a consideration of the surrounding circumstances was essential to determination of the type of interest transferred. *Id.* at 449. The Court stated that "[i]n the absence of some indication from the face of the trust or surrounding circumstances that a steady flow . . . of income to the minor would be required, there is no basis for the conclusion that there is a gift of anything other than for the future." *Id.*
56. Gregory v. Helvering, 293 U.S. 465 (1935). This case established the landmark principle that the substance of a transaction, and not the form, determines the taxable consequences of that transaction. See *id.*; *see also* Higgins v. Smith, 308 U.S. 473 (1940); Deal v. Commissioner, 29 T.C. 730, 736 (1958) (stating that when "determining whether the conveyance in question was a transfer by gift within the meaning of the statute, it is the substance of the transaction which controls"); Rev. Rul. 77-299, 1977-2 C.B. 343 (stating that the substance of the transaction determines whether the transaction is a "bona fide sale" or a gift).
57. *See, e.g.*, Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951); Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952).

extrinsic factors demonstrating the probability that a beneficiary would receive the property should be considered when characterizing the nature of the interest transferred.[58] In *Kieckhefer v. Commissioner*, the Seventh Circuit stated that only the terms of the trust instrument were relevant in determining whether the donor had transferred a present interest to the donee.[59] The court further stated that if the sole impediment to the use of the trust assets is the minority of the beneficiary, and not the terms of the instrument, the gift in trust must be deemed a transfer of a present interest, thereby qualifying for the annual exclusion.[60] Given the "simplicity and predictability" of the test adopted by the *Kieckhefer* court,[61] many circuits followed the same reasoning when faced with similar issues.[62]

Other circuit courts reached results contradictory to *Kieckhefer*.[63] In *Stifel v. Commissioner*, the Second Circuit stated that the circumstances surrounding the creation of a trust are relevant factors in determining the nature of the interest transferred.[64] The court stated that the surrounding circumstances in that case demonstrated the impracticality of the minor's ability to exercise the demand power and held that a transfer of a present interest had not occurred.[65] The court further stated that an analysis of the surrounding circumstances is essential in order

58. Szarwark, *supra* note 45, at 487.

59. *Kieckhefer*, 189 F.2d at 120-22. In *Kieckhefer*, the trustor created a trust naming his infant grandson as the beneficiary. *Id.* at 119. The trust could be terminated at the demand of the beneficiary or his guardian. *Id.* at 120. However, a guardian was never appointed. *Id.*

60. *Id.* at 122.

61. Sherman, *supra* note 9, at 658 (discussing the objectivity of the test applied by the *Kieckhefer* court and its virtues of "simplicity and predictability").

62. *See, e.g.*, United States v. Baker, 236 F.2d 317 (4th Cir. 1956); Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954). In *Gilmore*, the donor established trusts for the benefit of her seven minor grandchildren. *Id.* at 520. The trust instrument provided for payment of the trust corpus and income to the beneficiary upon the beneficiaries' demand. *Id.* The court characterized the beneficiaries' interests as a present interest based on the "right given to the donee, in the trust instrument, to use, possess, or enjoy" the trust property. *Id.* at 522 (citing Fondren v. Commissioner, 324 U.S. 18 (1945); United States v. Pelzer, 312 U.S. 399 (1941)).

63. *See, e.g.*, Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952); Perkins v. Commissioner, 27 T.C. 601 (1956).

64. *Stifel*, 197 F.2d at 110. In that case, the beneficiary of the trust was a minor who was given the right to terminate the trust at anytime by acting through her guardian. *Id.* at 108.

65. Upon looking at the surrounding circumstances, the *Stifel* court discovered that the minor beneficiary was incapable of demanding funds from the trust. *Id.* at 109-10. The court also found that no guardian had been appointed to exercise the demand power on behalf of the beneficiary. *Id.* Furthermore, the court implied that even if a guardian had been appointed, the exclusion could have been denied if the guardian was unlikely to exercise the demand power. *Id.*

to avoid the donor's ability to "make gifts which on paper were 100% present but in practice were 100% future."[66] The *Stifel* court followed a substance over form approach and thus its holding was consistent with the *Fondren* and *Disston* decisions, which were the controlling authority on this issue.

3. The *Crummey* Decision

The Ninth Circuit handed down the most significant decision dealing with this issue in *Crummey v. Commissioner.*[67] In *Crummey*, the taxpayers transferred property to an irrevocable trust, naming their two minor children and two adult children as beneficiaries.[68] In order to qualify for the annual exclusion, the taxpayers granted their children the power to compel immediate distribution of the trust funds within a specified period of time.[69] With respect to the minor beneficiaries, the trust instrument provided that a guardian could make such demand on their behalf.[70] The Commissioner of Internal Revenue challenged the applicability of the annual exclusion to the transfers in trust for the minor children, arguing that since the minors were not likely to exercise their withdrawal powers, a transfer of a present interest had not occurred.[71] The court held that the power to demand distribution of the trust funds and the legal capability of exercising that power are the sole factors taken into consideration for the purpose of characterizing the transfer as that of a present interest.[72] The court further stated that the likelihood of the beneficiary actually exercising withdrawal rights was not relevant in determining the type of interest transferred, reasoning that such a test would be too arbitrary when conducted by the Service.[73] Thus, the court found that the transfers to both the adult and

66. *Id.* at 110.
67. 397 F.2d 82 (9th Cir. 1968).
68. *Id.* at 82.
69. *Id.* at 83-84.
70. *Id.* at 84.
71. *Id.*
72. *Id.* at 88. In so holding, the *Crummey* court rejected both the *Stifel* and *Kieckhefer* approaches and reached a middle ground. The *Crummey* court rejected *Stifel* by stating that the applicability of the annual exclusion was not contingent upon the appointment of a guardian. *Id.* The *Crummey* decision rejected the *Kieckhefer* test by stating that there must be no impediment under the local law to the appointment of a guardian. *Id.*
73. *Id.*

minor beneficiaries were excluded from gift tax under § 2503(b).[74] The *Crummey* decision was significant because the court gave donors judicial approval of utilizing such trusts as a vehicle for estate and gift tax avoidance.

E. An Analysis of the Crummey *Decision*

1. Disregard for Congressional Intent

Using the annual exclusion to transfer wealth free of estate and gift tax is contrary to the Congressional intent in making such exclusion available. As previously stated, the primary purpose behind the gift tax laws was to prevent taxpayers from avoiding estate taxes by reducing their gross estate through inter vivos transfers.[75] An exclusion was allowed in order to avoid the burden of tracking gifts exchanged between family and friends.[76] However, Congress limited the applicability of the exclusion to gifts of present interests because gifts of future interests were more likely to be made for tax avoidance purposes.[77]

One weakness in the *Crummey* decision was its failure to recognize the impact of its holding on the underlying policies of the gift tax laws. First, most taxpayers' motives in the conveyance of property to such trusts is the diminishment of their gross estate and the ensuing avoidance of imposition of estate taxes.[78] Additionally, taxpayers can obtain an exclusion from the payment of gift taxes by granting the beneficiary a lapsing power to withdraw a certain sum within the specified period.[79] Such utilization of the annual exclusion is inconsistent with the underlying reason that inspired Congress to create the exclusion—to avoid keeping track of minor gifts.[80] Furthermore, recognizing the granting of Crummey power as a transfer of a present interest disregards one of the primary grounds for distinguishing present and future interests, that being the placement of an obstacle in the path of tax avoidance.[81] Since Crummey Trusts are used primarily as a device by

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74. *Id.*
75. *See supra* note 9 and accompanying text.
76. *See supra* note 15 and accompanying text.
77. *See supra* notes 24-25 and accompanying text.
78. Harris & Jacobson, *supra* note 28, at 204.
79. Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968).
80. Nicholas A. Vlietstra, Estate of Cristofani v. Commissioner: *The Expanded Potential of Crummey Powers for Transfer Tax Avoidance*, 45 TAX LAW. 583, 595 (1992). "[A]n exclusion was included in the gift tax laws for the express purpose of relieving gift givers of the burden of keeping an accounting of and reporting small gifts made in the course of the year." *Id.*
81. *Id.* Congress denied application of the exclusion to transfers of future interests because such transfers were more likely to be made for tax avoidance purposes. *Id.*

which one can accomplish a tax free transfer of property, the use of such trusts is inconsistent with the policies underlying the creation of estate and gift tax laws.

