VII. ANNUAL EXCLUSION GIFT PLANNING

A. Introduction

Generally, the gift tax and GST tax annual exclusions permit an individual to give an amount equal to the annual exclusion ($16,000 in 2022) per donee without incurring any gift tax or GST tax liability, provided that the gift is of a present interest. A married donor can annually give up to double that amount ($32,000 for 2022) per donee if the donor's spouse agrees to apply his or her annual exclusion amount by gift-splitting.

Although the annual exclusion amount may seem insignificant, a lifetime giving program that takes advantage of the gift tax and GST tax annual exclusions over a period of years can significantly reduce the donor's transfer tax liability.

This Chapter discusses the following topics related to annual exclusion gift planning:

- Benefits of annual exclusion gifts.
- Annual exclusion gifts to custodial accounts.
- Annual exclusion gifts in trust (*i.e.*, IRC § 2503(c) minor's trusts and *Crummey* trusts).

B. Benefits of Annual Exclusion Gifts

1. Federal Transfer Tax Savings

The use of annual exclusion gifts can result in considerable federal transfer tax savings.

a. <u>Generally</u>. Generally, annual exclusion gifts are not subject to gift tax or GST tax. In addition, because the donor's annual exclusion is applied to a gift before the donor's applicable exclusion amount, annual exclusion gifts do not use up any portion of the donor's applicable exclusion amount. Accordingly, over a period of time, a planned giving program using annual exclusion gifts can remove a significant amount of property from the donor's gross estate without incurring any transfer tax or using up any portion of the donor's applicable exclusion amount. In addition, any future appreciation and income generated by the transferred property is also removed from the donor's gross estate, further reducing the donor's estate tax liability.

> **<u>EXAMPLE</u>:** D gives $13,000 a year in cash to each of D's 3 children, 5 grandchildren, 10 great-grandchildren and 2 friends over the five- year period before D's death. Because of the annual exclusion, none of these gifts are subject to gift tax or GST tax. In addition, D did not use any portion of D's applicable exclusion amount or GST exemption, while effectively removing $1,300,000 from D's estate. Assuming a maximum estate tax rate of 50% at D's death, these annual exclusion gifts saved D's estate $650,000 in federal estate tax. In addition, any income and appreciation generated by the transferred property between the date of gift and D's date of death was also removed from D's estate.

b. **Leveraging the Annual Exclusion With Discounts.** Structuring a gift so that valuation discounts will apply to the transfer enables the donor to "leverage" the amount of property that can be transferred via annual exclusion gifts. For example, a discount for lack of marketability can be used to reduce the value of a business interest.

> **EXAMPLE:** The concept of "leverage" can be illustrated as follows: P makes a gift of limited partnership interests to C. An appraiser determines that a 50% discount is applicable to the limited partnership interests being transferred. Accordingly, each gift of $1 of limited partnership interests represents $2 of underlying value.

c. **Avoidance of Gross-Up Rule.** Another transfer tax benefit of annual exclusion gifts is the avoidance of the IRC § 2035(b) gross-up rule. Under the IRC § 2035(b) gross-up rule, gift taxes paid by the decedent on transfers within three years of death are included in the decedent's estate. Because annual exclusion gifts are not subject to federal gift tax, the gross-up rule is avoided. The advantage of avoiding the gross-up rule is the reduction in estate taxes that would be payable on gift taxes actually paid.

d. **Basis Considerations.** In planning to make any gift, practitioners should weigh the benefit of the transfer tax savings against potential capital gain tax cost that results from the loss of the step-up in basis that would have occurred had the property been subject to estate tax in the donor's estate. Property transferred by gift retains the donor's basis, but in years other than 2010, property transferred at death gets a step-up in basis to the property's fair market value at death. IRC §§ 1014 and 1015. If the donor pays gift tax on appreciated property, however, the donee's basis increases by the portion of the gift tax attributable to the appreciation in the property. Treas. Reg. § 1.1015-1(a)(2). Accordingly, annual exclusion gifts retain the donor's basis.

➔ **Planning Point:** For property transferred by gift, all of the appreciation in excess of the donor's basis (plus any adjustment for gift taxes paid on appreciated property) will be subject to income tax on the sale of the property.

2. State Transfer Tax Savings

Annual exclusion gifts can also reduce a donor's overall state transfer tax liability. This is true because most states impose some kind of death tax (*e.g.*, estate, inheritance, legacy or succession tax) after the donor's death. Not all states, however, impose a gift tax, and those states that impose a gift tax do so at lower tax rates than the death tax rates. Accordingly, making annual exclusion gifts over a period of time can result in considerable state transfer tax savings.

3. Income Shifting

Annual exclusion gifts can help reduce a family's overall income tax liability. This is accomplished in two ways. First, the donor can give income-producing assets to family members in lower income tax brackets. Second, the donor can transfer appreciated assets that will eventually

be sold at a gain to a family member who is subject to a lower capital gains tax rate or who can offset the gain with losses.

➔ **Planning Point:** Practitioners should note that the income tax benefit of shifting income-producing assets to children may be reduced by the Kiddie tax. IRC §§ 1(g) and 63(c)(5).

4. Non-Tax Benefits

As the estate tax exemption increases in the future, the transfer tax benefits of annual exclusion gifts discussed above may not be as compelling for families of more modest wealth. These families, however, may still be compelled to make annual exclusion gifts for non-tax reasons. Some of these reasons include the following:

a. Support Children or Other Beneficiaries. One of the most common non-tax reasons for making annual exclusion gifts is to provide for the support of family members. Donors will still wish to support their children, regardless of the tax consequences.

b. Provide Financial Experience to Beneficiaries. Probably the most important non-tax reason for making annual exclusion gifts is to provide some financial experience to less wealthy and/or less financially sophisticated family members or other individuals. This is especially true if the donor's wealth is considerable, and the beneficiary will eventually receive a significant amount of property. The donor could make annual exclusion gifts to a beneficiary in order to prepare the beneficiary for subsequent transfers of more significant amounts of property. Out of inexperience, some beneficiaries (especially minor beneficiaries) may make bad financial decisions or impulse purchases. These beneficiaries may benefit from learning from their mistakes made in investing or spending these relatively smaller amounts of property. If a beneficiary does not appear to have learned from these mistakes, the donor can adjust his or her gifting program or estate disposition accordingly.

c. Transfer Control of Closely-Held Family Business. Another non-tax reason for making annual exclusion gifts is the gradual transfer of control in a closely-held family business to the younger family generation. By making annual exclusion gifts of business interests, the donor can control which beneficiaries will have ownership interests in the business. This also allows the donor to see how these beneficiaries handle their ownership interests.

➔ **Planning Point:** Practitioners advising clients who wish to make annual exclusion gifts of business interests should be sure that the operating agreement of the business does not prevent the donees from obtaining immediate use, possession or enjoyment of the gifted business interests. A member's (or partner's) inability, under the operating agreement, to: (1) unilaterally withdraw his or her capital account; (2) independently effectuate a dissolution of the business; and (3) sell his or her business interest without the business manager's consent in the manager's sole discretion has been deemed to prevent gifted business interests from qualifying for the gift tax annual exclusion. *Hackl v. Comm'r*, 335 F.3d 664 (7th Cir. 2003).

This result might be avoided by giving a donee the unilateral right to sell his or her entire interest to third parties, subject to a right of first refusal by the entity and/or other interest holders to purchase the interest at the same price and terms as a bona fide offer from a third party. Also, the business manager's discretion to retain funds can be limited to the needs of the business with the balance of the funds being distributed to the interest holders. Alternatively, the business agreement could give each donee the right to withdraw assets from the entity. The right can be limited to the fair market value for the gifted interest and only be available for a limited period of time. Although such a provision might reduce the valuation discount, it should foreclose any argument that the donee does not have the right to the immediate use, possession and enjoyment of the property in the economic sense.

d. <u>Make Donor's Estate More Liquid</u>. Another non-tax reason for making annual exclusion gifts is to shift illiquid assets in order to make the donor's estate more liquid. If the donor's gross estate is significant and is comprised mainly of illiquid assets (*e.g.*, stock in a closely-held business), the estate may have to suffer the hardships of selling these illiquid assets or borrowing funds in order to pay the federal estate tax liability attributable to these illiquid assets. To avoid this problem, the donor could make annual exclusion gifts of the donor's illiquid assets and retain the liquid assets.

C. Annual Exclusion Gifts to Custodial Accounts

1. Background

Most states have adopted either the Uniform Gifts to Minors Act ("UGMA") or the Uniform Transfers to Minors Act ("UTMA"). These Uniform Acts basically authorize gifts of property to a minor without the appointment of a guardian. Generally, the UGMA allows securities, life insurance policies, annuity contracts or money to be transferred to a custodian for the minor's benefit, and the UTMA allows any type of property to be transferred to a custodian for the minor's benefit. The specific types of allowable property transfers vary from state to state.

➔ **<u>Planning Point</u>:** Before advising clients to transfer property to a custodial account for a minor, practitioners should verify what types of property can be transferred under applicable state law.

a. <u>Effecting Transfer</u>. Typically, a donor gives property to a minor under the Uniform Acts by depositing funds or registering assets in the name of an adult individual or a trust company, "as custodian for [MINOR'S NAME] under [NAME OF APPLICABLE UNIFORM ACT]."

<u>EXAMPLE</u>: T transfers $10,000 to a bank account for the benefit of T's minor nephew, N. N's father, B, created the account in Illinois and is the custodian. Title to the account might read as follows: "B, as custodian for N under the Illinois Uniform Transfers to Minors Act."

b. **Typical Provisions.** The custodian is the fiduciary, and the prudent person standard of investment typically applies to the investment and reinvestment of custodial property. The custodian is typically authorized to distribute any portion or all of the property "for the minor's support, maintenance and education" or "as the custodian deems advisable for the use and benefit of the minor." Custodial property must typically be distributed to the donee when he or she reaches majority age (usually 18 or 21). If the donee dies prior to attaining that age, the custodial property must be paid to the donee's estate.