2. Failure to Follow Precedent

In addition to undermining the purpose behind the estate and gift tax laws, the *Crummey* decision runs contrary to the weight of controlling case law. The *Fondren* and *Disston* decisions represent the Supreme Court's refusal to consider the terms of the trust in isolation from reality; rather, the Court required that the surrounding circumstances be considered when determining whether the transfer constituted a transfer of a present interest.[82] The *Crummey* court, in holding that the granting of "Crummey powers" is sufficient to create a transfer of a present interest, reasoned that it is not necessary to consider the likelihood that the power would be exercised. Rather, it is sufficient that the beneficiary of the trust simply possess the power to exercise the withdrawal rights.[83] The Crummey device is based upon the legal fiction that granting a withdrawal right creates a transfer of a present interest.[84] Many commentators have recognized that the Crummey demand power is a sham in most instances[85] because the nature of the transac-

82. Fondren v. Commissioner, 324 U.S. 18, 24 (1945); *Disston v. Commissioner*, 325 U.S. 442, 449 (1945). It is possible to justify the *Crummey* holding in light of the *Fondren* and *Disston* decisions by drawing a factual distinction between the two cases. *See* John L. Peschel, *Annual Gift Tax Exclusion: Refining the Crummey Power*, 33 S. CAL. TAX INST. 1401 (1981). Peschel notes that in situations such as *Fondren* and *Disston*, where the trustee was empowered to exercise discretion in the distribution of trust assets to single or multiple beneficiaries, the annual exclusion has been disallowed. *Id.* Unlike *Fondren* and *Disston*, in which the withdrawal power was granted to the trustee, in *Crummey* the withdrawal power was granted directly to the donee. Therefore, the determination of whether the transfer is a present interest hinged on the identity of the power-holder. Other commentators have not accepted this distinction, arguing that an analysis of the surrounding circumstances is required in determining whether a transfer of a present interest has taken place, regardless of the identity of the powerholder. *See* Vlietstra, *supra* note 80, at 590. Vlietstra states that given the *Fondren* and *Disston* decisions, it is difficult to understand the court's insistence on avoiding the significance of the surrounding circumstances. *Id.*

83. *Crummey*, 397 F.2d 82, 87-88.

84. Benya, *supra* note 46, at 199 ("[P]owers of withdrawal . . . facilitate creation of present interests in name only, while, in reality creating future interest.").

85. *See, e.g.*, Benjamin N. Henszey, *Crummey Power Revisited*, 59 TAXES 76-77 (1981).

tion typically indicates that the power will not be exercised due to the minor's practical inability to exercise such rights.[86] It is apparent that the *Crummey* court adopted a form over substance approach in determining whether a present interest had been transferred.[87] Since, the *Fondren* court required a substance over form analysis, the *Crummey* holding is contrary to controlling precedent.

F. *The Service's Position on the Issue*

Even though the *Crummey* decision displays disregard for the significance of precedent and legislative intent, the Service has recognized the holding as a valid decision.[88] The Service has recognized the application of the annual exclusion to transfers of property in trust for a minor if the minor has the right to demand the trust funds, even in the absence of a legally appointed guardian, provided that there would be no barrier to the appointment of such guardian.[89] Although such a ruling by the Service is not binding precedent on the courts, if the courts are faced with this issue in the near future,[90] they may utilize the Service's rulings to illustrate that the receipt of the Crummey power of withdraw-

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86. Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to Value Lines*, 43 TAX L. REV. 241, 344. Dodge stated that the "rationale [behind *Crummey*] defies common sense because even if the minor is informed of her rights it is extremely unlikely that the minor would be willing or practically able to exercise the rights." *Id.* Dodge further stated that "an unexercised inter vivos general power of appointment [should] not be treated as the equivalent of ownership for federal transfer tax purposes." *Id.* at 345.

87. Lloyd. L. Plaine, *How to Take Full Advantage of the Increased Exclusion for Gifts of Present Interests*, 27 TAX'N FOR ACCT. 366 (1981) (stating that the application of the present interest doctrine "elevates form over substance" by characterizing some interests as present interests even though such characterization is not proper).

88. The Service accepted the *Crummey* outcome in 1973. Rev. Rul. 73-405, 1973-2 C.B. 321, *rev'g* Rev. Rul. 54-91, 1954-1 C.B. 207; *see also* Priv. Ltr. Rul. 80-04-172 (Nov. 5, 1979); Tech. Adv. Mem. 79-02-007 (Sept. 26, 1978); Priv. Ltr. Rul. 78-26-050 (Mar. 29, 1978).

89. Rev. Rul. 73-405, 1973-2 C.B. 321. The ruling was based on Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); United States v. Baker, 236 F.2d 317 (4th Cir. 1956); and Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951). The ruling stated that:

> [I]t is now concluded that a gift in trust for the benefit of a minor should not be classified as a future interest merely because no guardian was in fact appointed. Accordingly, if there is no impediment under the trust or local law to the appointment of a guardian and the minor donee has a right to demand distribution, the transfer is a gift of a present interest that qualifies for the annual exclusion allowable under § 2503(b) of the code.

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

90. Stark v. Commissioner, 86 T.C. 243, 250-51 (1986); Neuhoff v. Commissioner, 75 T.C. 36, 46 (1980), *aff'd*, 669 F.2d 291 (5th Cir. 1982).

al is equivalent to the receipt of a present interest.[91]

The Service's acknowledgment that the grant of a Crummey power to a trust beneficiary created a transfer of a present interest was based upon previous court decisions which recognized that the right to obtain property upon demand was tantamount to the actual ownership of the property.[92] The Service extended the application of this rule to minors in Revenue Ruling 54-400, stating that the legal disability of minors does not prevent the exclusion from applying to gifts made to such minors.[93]

Although the Service has acquiesced in the *Crummey* decision, the Service's requirements of notice and the opportunity to exercise makes the validity of such trusts more restrictive than that set out by the *Crummey* court.[94] As a basis for this requirement, the ruling stated that the donor's intent is a significant factor in determining whether the circumstances demonstrate that a transfer of a present interest has taken place.[95] Lack of adequate notice and opportunity to exercise one's demand power is an indication of the donor's intent to deprive the donee of the right to present enjoyment of the trust property.[96] Although the Service has approved of the *Crummey* decision, it continues to deprive donors of the benefit of the annual exclusion if the circumstances reveal that such power was not intended to be exercised. Given

91. Tele-Communications, Inc. v. Commissioner, 95 T.C. 495, 510 (1990) (stating that although Private Letter Rulings are not an authoritative force of law, the court can consider them in reaching the outcome of the case); *see also* Cristofani v. Commissioner, 97 T.C. 74, 81 (1991) (stating that a previous ruling was a strong impetus in the court's determination that a lapsing power to demand possession of trust assets constitutes a present interest).

92. Burnet v. Guggenheim, 288 U.S. 280, 283-84 (1933); Corliss v. Bowers, 281 U.S. 376, 378 (1930). The *Corliss* court stated that "if a man disposes of a fund in such a way that another is allowed to enjoy the income" then "[t]he income that is subject to a man's unfettered command and that he is free to enjoy at his own opinion may be taxed to him as his income, whether he sees fit to enjoy it or not." *Id.*

93. Rev. Rul. 54-400, 1954-2 C.B. 319. "An unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest; and disabilities placed upon minors by State statutes should not be considered decisive in determining whether such donees have the immediate enjoyment of the property or the income therefrom." *Id.*

94. *See supra* notes 35-37 and accompanying text.

95. Rev. Rul. 81-7, 1981-1 C.B. 474. "[T]he donor's intent, as gleaned from the circumstances of the transfer, is a relevant consideration in determining when the rights actually conferred are meant to be enjoyed." *Id.*

96. *Id.*

the Service's reluctance to entirely sanction Crummey Trusts, the boundaries of the usefulness of such trusts remain an open ended question.

III. TESTING THE BOUNDARIES OF *CRUMMEY*

The scope of the utility of Crummey Trusts remains ambiguous.[97] The effectiveness of a Crummey Trust as a mechanism for estate and gift tax avoidance is greatly dependent upon the identity of the individuals who qualify as the beneficiaries of such trusts. Generally, the greater the number of potential beneficiaries, the greater the amount of wealth that may be transferred devoid of estate and gift taxation.[98] The class of eligible beneficiaries can substantially increase if there is no requirement that the beneficiaries of such trusts have a beneficial interest in the trust separate from their withdrawal powers. A recent tax court decision and Revenue Ruling indicate controversy as to whether the holders of Crummey powers must have a beneficial interest in the trust.[99]

A. *The* Cristofani *Decision*

In the recent decision of *Estate of Cristofani v. Commissioner*, the Tax Court further expanded the effectiveness of Crummey Trusts as a mechanism for estate and gift tax avoidance.[100] The trustor in *Cristofani* granted Crummey powers to her two children, who were the primary beneficiaries of the trust, and her five grandchildren, who were contingent beneficiaries.[101] The Tax Court, following the *Crummey*

97. Mason, *supra* note 34, at 574. Mason states that "[t]here has been little law defining the scope of the demand right rule articulated in *Crummey*. Thus, many questions remain unanswered or inadequately addressed." *Id.*

98. Matthew V. Ressegieu, *Utility of Crummey Trusts Expanded by New Decision*, 20 TAX'N FOR LAW. 136 (1991).

99. Cristofani v. Commissioner, 97 T.C. 74 (1991); *see infra* notes 100-03 and accompanying text; *see also* Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987); Tech. Adv. Mem. 90-45-002 (July 27, 1990); *infra* notes 108-10 and accompanying text.