2. Tax Consequences

The tax consequences of a custodial account are as follows:

a. **Estate Tax Consequences.** If the donor is not acting as custodian, the custodial property will be included in the donee's estate at the donee's death. If, however, the donor is acting as custodian at the donor's date of death and predeceases the donee, the custodial property will be included in the donor's estate under IRC §§ 2036, 2038 and/or 2041. Rev. Rul. 59-357, 1959-2 C.B. 212. When donors make related gifts to custodial accounts and appoint each other as custodian to avoid estate tax inclusion, the reciprocal transaction doctrine applies to unwind the transaction. *Exchange Bank & Trust Company v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1982).

> **EXAMPLE:** H and W are married and have one minor child, C. In order to avoid inclusion in each other's estates, H gives 25 shares of stock to W, as custodian for C. W gives 10 shares of stock to H, as custodian for C. H dies. The 25 shares of stock will be included in H's estate even though W is custodian because under the reciprocal transaction doctrine, H effectively retained the same control over the stock as if H had named himself custodian.

b. **Gift Tax Consequences.** A gift to a custodial account for a minor is a completed gift that qualifies for the annual gift tax exclusion to the extent of the annual exclusion amount. Rev. Rul. 59-357, 1959-2 C.B. 212. A donor may split gifts to a custodial account with the donor's spouse. IRC § 2513.

c. **GST Tax Consequences.** A gift to a custodial account for a minor skip person is a completed gift and is a "direct skip" and, thus, qualifies for the annual exclusion for GST tax purposes to the extent of the annual exclusion amount. IRC § 2642(c). Accordingly, a grandparent can make gifts to a custodial account for a grandchild or more remote descendant (or other skip person) without incurring any GST tax liability.

d. **Income Tax Consequences.** The income from custodial property is taxed to the minor, regardless of whether it is actually expended for the minor's benefit. The income is taxed to another individual, however, to the extent the income is used to discharge that individual's legal support obligation. Similarly, the income is taxed to the donor to the extent the income is used to satisfy the donor's obligations. Rev. Rul. 56-484, 1956-2 C.B. 23 *approved in* Rev. Rul. 59-357, 1959-2 C.B. 212; IRC § 677.

➔ **Planning Point:** Practitioners should check applicable state law regarding

a parent's legal obligation to support a minor when determining who is responsible for paying the tax on income from a custodial account.

3. Advantages and Disadvantages

The advantages and disadvantages of gifts to a custodial account are as follows:

a. <u>Advantages</u>. One advantage of gifts to a custodial account for a minor is the ease of transferring property. Proper reference to the applicable Uniform Act incorporates all of its provisions. No separate document (such as a trust instrument) is necessary. Another advantage is that, unlike a guardian, a custodian can typically act without court supervision.

b. <u>Disadvantages</u>. As discussed above, custodial accounts are problematic for federal estate tax purposes if the donor is serving as custodian. Most donors are not aware of this estate tax consequence. Another disadvantage is that some states restrict the types of property that can be contributed to a custodial account. Finally, the most significant disadvantage of custodial accounts is the requirement that the property be distributed at a certain age (usually 18 or 21). Over a period of time, annual exclusion gifts to a custodial account can result in a significant amount of property passing to the beneficiary. Most clients would not desire a significant amount of property to be distributed outright to a beneficiary at such a young age.

D. Annual Exclusion Gifts In Trust

1. Generally

A gift must be a "present interest" (an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property) in order to qualify for the gift tax and the GST tax annual exclusions under IRC §§ 2503(b) and 2642(c). Outright gifts typically qualify for the annual exclusion because the donee has the immediate use, possession and enjoyment of the gifted property. Generally, gifts in trust are gifts of a future interest that do <u>not</u> qualify for the annual exclusion, because the donee does not have the immediate use, possession and enjoyment of the trust property. Gifts to an IRC § 2503(c) minor's trust or a Crummey trust, however, are gifts of present interests and, therefore, <u>do</u> qualify for the annual exclusion. These two types of trusts are discussed below.

2. Gifts to IRC § 2503(c) Minor's Trusts

IRC § 2503(c) allows certain gifts in trust for a minor (an individual under age 21) to qualify for the annual exclusion. IRC § 2503(c) is a statutory exception to the general rule that a gift in trust is a gift of a future interest.

a. <u>Requirements</u>. A gift to an IRC § 2503(c) trust for the benefit of a donee under age 21 is a present interest qualifying for the annual exclusion if <u>all</u> of the following requirements are met:

(1) **<u>Distributions Prior to Age 21</u>.** The property and its income must be expendable by or for the benefit of the beneficiary <u>before</u> the beneficiary reaches age 21.