100. 97 T.C. 74 (1991); *see also* Ressegieu, *supra* note 98, at 136-37 (discussing the impact of the *Cristofani* decision on transfer tax avoidance).

101. *Cristofani*, 97 T.C. at 75-76. The trust assets were to go to the trustee's children upon her death, but in the event that either child did not survive her by 120 days, that child's shares would be distributed to the child's issue. *Id.* at 76. The interests of the grandchildren were, therefore, contingent remainders. "A contingent remainder . . . is an interest which, in addition to being dependent upon the termination of the prior estate, depends upon the resolution of some other contingency before the owner of the interest is entitled to take in possession." JOHN T. GAUBATZ & IRA M. BLOOM, ESTATES, TRUSTS, AND TAXES: CASES AND MATERIALS ON THE WEALTH TRANSMISSION PROCESS, § 10-7 (1983). A vested interest is "one in which the right of

reasoning, held that the contingent beneficiaries' legal ability to exercise their withdrawal rights was sufficient to create a transfer of a present interest, thereby invoking the application of the annual exclusion.[102] Thus, the donor was permitted to claim seven gift tax exclusions of $10,000 each for two successive years.[103]

B. Consequences of Holding Contingent Beneficiaries as the Legitimate Donees of a Crummey Trust

The *Cristofani* decision has transformed the Crummey Trust into a much more powerful and useful device for transfer tax avoidance than it was when first judicially approved. The decision extended the class of eligible beneficiaries to include those possessing a mere contingent remainder in a trust by holding that such beneficiaries holding Crummey powers have received a present interest.[104] Based on this decision, a donor can easily multiply the number of annual exclusions available to him through the conveyance of contingent interests which have a slight likelihood of vesting, thereby transferring substantial amounts of wealth devoid of estate and gift taxation.[105] Following *Cristofani*, the number of exclusions one can obtain is merely restricted by the number of people who will most probably not exercise their demand rights.[106] Furthermore, if the *Cristofani* decision is permitted to stand, the same rationale may apply to cases involving withdrawal rights not coupled with any type of interest in the trust, that is, a "naked withdrawal right".[107] Thus, permitting holders of Crummey powers

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the owner of the interest . . . to take possession is absolutely determined." *Id.*

102. *Cristofani*, 97 T.C. 74, 79-82; *see also* Crummey v. Commissioner, 397 F.2d. 82, 88 (9th Cir. 1968).

103. *Cristofani*, 97 T.C. at 84-85.

104. *Id.* at 82.

105. Vlietstra, *supra* note 80, at 585. Even though a donor takes a risk that a powerholder may exercise withdrawal rights, the donor can easily minimize such risks by cautiously selecting persons to whom such rights will be granted. *Id.* at 585 n.15.

106. Mason, *supra* note 34, at 593 ("[O]ne can, without altering the intended disposition in a real way, obtain as many exclusions as one can find people who will not exercise their demand right.").

107. James C. Cavanaugh & Robert J. Preston, *When Will Crummey Transfers to Contingent Beneficiaries be Excludable Present Interests?*, 76 J. TAX'N 68-69 (1992); Fiore, *supra* note 26, at 13; John E. Ramsbacher, *Crummey Powers for Contingent Beneficiaries Ok'd*, 19 EST. PLAN. (1992) ("*Cristofani* does not stand for the premise that naked powers qualify for present interest annual exclusions, although logic

without a beneficial interest in the trust to qualify as eligible beneficiaries allows taxpayers to avoid estate and gift taxation through the fabrication of annual exclusions.

C. *The Service's Position*

Attempts by taxpayers to multiply the number of annual exclusions have consistently been rejected by the courts and the Service.[108] When a donor confers withdrawal powers to a beneficiary who does not hold a sufficient interest in the trust, there is a manifestation that the donor's sole motive is to multiply the number of annual exclusions, thereby compelling the Service to reject the applicability of the exclusion under those circumstances.[109] These rulings apply in cases where the beneficiaries of the trust have no beneficial interest in the trust assets or hold only a contingent remainder in the trust.[110] Given the

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dictates that this should be permitted.").

108. The Service has ruled that the creation of reciprocal withdrawal powers by multiple grantors does not effectively create multiple annual exclusions. Rev. Rul. 85-24, 1985-1 C.B. 329. In this Revenue Ruling, two brothers created trusts for the benefit of their children and each brother granted to his nephew a withdrawal power not coupled with any interest in the trust property. The Service disallowed exclusions for the nephews who held naked withdrawal powers. *Id.*; *see also* United States v. Estate of Grace, 395 U.S. 316 (1969) (discussing reciprocal withdrawal powers).

Similar attempts to avoid taxation have been nullified by the courts. In Heyen v. United States, 945 F.2d 359 (10th Cir. 1991), a donor issued stock to 29 persons, 27 of whom immediately reissued the stock to members of the donor's family. The Tenth Circuit held that this was an unsuccessful attempt by the donor to multiply the number of annual exclusions available to him, and thus amounted to tax fraud. *Id.* at 365.

109. *See* Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987); Tech. Adv. Mem. 90-45-002 (July 27, 1990). Both Memoranda hold that the gift tax exclusion only applies to transfers wherein the powerholders are primary beneficiaries with a sufficient interest in the trust property. *See also* Moore, *supra* note 35, at ¶ 1101.1. Moore discusses the types of interests which may qualify as sufficient beneficial interest. For example, a beneficiary entitled to distribution of income or principal on a discretionary basis is considered to have a sufficient beneficial interest. A beneficiary who will be entitled to the future interest in the trust corpus is also considered to have a sufficient beneficial interest. Finally, a beneficiary who would be entitled to take a share of the trust property only upon the death of the primary beneficiaries of the trust will probably not have a sufficient beneficial interest *Id.*; *see also* Lynn K. Pearle, *Crummey Withdrawal Powers—Recent Developments*, 13 EST., GIFTS, & TR. J. 49, 50-51 (1988) (discussing the requirement of sufficient beneficial interest and the impact of Tech. Adv. Mem. 87-27-003).

110. Tech. Adv. Mem. 91-41-008 (June 24, 1991); Tech. Adv. Mem. 90-45-002 (July 27, 1990); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987). In the 1987 Technical Advice Memorandum, the trustor granted Crummey withdrawal rights to individuals having no beneficial interest in the trust and claimed 16 annual exclusions. A number of beneficiaries attempted to exercise their withdrawal power, but upon a discussion with the

controversial nature of the Crummey device and the Service's strong opposition to the expansion of such trusts, it is probable that the Service will request legislative action limiting the utility of Crummey Trusts in order to terminate such blatant abuse of the annual exclusion.[111]

D. *Arguments Opposing Proliferation of the Annual Exclusion Through the Expansion of Eligible Beneficiaries*

1. The Expansion is Not Supported by Case Law

As a basis for its holding, the *Cristofani* court placed considerable reliance on the reasoning set forth by the *Crummey* court.[112] Given the significant factual distinctions between the two cases, the court's reliance on *Crummey* cannot be justified.[113] While the beneficiaries in *Crummey* possessed a "substantial future economic benefit," the interest of the contingent beneficiaries in *Cristofani* was not vested and there was a high probability that it would never vest.[114] The *Cristofani* court rejected this "probability" principle by stating that the vesting probability is irrelevant. Rather, the court held that the only relevant factor to consider in determining whether there has been a transfer of a present interest is the beneficiary's legal right to exercise the demand power.[115] Given the significant distinctions between the two cases, the *Cristofani* court should have conducted a thorough analysis of the surrounding circumstances prior to concluding that the contingent beneficiaries had received a present interest in the trust. The court's failure to recognize this vital distinction between *Crummey* and its own case has the effect of transforming Crummey Trusts into a much more powerful tax avoidance tool than originally contemplated by the *Crummey*

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trustee, retracted their request. The Service rejected the eligibility of the beneficiaries due to lack of sufficient beneficial interest. *Id.* In AOD 1992-09 (Apr. 6, 1992), the Service acquiesced in the *Cristofani* result because, if it chose to appeal, it would have to do so in the Ninth Circuit where *Crummey* was originally decided. *Id.*

111. *Contingent Remaindermen Get Crummey Demand Rights Too*, 17 TR. MGMT. EST. & GIFT TAX'N J. 91 (1992).

112. Cristofani v. Commissioner, 97 T.C. 74, 79-82 (1991); Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

113. Vlietstra, *supra* note 80, at 591 ("[T]he difference between the interests of the beneficiaries in *Crummey* and those in *Cristofani* is significant enough that the court should have adopted a more comprehensive test in determining whether the grandchildren had received gifts of other than a future interest.").

114. This argument was raised by the Service in *Cristofani*, 97 T.C. at 82.

115. *Id.*

court.

The *Cristonfani* court also cited *Perkins v. Commissioner*[116] as supporting authority for its holding.[117] However, *Perkins* does not support the position of the *Cristofani* court. While the *Perkins* court specifically stated that "the circumstances surrounding the creation of the trusts and the making of the gifts are relevant factors to be considered along with the trust instruments themselves,"[118] the *Cristofani* court insisted that such extrinsic factors were not pertinent.[119] Thus, there is a lack of support for the *Cristofani* court's determination that the circumstances surrounding the creation of such trusts are not relevant considerations in analyzing the nature of the interest transferred.