(a) <u>Either Principal Interest or Income Interest Can</u>

Qualify. IRC § 2503(c) literally requires both the property and its income to be expendable by or for the benefit of the beneficiary prior to age 21. The Regulations, however, allow an annual exclusion to the extent the income interest or the principal interest meets this requirement. Treas. Reg. § 25.2503-4(b)(c).

> **EXAMPLE:** T creates a trust for the benefit of T's minor child, C. All income is to be distributed annually to C, and the entire trust property is to be distributed to C at age 25. Such a transfer is a gift of a present interest qualifying for the annual exclusion with respect to C's right to income but is a gift of a future interest with respect to C's right to corpus.

(b) No Substantial Restriction. The terms of the trust must not substantially restrict the exercise of the trustee's discretion to determine the amounts, if any, of the income or property to be expended for the minor beneficiary's benefit and the purpose for which the expenditure is to be made. Treas. Reg. § 25.2503-4(b)(1). A distribution standard with no objective limitation (*e.g.*, welfare, happiness, or convenience) is not a substantial restriction. Rev. Rul. 67-270, 1967-2 C.B. 349. A more limited distribution standard (*e.g.*, education expenses only, if beneficiary is disabled, or if the beneficiary is not otherwise adequately provided for) would substantially restrict the trustee's discretion and disqualify the trust for the annual exclusion. Rev. Rul. 69-345, 369-1 C.B. 226; *Illinois National Bank of Springfield v. U.S.*, 91-1 U.S.T.C. ¶60,063 (C.D. Ill. 1991).

> **EXAMPLE:** T creates a trust for the benefit of T's minor child, C. The trust provides that the income is distributable to C for his welfare, and the principal is distributable to C for his education only. Such a transfer is a gift of a present interest qualifying for the annual exclusion with respect to C's right to income but is a gift of a future interest with respect to C's right to corpus.

(2) Passes at Age 21. Any portion of the property and the income not expended by or for the donee must "pass" to the donee at age 21.

(a) Extension of Trust After Age 21. The trust need not terminate when the donee reaches age 21 in order to "pass" to the donee at age 21. Treas. Reg. § 25.2503-4(b)(2). The donee's right to withdraw the entire trust property at age 21 will satisfy the requirement that the entire property pass to the donee at age 21. This is true even if the donee's right of withdrawal lasts for a finite period of time after reaching age 21. Rev. Rul. 74-43, 1974-1 C.B. 285.

(b) Passed to Beneficiary Prior to Age 21. IRC § 2503(c) literally requires any portion of the property and the income not expended by or for the donee to pass to the donee at age 21. The Internal Revenue Service ("IRS"), however, has allowed an annual exclusion to the extent such property passes to the donee prior to age 21. The IRS reasoned that IRC § 2503(c) only sets the maximum age requirement at age 21. Rev. Rul. 73- 287, 1973-2 C.B. 321.

(3) Distribution at Death Prior to Age 21. If the beneficiary dies

before reaching age 21, the property and the income must be payable: (a) to the beneficiary's estate; or (b) as the beneficiary may appoint under a general power of appointment.

(a) Lifetime or Testamentary General Power of Appointment Sufficient. A lifetime general power of appointment or a testamentary general power of appointment qualifies. Treas. Reg. § 25.2503-4(b).

(b) No Substantial Restriction on Exercise of Power. If the beneficiary has a general power of appointment, the terms of the trust must not substantially restrict the beneficiary's exercise of that power. Treas. Reg. § 25.2503-4(b).

> **EXAMPLE:** T creates a trust for the benefit of T's minor child, C. The trust terms are as follows: (1) income and principal are distributable to C for his welfare prior to age 21; (2) at age 21, C may withdraw the entire trust property; and (3) at age 20, C will have a testamentary general power of appointment over the trust property. State law allows individuals 18 years of age to execute wills. Accordingly, the trust will not qualify for the exclusion under IRC § 2503(c) because the trust substantially restricts C's right under state law to exercise C's general power of appointment in C's will.

(c) Inability to Exercise Power Due to Disability. The fact that under local law a minor is under a disability and, thus, is unable to exercise a lifetime general power of appointment or to execute a will does not disqualify the trust under IRC § 2503(c). Treas. Reg. § 25.2503-4(b). The possession of general power of appointment is sufficient.

> **EXAMPLE:** T creates a trust for the benefit of T's minor child, C. The trust terms are as follows: (1) income and principal are distributable to C for his welfare prior to age 21; (2) at age 21, C may withdraw the entire trust property; and (3) C has a testamentary general power of appointment over the trust property. State law allows individuals 18 years of age to execute wills. Even though C is under age 18 and cannot execute a will, the trust still qualifies as an IRC § 2503(c) trust, transfers to which qualify for the gift tax annual exclusion to the extent of the annual exclusion amount.

b. Tax Consequences. The tax consequences of an IRC § 2503(c) trust are as follows:

(1) Estate Tax Consequences. IRC § 2503(c) trust property is included in the donee-beneficiary's gross estate because the trust provides that the trust property is payable to the beneficiary's estate or if the beneficiary has a general power of appointment

over the trust property. If the donor serves as trustee, however, IRC § 2503(c) trust property will be included in the donor's estate under IRC §§ 2036 or 2038.