Although there is a lack of guidance with respect to determining the identity of those qualifying as legitimate donees of a Crummey Trust, the one case that touched upon this issue was completely disregarded by the *Cristofani* court.[120] In *Jacobson v. United States*, the donees had the power to transfer their interests in the trust to their children, thus allowing the children to have immediate access to the assets of the trust.[121] The *Jacobson* court held that the taxpayer could not avail himself of the annual exclusion, reasoning that the exclusion is restricted to cases where the persons benefiting from the exercise of the demand power are also principal beneficiaries of the trust.[122] The court found that the children of the grantor, not the grandchildren, were the beneficiaries of the trust.[123] Although *Jacobson* does not have precedential value for the tax court, commentators have noted that the case was

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116. 27 T.C. 601 (1956).

117. *Cristofani*, 97 T.C. at 80.

118. Perkins v. Commissioner, 27 T.C. at 605. The *Perkins* court stressed the significance of the circumstances surrounding the gift in determining whether it constituted a transfer of a present or future interest. *Id.* at 605. The court considered several factors extrinsic to the trust instrument, including the trustee's failure to distribute any assets to the beneficiary, the beneficiary's failure to exercise his right to withdraw, the impracticality of the minor's ability to demand funds, the ability of the beneficiary's parents to provide financial support, and the failure to appoint a guardian to exercise such rights on behalf of the minor beneficiary. *Id.* at 604. However, the *Perkins* court characterized the transaction as a transfer of a present interest because the beneficiary's parents had the right to demand the trust funds, and such demand could not be legally resisted. *Id.* at 605.

119. *Cristofani*, 97 T.C. at 81.

120. *Jacobson v. United States*, 78-2 U.S. Tax Cas. (CCH) ¶ 13,256 (D. Neb. 1978).

121. *Id.* The taxpayer in *Jacobson* contended that such power vested in the donee was similar to Crummey power and thus entitled him to an annual exclusion. *Id.*

122. *Id.*; *see also* Mason, *supra* note 34, at 590-92. Mason points out that the difficulties associated with drawing distinctions between principal and secondary beneficiaries results from the court's failure to provide guidelines as to how this distinction must be made. *Id.* at 591.

123. *Jacobson*, 78-2 U.S. Tax Cas. (CCH) ¶ 13,256.

entitled to be mentioned by the *Cristofani* court, especially given the fact that its application could have altered the outcome of the *Cristofani* decision.[124]

The lack of support from applicable case law and the court's disregard for cases that could have altered its holding leave the *Cristofani* decision vulnerable to attack.

2. Relevance of the Donor's Intention

An alternative argument raised by the Service in *Cristofani* was that the creation of a contingent interest in a trust is an indication of the donor's intention not to confer actual benefits on those holding such an interest.[125] Rather, the donor displayed an intention to procure tax benefits by multiplying the number of annual exclusions available to him.[126] Such contentions have been rejected on the grounds that a donor's tax saving motive is irrelevant in ascertaining the tax consequences of a transaction.[127] However, given the excessive abuse of the annual exclusion for transfer tax avoidance, a greater scrutiny of the donor's intentions is justified.

Additionally, in order to give effect to the substance of a transaction, as opposed to its legal form, the courts have considered the donor's intent relevant under certain circumstances.[128] In *Deal v. Commissioner*, the taxpayer transferred property to her children and received a series of demand notes in exchange for the purchase price.[129] The taxpayer nullified the notes one by one in an amount equal to the annual gift tax exclusion.[130] The Tax Court concluded that the donor was not entitled to the annual exclusion because there was never an intention

124. Vlietstra, *supra* note 80, at 593. Vlietstra notes the factual distinctions between *Jacobson* and *Cristofani*, yet he concludes that since *Jacobson* was the only case that had considered secondary beneficiaries as eligible donees, the case deserved to be mentioned. *Id.*

125. *Cristofani*, 97 T.C. at 84.

126. *Id.*

127. *Cristofani*, 97 T.C. at 84; Perkins v. Commissioner, 27 T.C. 601 (1956). The *Perkins* court stated that "regardless of the petitioners' motives, or why they did what they in fact did, the legal rights in question were created by the trust instruments and could at any time thereafter be exercised. Petitioners having done what they purported to do, their tax-saving motive is irrelevant." *Id.* at 606.

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

129. *Id.* at 731-32.

130. *Id.* at 732-34.

to enforce the notes.[131] The entire value of the transaction was considered to be a taxable gift in the year of the alleged sale.[132] Based on the *Deal* rationale, the donor's intent should be a relevant consideration in assuring that the substance of a transaction prevails over its legal form.

3. Implied Illusory Demand Right

The Service's refusal to extend *Crummey* benefits to contingent beneficiaries is an illustration of its determination to ensure that the substance of a transaction takes precedence over its legal form.[133] A contingent beneficiary's failure to exercise his demand power evidences the existence of a collusive agreement between the donor and the beneficiary that the right will not be exercised, thereby rendering the right illusory.[134] Given the fact that the beneficiary's interest may never vest, it is not logical to assume that the beneficiary has simply chosen not to exercise this lapsing right.[135] In light of the excessive abuse of the Crummey power, the existence of a collusive agreement should be presumed, thus shifting the burden of proving the non-existence of such understanding to the taxpayer.[136] However, the *Cristofani* court held that the existence of such an agreement will not be implied in the absence of direct evidence of such fact.[137] The Tax Court's decision in

131. *Id.* at 734.

132. *Id.* at 736-37.

133. Cavanaugh & Preston, *supra* note 107, at 70.

134. *Id.* In a relevant ruling, the Service stated that the annual exclusion does not apply to cases where the beneficiaries' rights are illusory. Rev. Rul. 81-7, 1981 C.B. 474; *see also* Tech. Adv. Mem. 90-45-002 (July 27, 1990); Tech. Adv. Mem. 91-41-008 (July 24, 1991) (developing the collusive agreement argument). In Technical Advice Memorandum 91-41-008, the trustor established a trust naming her three children as primary beneficiaries and her 32 grandchildren as contingent beneficiaries, and thereby attempted to transfer $350,000 free of gift taxes. *Id.* The Service disallowed the exclusion, reasoning that logic implicated an implied understanding that the beneficiary would not exercise such rights. *Id.*

135. Cavanaugh & Preston, *supra* note 107, at 70 (stating that a contingent beneficiary's failure to exercise his withdrawal demonstrates the existence of an agreement to refrain from exercising such power). *See also* Jeffrey N. Pennell, *Recent Wealth Transfer Tax Developments*, *in* SOPHISTICATED ESTATE PLANNING TECHNIQUES (ALI-ABA Course of Study, Sept. 17, 1992), *available in* Westlaw, File No. C766 ALI-ABA 253.

136. *But see* Mason, *supra* note 34, at 596. Mason provides two reasons as to why the burden of proof should not be judicially or statutory modified. First, it is likely that the Service will refrain from challenging demand rights based on existence of such agreements. Second, the Crummey demand right has been firmly established within the legal system and many have relied on it. *Id.*

137. *See Cristofani v. Commissioner*, 97 T.C. 74, 77 (1991); *see also Linderme v. Commissioner*, 52 T.C. 305, 307 (1969) (stating that the government must present "adequate grounds for inferring an agreement" in order for the existence of an agree-

Cristofani allows an inference that the existence of a legal fiction prevails over the substance of the transaction.[138] Since the Supreme Court has held that the legal form of the transaction must yield to its substance, this decision is contrary to the weight of controlling precedent.[139]

IV. SUGGESTED REMEDIES FOR THE *CRUMMEY/CRISTOFANI* PROBLEMS

Since Crummey Trusts have undermined the policy underlying the gift tax statutes and have failed to follow precedent, judicial or legislative action is necessary to limit their use as a tax avoidance device and to further the policy goals behind the statutes. This Comment discusses possible solutions available to the legislature or the judiciary should they encounter this issue in the near future.

A. *Elimination of Crummey Trusts*

One alternative available to the legislature or the judiciary is absolute elimination of the Crummey Trust.[140] Various commentators support this view based on the argument that a donor who wants to give another the alternative to accept a gift may do so informally, without the aggravation of creating a formal trust.[141] This contention implies that transfers to a trust in conjunction with the granting of Crummey Powers is primarily a tax avoidance maneuver.

Some commentators have noted that the validity of Crummey Trusts cannot be questioned given the current definition of present and future interests.[142] These scholars argue that a gift should qualify as a transfer of a present interest if at the moment of the transfer, the donee has

ment to be implied).

138. Cavanaugh & Preston, *supra* note 107, at 70.

139. *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); *see also* Deal v. Commissioner, 29 T.C. 730, 736 (1958).

140. Pennell, *supra* note 135, at § 13.1.

141. Vlietstra, *supra* note 80, at 594; *see also* Boris I. Bittker, *The $10,000 Per-Donee Gift Tax Exclusion*, 44 OHIO ST. L.J. 447, 463 (1983) ("[I]n *Crummey* the beneficiaries, whether adults or minors, were obviously not expected to exercise their rights under the demand clause, if that had been contemplated, the donor would undoubtedly have made outright gifts to the beneficiaries rather than have put the funds into the trust and watch them flow out immediately thereafter.").

142. *See* Sherman, *supra* note 9, at 664-66; B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 124.4.3 at 124-22 to 124-23 (1984); *see supra* notes 18 and 22 for definitions of future and present interests, respectively.

"entire legal and equitable title to the property."[143] Therefore, a mere power to withdraw assets from a trust cannot qualify as a present interest.

Critics of this proposal contend that this alternative would encourage taxpayers to seek different means of transferring gifts free of gift taxation.[144] For instance, a donor may transfer assets to several people with the understanding that such people would transfer it to the intended beneficiary.[145] However, since recent cases have held that such attempts to circumvent gift taxes constitute tax fraud, many taxpayers will be more reluctant to use this method as a means of tax avoidance.[146] Thus, confining the applicability of the annual exclusion to situations in which the donee receives the entire legal and equitable title to the property can operate to cease such conspicuous misappropriation of the annual exclusion.

B. Limiting the Utility of Crummey Trusts

A second alternative is to impose limitations on the utility of Crummey Trusts. The Joint Committee on Taxation has suggested a modification of the meaning of the term "present interest" for purposes of the annual gift tax exclusion.[147] Based on this new definition, in order for a gift coupled with a Crummey demand power to qualify for the annual exclusion, the beneficiary must have the power to exercise his withdrawal rights for life.[148] If this proposal is enacted into law, the powerholder would have a continuing right of withdrawal over the transferred property.[149] Furthermore, this proposal would grant to the beneficiary of the trust complete control over the trust assets and terminate the grantor's ability to qualify a sham transfer as a conveyance

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143. Sherman, *supra* note 9, at 664-66; *see also* Mason, *supra* note 34, at 598 (stating that "the creation of a general power of appointment in another—which is what a demand right is—cannot give rise to an annual exclusion"); Dodge, *supra* note 86, at 344 (stating that a general power of appointment should not be considered akin to outright ownership of property, arguing that such reasoning "defies common sense").

144. Mason, *supra* note 34, at 598 ("the effect of the proposed rule is to channel the evaders into . . . alternative abuse[s]").

145. *Id.* This method of avoidance is commonly referred to as the "conduit method." *Id.*

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

147. STAFF OF JOINT COMM. ON TAXATION WITH THE STAFF OF COMM. ON WAYS & MEANS, 100TH CONG., 2D SESS., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMMITTEE ON WAYS AND MEANS 269 (Comm. Print 1987), *microformed on* CIS No. 87-H782-24 (Congressional Info. Serv.) [hereinafter JOINT COMM. PRINT].

148. *Id.* "Possible proposal[:] Require that the power of withdrawal last until the death of the donee in order to characterize an interest as a present interest." *Id.*

149. Moore, *supra* note 35, at § 1106.

of a present interest.[150] The threat of the actual exercise of the demand power in conjunction with the donor's loss of control over the trust property would deter taxpayers from avoiding estate and gift taxation through such inter vivos transfers.

C. *Applying a Substance Over Form Analysis*

The third solution is to apply a substance over form analysis in determining whether an actual transfer of a present interest has occurred. This test would require the court to analyze the surrounding circumstances to determine the character of the interest transferred.[151] If the donee's right to demand the trust assets is unlikely to be exercised due to a prior understanding with the donor, or due to basic obstacles, the donee's right is, in essence, a "hollow" one.[152]

Critics of this approach have argued that this tactic would afford the courts too much discretion.[153] Furthermore, given the tremendous economic burdens associated with investigating the circumstances surrounding each individual transaction, the Service has manifested a preference for avoiding such inquiry whenever possible.[154] Although the substance over form analysis of each individual transaction may encourage taxpayers to refrain from such manifest avoidance of taxes, the administrative and economic difficulties associated with such a policy make it an impractical solution.

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150. JOINT COMM. PRINT, *supra* note 147, at 269. As a basis for its argument, the Committee stated that the present interest requirement of the annual exclusion is meant to ensure that the donee actually obtains control over the gift. *Id.* A second basis for the proposal was that the Crummey withdrawal power is often used as a means of avoiding gift or estate taxes. *Id.*; *see also* Pearle, *supra* note 109, at 52 ("The real significance of this proposal . . . [is] the shift of control that would result from giving the powerholder a lifetime withdrawal power.").

151. This test was applied by the Supreme Court in two cases: Disston v. Commissioner, 325 U.S. 442 (1945), and Fondren v. Commissioner, 324 U.S. 18 (1945).

152. Vlietstra, *supra* note 80, at 594. The article states that "[t]he gift of such a specious interest is, in reality, no gift at all." *Id.*

153. *See* Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968).

154. Kathleen F. Bay, *Crummey Powers, Annual Exclusions, and The Need For a Continuing Interest In Trust*, 2 PROB. & PROP. 10-11 (1988). Although the Service may reach decisions by making factual determinations on each particular case, it prefers a legal holding which could enable it to avoid being forced to consider the surrounding circumstances in similar factual scenarios. *Id.* at 11.

D. *Per Donor Annual Exclusion*

The final approach proposed to terminate the use of the annual exclusion for the purpose of substantial estate and gift tax avoidance is to place limitations on the annual exclusion available to each individual donor.[155] Recent Joint Committee on Taxation proposals have suggested that a $30,000 per donor limit be imposed on the availability of the annual exclusion.[156] Furthermore, in order to avoid creating a policy which would characterize a society as one of tax evaders, an exclusion may be established for *de minimis* transfers or transfers for "consumption, support, or welfare."[157] This proposal discontinues the use of the annual exclusion for gifts of "business property, real estate, life insurance, annuity contracts or transfers into or through a trust," which are in essence a transmission of wealth to successive generations.[158]

In addition to terminating the manipulation of the annual exclusion for gift and estate tax avoidance, this proposal recognizes and remedies the inequity between cases involving donors with sizable families and cases involving donors with smaller families. Under the per-donee exclusion rule currently in effect, donors with large families may transfer greater amounts of wealth free of estate and gift tax than donors with smaller families.[159] Furthermore, such donors are more capable of avoiding the progressive estate tax rates through inter vivos transfers to each donee.[160] Thus, replacing the per-donee annual exclusion with a flat per-donor annual exclusion assists in preventing taxpayers from

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155. Pennell, *supra* note 135, at § 13.1.

156. Joint Committee on Taxation, Staff Explanation of Miscellaneous Tax Proposals Scheduled for Hearing Feb. 21-22 before House Ways and Means Committee's Subcommittee on Select Revenue Measures, (JCS-4-90); *see also* Harrison, *supra* note 14, at 376 (discussing the 1990 Joint Committee on Taxation Proposal); Warren G. Lamont, *Transfer to Partner Account Qualifies For Gift Exclusion*, 17 EST. PLAN. 206 (1990) (discussing the use of the annual exclusion for transfer tax avoidance and the possibility of preventing such tax avoidance techniques by converting to a per donor annual exclusion).

157. Dodge, *supra* note 86, at 343-44. Dodge proposes a $5,000 per donee exclusion for gifts of "consumable items," and "an unlimited exclusion for 'support type items' (such as lodging, food, transportation, etc.)" provided to individuals who reside with the donor. *Id.* Dodge also suggests an exclusion for educational expenses including room and board, and an exclusion for medical expenses. *Id.*; *see also* K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395, 401 (1988) (discussing converting to a per donor annual exclusion); Milton L. Ray, *The Transfer-for-Consumption Problem: Support and the Gift Tax*, 59 OR. L. REV. 425, 448-50 (1981) (discussing the enactment of transfer-for-consumption exclusion).

158. Dodge, *supra* note 86, at 344.

159. Mason, *supra* note 34, at 605.

160. *See* Sherman, *supra* note 9, at 674-75. (stating that the per donee annual exclusion impairs the progressivity of the transfer tax system due to substantial inter vivos transfers made by the wealthy).

overtly abusing the annual exclusion as a means of tax avoidance.

Although the proposed solutions set forth above may cease the misuse of the annual exclusion for gift and estate tax avoidance, those opposed to such revisions contend that current gift and estate tax burdens imposed on beneficiaries already deter such evasive actions.[161] The final portion of this Comment considers the tax burdens imposed on the beneficiary, and the impact of such burdens on the donor's attempts to secure cooperation.