➔ **<u>Planning Point</u>:** The discretionary power the trustee must have to qualify for the exclusion under IRC § 2503(c) would cause the trust to be included in the grantor's estate if the grantor were the trustee. Accordingly, the grantor of an IRC § 2503(c) trust should <u>not</u> serve as the trustee.

(2) <u>Gift Tax Consequences</u>. Obviously, transfers to a properly drafted IRC § 2503(c) will qualify for the gift tax annual exclusion.

(3) <u>GST Tax Consequences</u>. The grantor's transfer of property to an IRC § 2503(c) trust for a skip person (*e.g.*, a grandchild or more remote descendant) can qualify for the annual exclusion for GST tax purposes. A transfer in trust qualifies for the annual exclusion for GST tax purposes if: (a) the transfer is a direct skip; (b) the trust meets the requirements for the gift tax annual exclusion under IRC § 2503(b); (c) no part of the income or principal may be distributed to or for any person other than the skip person-beneficiary; and (d) the trust assets must be included in the skip person-beneficiary's estate if the skip person-beneficiary dies before the trust terminates. IRC § 2642(c). An IRC § 2503(c) trust can be tailored to meet these requirements:

(a) <u>Direct Skip</u>. To qualify for the GST tax annual exclusion, the transfer to the IRC § 2503(c) trust must be a direct skip (*i.e.*, a transfer to a skip person subject to gift tax). A trust is a skip person if: (1) all interests in the trust are held by skip persons; <u>or</u> (2) if no person holds an interest in the trust and at no time after the transfer may a distribution be made to a non-skip person. An IRC § 2503(c) trust with a skip person (*e.g.*, a grandchild or more remote descendant) as sole beneficiary would meet this requirement.

(b) <u>Annual Exclusion Requirement Must Be Met</u>. To qualify for the GST tax annual exclusion, the trust must meet the requirements for the gift tax annual exclusion under IRC § 2503(b). An IRC § 2503(c) trust, by its nature, meets the present interest requirement of the gift tax annual exclusion under IRC § 2503(b).

(c) <u>No Distributee Other Than Skip Person-Beneficiary</u>. To qualify for the GST tax annual exclusion, no part of the income or principal of the IRC § 2503(c) trust may be distributed to or for any person other than the skip person-beneficiary. This requirement is met if the terms of the IRC § 2503(c) trust provide that income and principal are distributable only to or for the skip person-beneficiary.

(d) <u>Included in Beneficiary's Gross Estate</u>. To qualify for the GST tax annual exclusion, the IRC § 2503(c) trust assets must be included in the skip person-beneficiary's estate if the skip person-beneficiary dies before the trust terminates, regardless of when the skip person-beneficiary dies. This requirement is met if the IRC § 2503(c) trust provides that at the skip person-beneficiary's death, the trust property is payable to the beneficiary's estate or as the beneficiary may appoint under a general power of appointment.

<u>EXAMPLE</u>: T creates a trust for the benefit of T's minor grandchild,

G. The trust terms are as follows: (1) income and principal are distributable to G for his welfare prior to age 21; (2) at age 21, G may withdraw the entire trust property; (3) if G dies prior to age 21, the trust property will be payable to G's estate; and (4) on or after age 21, G will have a lifetime general power of appointment over the trust property. The trust will be included in G's estate if G dies before the trust terminates, regardless of when G dies. Accordingly, the trust meets this requirement.

c. **Income Tax Consequences.** The income from an IRC § 2503(c) trust is taxed to the minor if it is distributed to or for the minor. Accordingly, the "kiddie tax" (see IRC § 1(g)) is applicable to an IRC § 2503(c) trust to the extent the income is distributed to or for a minor beneficiary under age 19. The income is taxed to another individual, however, to the extent the income is used to discharge that individual's legal support obligation. Similarly, the income is taxed to the donor to the extent the income is used to satisfy the donor's obligations. Otherwise, the income is taxed to the trust.

d. **Advantages and Disadvantages.** The advantages and disadvantages of an IRC § 2503(c) trust are as follows:

(1) **Advantages.** The main advantage of an IRC § 2503(c) trust is the potential transfer tax savings. Transfers to an IRC § 2503(c) trust will qualify for the gift tax annual exclusion to the extent of the annual exclusion amount ($13,000 in 2010 or $26,000 if gifts are split). If structured properly, transfers to an IRC § 2503(c) trust will also qualify for the annual exclusion for GST tax purposes to the extent of the annual exclusion amount. The transferred funds (and appreciation in value of or income generated by the transferred funds) will be removed from the donor's gross estate.

(2) **Disadvantages.** From a client's perspective, the main disadvantage of an IRC § 2503(c) trust is that the trust property must either be payable to the beneficiary at age 21 or subject to a right of withdrawal at age 21. The concern is that the beneficiary may be too young and financially irresponsible to handle the funds outside a trust. Clients who prefer the funds continue in trust for the beneficiary might instead consider a *Crummey* trust, discussed below.

3. Gifts to *Crummey* Trusts

A variation of the IRC § 2503(c) trust is the "*Crummey*" trust, named after the decision in *Crummey v. Comm'r*., 397 F.2d 82 (9th Cir. 1968). A *Crummey* trust allows certain gifts in trust for a minor to qualify for the annual exclusion without requiring that the trust property be payable to or subject to a right of withdrawal by the beneficiary at age 21.

a. **Background.** Generally, transfers to a discretionary trust (a trust that gives the trustee discretion to distribute income and principal) do not qualify for the annual exclusion because the beneficiary is receiving a future interest. The annual exclusion is available, however, for transfers to such a trust if the beneficiary is given a sufficient right of withdrawal (also called a "demand right") over the transferred property.

(1) **Pre-*Crummey*.** Prior to the *Crummey* case, transfers to a trust subject to such a right of withdrawal by an adult beneficiary qualified for the gift tax annual exclusion. The beneficiary in these cases had a right of withdrawal over the entire trust property at all times.

(2) **Crummey.** The *Crummey* case involved a minor beneficiary with a right of withdrawal and a substantially narrower right of withdrawal than in previous cases allowing the annual exclusion. The right of withdrawal in *Crummey* extended only to the amount of the annual transfer to the trust (not the entire trust property), and the right of withdrawal expired at the end of the calendar year in which the transfer was made. If the right of withdrawal was not exercised by the end of the calendar year, the right lapsed, and the annual transfer was retained in trust. The *Crummey* case allowed the annual exclusion for a minor beneficiary with such a right of withdrawal to the extent of the entire value of the transfer subject to the right of withdrawal. The court reasoned that the issue was whether the beneficiary had a right to enjoy the transferred property, not whether the beneficiary actually enjoyed the transferred property. Subsequent cases and rulings confirm the allowance of the annual exclusion for transferred property subject to such a right of withdrawal, regardless of the age or mental competency of the powerholder. *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970); Rev. Rul. 73-405, 1973-2 C.B. 321.

b. **Rights of Withdrawal.** The typical *Crummey* clause gives the beneficiary a noncumulative right to withdraw part or all of a contribution to the trust for a limited time period. Because it is usually undesirable for the entire trust property to be subject to a right of withdrawal, the *Crummey* clause often limits the amount subject to withdrawal.

(1) **Annual Exclusion Amount.** The trust could limit the amount subject to withdrawal to the amount that would qualify for the gift tax annual exclusion (with or without gift splitting). This limitation is appropriate if the donor does not wish for the beneficiary to have the power to withdraw any more trust property than necessary to qualify for the maximum gift tax annual exclusion.

> **EXAMPLE:** T creates a trust for the benefit of B. The trust terms are as follows: (a) income and principal are distributable to B for his support needs; (b) at age 30, B may withdraw the entire trust property; and (c) B has a noncumulative right to withdraw a portion of each trust contribution not to exceed the gift tax annual exclusion amount. T transfers $5,000 to the trust in 2007 and $13,000 to the trust in 2010. Regardless of whether B exercises his rights of withdrawal, both of T's gifts will qualify for the gift tax annual exclusion.

(2) **Greater of $5,000 or 5% of Trust Property.** The annual lapse of a *Crummey* beneficiary's right of withdrawal in excess of the greater of $5,000 or 5% of the trust property is generally deemed to be a taxable gift by the powerholder. IRC § 2514(e). In order to prevent the lapse of the right of withdrawal from having any negative estate or gift tax consequences for the beneficiary, the amount subject to withdrawal could be limited to the greater of $5,000 or 5% of the trust property each year (a "5 or 5 power"). This is because the failure to exercise a 5 or 5 power is not a taxable gift, and the lapse of such a power will not cause any of

the trust property to be included in the beneficiary's gross estate. IRC §§ 2514(e) and 2041(b)(2). The only drawback to a 5 or 5 power is that the annual exclusion allowed is limited to that amount.

> **EXAMPLE:** T creates a trust for the benefit of B. The trust terms are as follows: (a) income and principal are distributable to B for his support needs; (b) at age 30, B may withdraw the entire trust property; and (c) B has a noncumulative right, exercisable when any transfer is made to the trust, to withdraw the greater of $5,000 or 5% of the trust property. T transfers $12,000 to the trust in 2008 when the entire trust property is worth $80,000. B has a right to withdraw only $5,000 of the $12,000. Accordingly, only $5,000 qualifies for the gift tax annual exclusion.