V. ESTATE AND GIFT TAX CONSEQUENCES TO BENEFICIARIES OF CRUMMEY TRUSTS RESULTING FROM THE LAPSE

A significant concern associated with Crummey Trusts are the accompanying estate and gift tax burdens imposed on powerholders upon the lapse of the withdrawal power. Due to these burdens, the trustor may have difficulty in securing participation in this tax avoidance plan.[162] Although, these adverse tax consequences can be significant, sections 2514(e) and 2041(b)(2) of the Internal Revenue Code shield the greater of $5,000 or five percent of the trust's assets, out of which the lapse could have been exercised, from such unfavorable tax consequences.[163] However, problems associated with the adverse tax consequences continue to exist despite the protection afforded by Internal Revenue Code sections 2514 and 2041, because the amounts contributed to such trusts generally exceed the amount shielded under the Code.[164] The

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161. Vlietstra, *supra* note 80, at 586 n.18.

162. *Id.* ("The possessor of a demand right does assume some burdens in holding the right to withdraw, and therefore the trustor's ability to enlist cooperation in his scheme may be limited to some extent.").

163. I.R.C. § 2514(e) provides in relevant part:

> The lapse of a power of appointment . . . 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 of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

I.R.C. § 2514(e) (West 1992); *see also* Rev. Rul. 66-87, 1966-1 C.B. 217 (holding that the five percent limitation on the lapsed power exclusion is based on the income the decedent could have withdrawn from the trust rather than on the corpus of the trust).

164. *See* William Natbony, *The Crummey Trust and "Five and Five" Powers After*

existence of this lapse problem has intensified due to the enactment of the Economic Recovery Tax Act of 1981, which increased the annual exclusion from $3,000 to $10,000 without a corresponding increase in the value of the lapse permitted under Internal Revenue Code § 2514.[165] The adverse estate and gift tax consequences imposed on beneficiaries has driven practitioners to create means of avoidance, that permit taxpayers to obtain the benefits of Crummey Trusts without bearing the costs.

A. *Gift Tax Consequences to the Beneficiary*

Failure to exercise a demand power may generate adverse gift tax consequences for the beneficiary of a Crummey Trust. Under § 2514(c) of the Internal Revenue Code, by virtue of the demand provision in the trust, which may be exercised in favor of the beneficiary, the beneficiary possesses a general power of appointment.[166] The lapse of a power of appointment is deemed to be a release of the power.[167] A release of a power of appointment is considered a transfer of the property to the other trust beneficiaries, thereby resulting in a taxable gift.[168] Further-

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ERTA, 60 TAXES 497, 499 (1982).

165. See *supra* note 16 and accompanying text for a discussion of modifications of the annual exclusions; *see also* Natbony, *supra* note 164, at 497. Natbony states that:

> An unintended effect of the enactment in the Economic Recovery Tax Act of 1981 ("ERTA") of an increase in the Section 2503(b) annual exclusion involves the interaction of the gift tax annual exclusion and *Crummey* trust powers with the gift and estate tax powers of appointment and grantor trust rules. The seemingly innocuous change made by ERTA, raising the annual exclusion from $3,000 per annum to $10,000 per annum, creates new complexities in tax planning.

Id. Prior to the enactment of ERTA, donors could transfer a maximum of $6,000 (gift splitting included) free of gift tax. *Id.* at 499. However, in order to come within the limitation of §§ 2514(e) and 2041(b)(2), the transfer was limited to $5,000. Thus, the donor was deprived of taking full advantage of the annual exclusion. *Id.* After ERTA, donors may transfer a maximum of $20,000 free of gift tax. *Id.* The significant divergence between the $20,000 annual exclusion and the $5,000 limitation has resulted in new complications in tax planning. *Id.*

166. Section 2514(c) provides that a general power of appointment is the "power which is exercisable in favor of the individual possessing the power . . . , his estate, his creditors, or the creditors of the estate . . . ." I.R.C. § 2514(c) (West 1992).

167. Section 2514(e) of the Code provides that "[t]he 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." I.R.C. § 2514(e) (West 1992). A release is defined as a "complete, permanent, and unrestricted giving up of all power of appointment over the property." Henry J. Lischer, *The "Crummey Trust"*, 4 EST., GIFTS & TR. J. 17, 20 n.20 (1979).

168. *See* Treas. Reg. § 25.2514-3(c)(4) (as amended in 1986) (A beneficiary who allows the lapse of the Crummey power is deemed to have made a gift transfer to

more, such transfers would be characterized as gifts of future interests, and thus not qualify for the annual gift tax exclusion.[169] Therefore, if a donor transfers $30,000 to a trust for the benefit of his three children and grants to each of the beneficiaries a lapsing power to withdraw $10,000, then upon the lapse of the withdrawal power each beneficiary is considered to have made a taxable gift to the other beneficiaries of the trust.

The lapse problem becomes more complicated where the beneficiary of the Crummey Trust is a minor, because relevant Treasury Regulations indicate that a beneficiary's incapacity as a minor prevents the lapse of the demand power from being considered a taxable transfer.[170] Despite the apparent meaning of this regulation, practitioners generally hesitate to significantly rely on it because the "present interest doctrine" requires that a legal guardian be available to compel distribution of the trust funds in favor of the minor beneficiary.[171] Thus, in cases involving minor beneficiaries, similar to cases involving adult beneficiaries, the lapse of the power of withdrawal effectively results in a taxable gift being made to the other trust beneficiaries, thereby deterring potential beneficiaries from taking part in this tax avoidance scheme.

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the other beneficiaries or remaindermen of the trust.). Section 2501 of the Code imposes a tax "on the transfer of property by gift." I.R.C. § 2501(a)(1) (West 1992). The taxpayer has the burden of showing that a transfer does not give rise to gift tax liability. Natbony, *supra* note 164, at 503.

169. Harris & Jacobson, *supra* note 28, at 206; Moore, *supra* note 35, at ¶ 1104.2. For definitions of future interest, see *supra* note 18.

170. "In any case where the possessor of a general power of appointment is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, and the power may not be validly exercised or released on his behalf, the failure to exercise or release the power is not a lapse of the power." Treas. Reg. § 25.2514-3(c)(4) (as amended in 1986).

171. Edward D. Tarlow & Catherine M. Vacca, *Recent Developments Clarify Tax Effects of Lapse of Crummey Powers, But Problems Remain*, 13 EST. PL. 270-71 (1986); *see also* Rev. Rul. 73-405, 1973-2 C.B. 321. This ruling should be considered when determining whether a taxable lapse has occurred in cases where the beneficiary of the trust is a minor. The ruling states that in order for a contribution to a trust to qualify as the transfer of a present interest, thereby, triggering the applicability of the annual exclusion, there must be no impediment to the appointment of a guardian. *Id.* Under these conditions, the incapacity will no longer be an issue because the guardian can exercise the demand power on behalf of the minor beneficiary. Thus, the incapacity of the minor will not prevent the occurrence of a taxable lapse. *See* Treas. Reg. § 25.2514-3(c)(4) (as amended in 1986).

1. Statutory Relief for the Lapse Dilemma

Sections 2514(e) and 2041(b)(2) of the Internal Revenue Code provide relief for this lapse problem by stating that the lapse of a general power of appointment is a taxable event only to the extent that the value of the property subject to the power exceeds the greater of $5,000 or five percent of the aggregate value of the trust's assets.[172] Thus, if a beneficiary of the trust does not exercise his withdrawal power with respect to a $5,000 contribution to the trust, he will not be subject to gift tax liabilities.[173]

This "five or five" power may be used by the beneficiary to escape the negative tax consequences imposed on him. This device can be utilized by limiting the demand power to the amount of $5,000 or five percent of the trust assets.[174] However, the five and five limit is an impediment to a donor's aspiration to take complete advantage of the annual exclusion through contribution of gifts equalling $10,000 (or $20,000 if the spouse joins), unless the corpus of the trust exceeds $200,000 (or $400,000 if both husband and wife are contributing to the trust).[175] For instance, A may transfer $20,000 to a trust for the benefit

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172. I.R.C. § 2514(e) (West 1992); I.R.C. § 2041(b)(2) (West 1992). See *supra* note 163 for text of the statute; *see also* Richard B. Covey, *The Estate Planning Benefits Available Via A "$5,000 and 5%" Withdrawal Power*, 34 J. TAX'N 98 (1971) ("The effect of these two statutes is to grant preferred treatment to a power of withdrawal not in excess of the greater of $5,000 or 5% of the trust principal . . . in the sense that the lapse of the power will not have any adverse estate or gift tax consequences.").

173. Under certain circumstances, if a powerholder receives more than one such withdrawal power, the two powers must be combined for the purpose of determining whether there has been a lapse in excess of the "five and five" restriction. The Service has stated that in cases where multiple contributions are made to a single trust for the powerholder's benefit, those powers will be aggregated. Rev. Rul. 85-88, 1985-2 CB 201. In addition, aggregation will occur if the grantor creates two different trusts for the same beneficiary and grants to the beneficiary withdrawal powers with respect to both trusts. *Id.* The ruling stated that permitting multiple "five and five" exemptions "would elevate form over substance." *Id.* In reaching this conclusion the Service relied on the express language of § 2514(e), which states the five and five exemption applies with respect to "lapse of *powers* during [the] calendar year." I.R.C. § 2514(e) (West 1992) (emphasis added); *see also* Lynn K. Pearle, *New Rulings Affect Use of Crummey Withdrawal Powers*, 10 EST. GIFTS & TR. 179, 179-80 (1985) (discussing the impact of Revenue Ruling 85-88). This aggregation is not necessarily detrimental to an estate plan, since it may result in beneficial consequences by permitting aggregation of the principal of each trust for the purposes of determining the five percent limitations. Roy M. Adams & Scott Bieber, *Making "5 and 5" Equal 20: Crummey Powers after ERTA*, 122 TR. & EST. 22, 25 (1983).