(3) Unlimited Amount. The trust could provide that the entire transfer is subject to a right of withdrawal by the beneficiary. This would preserve the full benefit of the available annual exclusion amount. The lapse of such a right of withdrawal in excess of the 5 or 5 amount, however, may have adverse estate tax and gift tax consequences to the beneficiary. Such adverse gift tax consequences may be avoided if the beneficiary has a general power of appointment (which prevents the beneficiary from inadvertently making a completed gift upon the lapse of his withdrawal right).

(4) Hanging Power. A "hanging power" can be used to obtain the protection of the 5 or 5 power and the full benefit of the annual exclusion. The hanging power is drafted as a cumulative power of withdrawal that lapses each year to the extent of the greater of $5,000 or 5% of the trust property. The drawback of a hanging power is that the amount subject to a hanging power at the powerholder's death is includible in his or her estate. That drawback may be ameliorated, however, if contributions to the trust cease and annual $5,000 or 5% lapses continue for several years while the powerholder remains alive.

> **EXAMPLE:** T creates a trust for the benefit of B. B has a cumulative annual right of withdrawal over any property transferred to the trust during the year. The withdrawal right lapses at the end of each year to the extent of the greater of $5,000 or 5% of the trust property. T transfers $75,000 to the trust on October 12, 2006 (and B then has a right to withdraw the property). The trust property is worth $80,000 on December 31, 2006. B did not exercise B's right of withdrawal. Accordingly, $5,000 (because $5,000 is greater than 5% of $80,000) lapsed at the end of 2006 with no gift or estate tax consequences to B. B has a continuing power to withdraw $70,000. This power of withdrawal will be included in B's gross estate if B dies while the hanging power is in existence. However, future lapses of powers of withdrawal will decrease the amount includible in B's gross estate.

c. Multiple *Crummey* Powerholders. A trust may have multiple beneficiaries with identical withdrawal rights. Increasing the number of beneficiaries who have *Crummey* withdrawal rights may maximize the number of annual exclusions that may be claimed

with respect to a given transfer in trust. Accordingly, an incentive exists to use more *Crummey* powerholders if the value of assets to be transferred to the trust in a given calendar year will be greater than the amount of a single annual exclusion.

To qualify for the annual exclusion, each beneficiary with a withdrawal right must have a legal right to exercise the withdrawal power. Transfers subject to a right of withdrawal, even such a right held by contingent beneficiary, qualify for the annual exclusion. *Cristofani Est. v. Comm'r*, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 1; see also *Kohlsaat Est. v. Comm'r*, T.C. Memo. 1997-212.

> **EXAMPLE:** T creates a trust for the lifetime benefit of T's child, C. The trust terms are as follows: (1) income and principal are distributable to C for his support needs; (2) at age 40, C may withdraw the entire trust property; (3) at C's death, any remaining trust property is to be distributed to G; and (4) C and C's child, G, each have a noncumulative right to withdraw an amount equal to one-half of the value of any contribution to the trust (but not to exceed, in any calendar year, the amount of the federal gift tax annual exclusion for such year). T transfers $24,000 to the trust in 2008. The entire $24,000 subject to withdrawal, one-half by C and one-half by G, qualifies for the gift tax annual exclusion.

d. Notice and Reasonable Time to Exercise Right of Withdrawal. The beneficiary must have notice of his or her right of withdrawal and have a reasonable amount of time to exercise his or her right of withdrawal before it lapses. Rev. Rul. 81-7, 1981-1 C.B. 474. What is a "reasonable" amount of time varies. IRS rulings have approved withdrawal periods ranging from 30 to 90 days. PLR 8134135; PLR 8015133; PLR 8015133. The *Crummey* case involved a two-week withdrawal period. At least one case held that knowledge of a contribution to a trust and right of withdrawal satisfies the adequate notice requirement. *Holland Est. v. Comm'r*, 73 T.C.M. (CCH) 3236 (1997).

➔ **Planning Point:** Although the beneficiary's knowledge of additions to and right of withdrawal from a trust may be adequate, the trustee of a *Crummey* trust should still give beneficiaries immediate written notice of additions to the trust to secure the gift tax annual exclusion.

e. Tax Consequences. The tax consequences of a *Crummey* trust are as follows:

(1) Estate Tax Consequences. The estate tax consequences of a *Crummey* trust are essentially the same as the estate tax consequences of an IRC § 2503(c) trust. As discussed earlier, the amount subject to withdrawal in excess of the 5 or 5 amount is includible in the beneficiary's estate if the right of withdrawal lapses. IRC § 2041. *Crummey* trust property should not be included in the donor's estate unless the trust income or principal is used to discharge the donor's legal obligations, or the donor is serving as trustee at the donor's date of death (and all discretionary distributions are not limited to ascertainable standards).

(2) **<u>Gift Tax Consequences</u>.** Transfers to a properly drafted *Crummey* trust should qualify for the gift tax annual exclusion to the extent of the lesser of the annual exclusion amount or the amount subject to withdrawal.

➔ **<u>Planning Point</u>:** If a donor intends for a gift of a business interest to qualify for the gift tax annual exclusion, the practitioner must be sure that the transfer is in accordance with the *Hackl* decision, which is discussed earlier in this Chapter.