174. Tarlow & Vacca, *supra* note 171, at 271.

175. *See* Benya, *supra* note 46, at 197 (stating that Crummey powers are often used to establish a present interest equivalent to the annual exclusion).

of his four children, and may grant to each child a lapsing power to withdraw $5,000. The maximum amount that can be transferred while avoiding imposition of gift taxes is $20,000—an amount significantly less than the amount of $80,000 eligible for the annual exclusion (assuming gift splitting is available). The disparity between the $10,000 annual exclusion and the five and five exception has caused a great deal of tension for estate planners who commonly used the five and five rule as an avoidance device, thereby inducing them to pursue other means of avoidance.

2. Additional Avoidance Devices

At first glance it may appear as though the tax burdens imposed on the beneficiary of Crummey Trusts compensate for the grantor's ability to avoid gift and estate tax laws through the creation of such trusts. However, various methods have been used by tax practitioners to avoid such adverse gift tax consequences on the power holder.[176]

A grantor may take full advantage of the annual exclusion to transfer his estate free of estate and gift taxes, yet avoid the adverse tax consequences imposed on the beneficiary by creating a one-beneficiary trust. When the trust has only one beneficiary who will eventually be the recipient of the trust corpus, the lapse of the power does not result in the transfer of property to others.[177] Therefore, no gift tax liability will result.[178]

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176. John Freeman Blake, *Drafting Five or Five Powers for Maximum Flexibility*, 14 TAX'N FOR LAW. 126 (1985) ("[A] major goal of proper drafting is to assure that the lapse of the power is not treated as a gift by the beneficiary, and to assure that the amount includible in the beneficiary-decedent's estate is limited.")

177. Priv. Ltr. Rul. 81-42-061 (July 21, 1981). When "the trust instrument provides that the sole-beneficiary or his estate will receive the trust-corpus, . . . the lapse of the annual demand right (or its release) will not result in a taxable gift . . . ." *Id.*; *see also* Pearle, *supra* note 173, at 180 ("If a trust is created for the benefit of one beneficiary, with that beneficiary or his estate as the ultimate taker, there will be no gift tax consequences under § 2014(e) upon the lapse of a withdrawal power because the beneficiary's lapsed power favors his own estate.")

178. Several disadvantages are associated with using single-beneficiary trusts as a method of avoiding the adverse gift tax consequences imposed on the beneficiary. First, if the beneficiary dies intestate, trust property may revert to the trustor under the state's intestacy statute, thereby eradicating the benefits of the transfer. Tarlow & Vacca, *supra* note 171, at 271. Second, creating separate trusts for multiple beneficiaries increases economic and administrative burdens. *Id.* Third, the trust corpus will be included in the beneficiaries' gross estate under § 2033 of the Code, which states

Another method often employed to avoid gift taxes is the hanging power of withdrawal.[179] Taxpayers may avoid gift tax liability by drafting the trust documents so that the demand right lapses only to the extent that the amount subject to demand exceeds the greater of $5,000 or five percent of the trust assets.[180] Thus, the demand power in excess of the section 2514 exception remains outstanding. For example, a donor may transfer $10,000 in trust for the benefit of his child and limit the lapse in that year to the greater of $5,000 or five percent of the trust corpus. Since the power of withdrawal has not lapsed, no transfer has occurred thereby eliminating imposition of gift taxes.[181] Donors commonly utilize this technique with respect to young donees, since they can allow the power to remain outstanding without apprehension of unwanted exercises of Crummey demand rights.[182] However, since the prolongation of the demand right period may cause the creator of the trust to suffer anxiety based on the possibility that the beneficiary

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that "[t]he value of the gross estate shall include the value of all property to the extent of interest therein of the decedent at the time of his death." I.R.C. § 2033 (West 1992).

179. Richard Covey, *Use of Hanging Powers*, PRACTICAL DRAFTING, Oct. 1982, at 77.

180. Tarlow & Vacca, *supra* note 171, at 271; *see also* Emily F. Johnson, *Estate Planning Issues in a Matrimonial Practice*, *in* WHAT MATRIMONIAL LAWYERS NEED TO KNOW ABOUT BANKRUPTCY, TAX AND CORPORATE LAW ISSUES (PLI Tax Law & Estate Planning Course Handbook Series No. 61, 1992), *available in* Westlaw, File No. 214 PLI/EST 61 ("[T]he portion of the power in excess of '5 and 5' does not lapse in the year in which it arises and, instead, 'hangs' until it can lapse without exceeding the '5 and 5' amount.")

181. Johnson, *supra* note 180, at 61. There are several drawbacks connected with the use of the hanging power of withdrawal as a method of gift tax avoidance. In cases involving adult beneficiaries, the length of time this power is outstanding may entice the beneficiary to exercise such power. Moore, *supra* note 35, at ¶ 1104.2. This may also cause the beneficiary to be taxed on a greater portion of the trust's income than he would have been had the power lapsed within a specific period of time. *Id.*

Under certain circumstances, the Service has questioned the validity of "hanging powers" as a method of gift tax avoidance. Tech. Adv. Mem. 89-01-004 (Sept. 16, 1988). This decision was based on the fact that the primary purpose of the hanging power was to evade imposition of federal gift taxes. *Id.* However, the hanging power in that case provided that "if upon the termination of any power of withdrawal, the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes," then a portion of the power would not lapse. *Id.* The Service's rejection of such use of "hanging powers" was based on public policy grounds. *Id.* (citing Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944)). Several reasons were provided for the contention that the use of hanging powers are contrary to public policy. First, tax officials would be deterred from seeking collection of the taxes because such an attempt would simply void the gift. *Id.* Also, this would require courts to render judgments with respect to moot questions. *Id.*

182. Rotherberg, *supra* note 35, at 325.

may exercise his demand right,[183] donors prefer other tax avoidance devices.

The next alternative for avoiding the adverse gift tax consequences imposed on the beneficiary of a Crummey Trust is to grant the beneficiary a testamentary power of appointment. Upon lapse of the withdrawal power, the beneficiary is considered to have conveyed an interest in the trust property, thus resulting in a taxable gift.[184] A testamentary power of appointment prevents the occurrence of the shifting of interest, thereby escaping the taxable transfer.[185] The beneficiary of a Crummey Trust who holds a testamentary power of appointment can control the identity of the ultimate recipients of the trust assets by designating, by will only, who those recipients will be.[186] Relevant regulations state that when a beneficiary of the trust retains the power to dispose of the property, the purported conveyance is considered an incomplete gift.[187] Since the beneficiary holds the power of disposition over the property, a completed gift will not occur and a gift tax will not be imposed.[188]

However, this avoidance device has negative estate tax consequences. If the beneficiary dies during the period in which the general power of appointment over the trust property is outstanding, then all of the property will be included in the beneficiary's gross estate.[189] Such adverse

183. Moore, *supra* note 35, at ¶ 1104.2.

184. *See supra* notes 166-69 and accompanying text.

185. Adams & Bieber, *supra* note 173, at 23.

186. Priv. Ltr. Rul. 82-29-097 (April 22, 1982). When the trust beneficiaries are empowered to appoint the trust assets through a testamentary transaction, they have retained "dominion and control" over the trust property, thereby thwarting the gift. *Id.*

187. The regulations on this issue state that "if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case." Treas. Reg. § 25.2511-2(b) (as amended in 1983); *see also* Sanford's Estate v. Commissioner, 308 U.S. 39, 43-44 (1939) (holding that the donor's retention of power to revoke or alter the terms of the trust and the donor's ability to modify the ultimate beneficiaries of the trust prevents the completion of the gift, thereby avoiding imposition of gift taxation); Harris & Jacobson, *supra* note 28, at 208 (discussing the impact of granting a testamentary power of appointment to trust beneficiaries).

188. Treas. Reg. § 25.2511-2(b) (as amended in 1983).

189. Section 2041 of the Code provides, in relevant part:

> The value of the gross estate shall include the value of all property . . . [t]o the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21,

estate tax consequences can also be defeated by granting a special power of appointment to the trust beneficiary, as opposed to a general power of appointment.[190] A special power of appointment allows the beneficiary to select a specified class of beneficiaries as the ultimate recipients of the trust assets, for example, his spouse or children.[191] This power will make the gift incomplete and will reduce the potential estate tax liability imposed upon the beneficiary's death.[192] Thus, a special power can operate as an effective method by which one can avoid the imposition of gift tax upon the lapse of the withdrawal power, and contemporaneously reduce the risk of inclusion of trust property in the beneficiary's taxable estate.

Although the imposition of the gift tax liabilities on the beneficiaries of Crummey Trusts may initially deter individuals from cooperating in the donor's tax avoidance scheme, the use of the many avoidance devices at the disposal of estate planners makes such adverse tax consequences virtually disappear. However, in addition to such negative gift tax consequences, estate planners must consider the estate tax consequences imposed on the beneficiaries.

B. *Estate Tax Consequences*

The holder of a Crummey demand power may also suffer adverse

> 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035-2038, inclusive.

I.R.C. § 2041 (West 1992).

190. Adams & Bieber, *supra* note 173, at 23 (stating that a special power of appointment could be utilized in lieu of a general power of appointment in order to minimize the impact of the negative estate tax consequences on the trust beneficiary).

191. A special power of appointment is "a power that could be exercised in favor of persons, not including the donee, who constituted a group not unreasonably large, if the donor did not manifest an intent to create or reserve the power primarily for the benefit of the donee." RESTATEMENT (SECOND) OF PROPERTY § 11.4 (1986).

192. Treas. Reg. § 25.2511-2(c) (as amended in 1983). This regulation provides that a gift is incomplete to the extent that the beneficiary has the power to designate the ultimate recipients of the trust's assets. *Id.* If a primary beneficiary, holding a special power of appointment, passes away while the power remains outstanding, only a fraction of the trust assets subject to the power of appointment will be included in the primary beneficiary's estate. *Id.* The numerator of such fraction is the amount by which the portion lapsed exceeds the "five or five" limitations. The denominator of the fraction is the value of the beneficiary's trust share at the date of death or the alternate valuation date. The amount included in the estate would be calculated by multiplying the fraction by the value of beneficiary's share in the trust at the date of death or alternate valuation date. *See* Treas. Reg. § 20.2041-3(d)(4) and (5) (as amended in 1986); *see also* Adams and Bieber, *supra* note 173, at 23-24.

estate tax consequences by holding a general power of appointment over the trust property. If the beneficiary owns the trust property at death due to termination of the trust, then pursuant to section 2033 of the Code, the trust property will be included in the beneficiary's gross estate.[193] Additionally, if the beneficiary dies prior to the termination of the trust, and the trust instrument provides that the trust property be distributed to the estate of the beneficiary, section 2033 mandates the inclusion of the trust property in the beneficiary's taxable estate.[194] Even if the trust property is not included in the beneficiary's gross estate under section 2033, section 2041 may operate to cause such inclusion. Under section 2041(a)(2), the gross estate of a decedent beneficiary includes the value of demand rights held at the time of death.[195] Thus, if the trust instrument provides a beneficiary with a Crummey power, and the beneficiary dies while the power is operative, the value of the property subject to the demand right will be included in his gross estate. The Service has stated that this rule applies to minors incapable of exercising their demand power.[196] Applicable case law supports the Service's position on this issue, stating that property subject to power of appointment will be included in the gross estate, despite the incompetency of the powerholder.[197]

Furthermore, the value of lapsed demand rights may also be included in the decedent's gross estate.[198] This situation will arise if the nature

193. Section 2033 of the Code states: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." I.R.C. § 2033 (West 1992).

194. *See id.*

195. Section 2041 provides that the value of property subject to a general power of appointment is included in the powerholder's gross estate. I.R.C. § 2041(a)(2) (West 1992).

196. Rev. Rul. 75-351, 1975-2 C.B. 368. This ruling stated that "the value of trust assets at the date of the beneficiary's death is includible in the beneficiary's gross estate under the provisions of section 2041(a)(2) of the Code, even though, under the applicable local law, the beneficiary was legally incompetent to execute a will from the date of creation of the trust until the date of death." *Id.*

197. Estate of Rosenblatt v. Commissioner, 633 F.2d 176, 181 (10th Cir. 1980); Fish v. United States, 432 F.2d 1278, 1280 (9th Cir. 1970); Boeving v. United States, 650 F.2d 493, 495 (8th Cir. 1981); Williams v. United States, 634 F.2d 894, 894 (5th Cir. 1981). *But see* Finley v. United States, 404 F. Supp. 200, 203 (S.D. Fla. 1975) (holding that the incompetency of the powerholder prevents him from possessing the power of appointment; therefore, the appointive property will not be included in his gross estate).

198. Section 2041(a)(2) provides that the gross estate of the decedent shall include the value of all property to which the decedent released a general power of appoint-

of the transfer is such that if it were a transfer of property owned by the powerholder, it would be includible in the powerholder's gross estate under Internal Revenue Code sections 2035 (three year rule),[199] 2036 (retained life estate),[200] 2037 (transfers taking effect at death),[201] or 2038 (revocable transfers).[202] Additionally, section 2041 requires that the lapse of a general power of appointment be considered a transfer for purposes of sections 2035 through 2038.[203]

However, the gravity of estate tax burdens imposed on the beneficiaries generally are not of such significance to dissuade the donees from taking part in this tax avoidance scheme. First, the donee's power to compel distribution of the funds is ordinarily outstanding only for a period of less than two months.[204] Second, donors tend to choose young donees, thus reducing the likelihood that the donee will pass

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ment. I.R.C. § 2041(a)(2) (West 1992). This allows the decedent to continue holding the property in a manner that would have resulted in the property's inclusion under §§ 2035-2038 if the decedent had made the transfer directly.

199. Section 2035 of the Code provides that "the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death." I.R.C. § 2035(a) (West 1992).

200. Under § 2036 of the Code, the gross estate of the decedent includes the value of property transferred by the decedent if he retains the right to income from the property. I.R.C. § 2036 (West 1992). Thus, if the beneficiary has an income interest in the trust and allows a general power of appointment to lapse, the property subject to the power will be included in his gross estate. *Id.*

201. Section 2037 of the Code provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has . . . made a transfer . . . if
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> (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and
>
> (2) the decedent has retained a reversionary interest in the property . . . and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

I.R.C. § 2037 (West 1992).

202. Section 2038 of the Code provides:

> The value of the gross estate shall include the value of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . by the decedent alone or . . . in conjunction with any other person . . . , to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

I.R.C. § 2038 (West 1992).

203. I.R.C. § 2041(a)(2) (West 1992).

204. Mason, *supra* note 34, at 593 n.64.

away before the termination of the trust.[205] Third, since most donees have small estates, the estate will not be taxed based on the unified credit.[206] Furthermore, section 2041(b)(2) excludes the greater of $5,000 or five percent of the trust's assets from inclusion in the gross estate of a decedent.[207] Therefore, the estate tax burdens imposed on the beneficiary do not appear to be so serious as to deter one from aiding the donor in his endeavor to escape estate and gift tax liability.

VI. CONCLUSION

The Crummey Trust is the common technique by which individuals exploit the annual exclusion, transferring substantial amounts of wealth to successive generations free of estate and gift taxation. Such use of the annual exclusion displays extreme disregard for the value of precedent due to the failure to give effect to the substance of the transaction as opposed to the legal form. Additionally, Crummey Trusts undermine the underlying policies of the annual exclusion by permitting it to be used as a vehicle for estate tax avoidance. Furthermore, expanding the class of beneficiaries eligible for Crummey Trusts to include those possessing a mere contingent remainder in the trust transforms such trusts into a much more powerful and useful device for transfer tax avoidance

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205. *Id.*

206. *Id.* Section 2010 of the Code provides that "[a] credit of $192,800 shall be allowed to the estate of every decedent against the tax imposed by section 2001." I.R.C. § 2010 (West 1992). Thus, the first $600,000 of an estate can pass through free of estate tax. *Id.*; *see also* Moore, *supra* note 35, at ¶ 1104.3. Moore states that in the event that such trust property were included in the powerholder's estate, the application of the unified credit and applicable deduction would render the inclusion immaterial for purposes of estate taxation. *Id.* This would most likely occur with respect to young beneficiaries who had no significant assets subject to estate taxation. *Id.*

207. I.R.C. § 2041(b)(2) (West 1992). Section 2041(b)(2) provides:

> 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 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, exceeded in value, at the time of such lapse, the greater of the following amounts:
>
> (A) $5,000, or
>
> (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

Id.

than originally contemplated. Tolerating the continued vitality of such trusts is judicial acquiescence to a sham which frustrates the purposes of the estate and gift tax laws.

Given such blatant abuse of the annual exclusion for purposes of gift and estate tax avoidance, a revision in the tax law is necessary to deter taxpayers from engaging in such tax avoidance schemes. The current estate and gift tax burdens imposed on the beneficiary do not accomplish this objective due to the many avoidance devices at the disposal of estate planners, each of which results in the mitigation of such adverse tax consequences. Such deterrence objectives may be accomplished through the elimination of Crummey Trusts, the limitation of the utility of such trusts, or the conversion to a per-donor exclusion system. The adoption of such alternative proposals will result in the ultimate invalidation of the Crummey Trust.

DORA ARASH