(3) **<u>GST Tax Consequences</u>.** The donor's transfer of property to a *Crummey* trust for a skip person (*e.g.*, a grandchild or more remote descendant) can be structured to qualify for the annual exclusion for GST tax purposes.

(a) **<u>Direct Skip</u>.** To qualify for the GST tax annual exclusion, the transfer to the *Crummey* trust must be a direct skip (*i.e.*, a transfer to a skip person subject to gift tax). A *Crummey* trust with a skip person (*e.g.*, a grandchild or more remote descendant) as beneficiary would meet this requirement.

(b) **<u>Annual Exclusion Requirement Must Be Met</u>.** To qualify for the GST tax annual exclusion, the trust must meet the requirements for the gift tax annual exclusion under IRC § 2503(b). Transfers to a properly drafted *Crummey* trust, by its nature, would meet the present interest requirement of the gift tax annual exclusion under IRC § 2503(b).

(c) **<u>No Distributee Other Than Skip Person-Beneficiary</u>.** To qualify for the GST tax annual exclusion, no part of the income or principal of the *Crummey* trust may be distributed to or for any person other than the skip person-beneficiary. This requirement is met if the terms of the *Crummey* trust provide that income and principal are distributable only to or for the skip person-beneficiary.

➔ **<u>Planning Point</u>:** Transfers to a single trust with <u>multiple</u> *Crummey* powerholders will not qualify for the annual exclusion for GST tax purposes. To qualify for the annual exclusion for GST purposes, the trust must be created for the benefit of one beneficiary (or segregated into separate trusts if there are multiple beneficiaries).

(d) **<u>Included in Beneficiary's Gross Estate</u>.** To qualify for the GST tax annual exclusion, the *Crummey* trust assets must be included in the skip person-beneficiary's estate if the skip person-beneficiary dies before the trust terminates, regardless of when the skip person-beneficiary dies. This requirement is met if the *Crummey* trust provides that at the skip person-beneficiary's death, the trust property is payable to the beneficiary's estate or as the beneficiary may appoint under a general power of appointment.

(4) **<u>Income Tax Consequences</u>.**

(a) **<u>Powerholder as Trust Owner</u>.** Since the beneficiary of the Crummey trust, through the utilization of the Crummey provision, has a power of withdrawal, the beneficiary will be treated as the owner of that portion of the trust subject to his or her power under

IRC § 678(a). Rev. Rul. 81-6, 1981-1 C.B. 385. IRC § 678 is usually triggered by the mere existence of the power of withdrawal, rather than its exercise or the legal ability to exercise it. Accordingly, the beneficiary must include as taxable income the income to which he or she has a right during the appropriate calendar year (along with a corresponding portion of the trust's deductions and credits). IRC § 671. A specific method is provided for calculating the interest that a beneficiary would have in such a trust as well as the tax consequences of both the income and the corpus rights of withdrawal. See Treas. Reg. § 1.671- 3(a)(3); (b)(3).

> **EXAMPLE:** B, a beneficiary of a *Crummey* trust, holds a power of withdrawal over annual transfers to the trust. Both B and the trust are calendar-year taxpayers. On January 1, the trust receives a $5,000 transfer subject to a power of withdrawal that continues until the end of the year. The corpus of the trust, as augmented by the $5,000 transfer, is $100,000. Under Treas. Reg. § 1.671- 3(a)(3), the beneficiary would include for income tax purposes 5% ($5,000/$100,000) of the trust income, deductions and credits for the year. The 5% figure is the ratio of the property subject to the power of withdrawal over the total value of the trust property.

➔ **Planning Point:** If the trust has no income, deductions or credits (*e.g.*, a *Crummey* trust that holds only insurance on the life of the donor), IRC § 678 will not have any practical application. Furthermore, a *Crummey* power of withdrawal usually is restricted both in scope and in time. The donee can only withdraw the annual contribution to the trust and only for a limited period of time. As a result, if IRC § 678 is applicable, it should have partial application only. *See Oppenheimer v. Comm'r*, 16 T.C. 515 (1951); *Krause v. Comm'r.*, 56 T.C. 1242 (1971). The IRS has addressed this issue only indirectly by stating that the pro rata share of a trust to which IRC § 678 applies "should take into account the length of time during which [the beneficiary] has the power to vest in himself the additions of corpus to the trust." PLR 8142061. In any event, the income tax consequences to the beneficiaries should have little significance in a typical *Crummey* trust that holds only insurance.

Another aspect of the income tax consequences to a *Crummey* powerholder involves powerholders who allow a power of withdrawal to lapse but retain an interest in or a power over the trust that, were the beneficiary the trust's grantor, would trigger the grantor trust rules of IRC §§ 671 through 677. See IRC § 678(a)(2). This would arise in situations in which the powerholder is also, for example, a discretionary or mandatory income beneficiary, a remainder beneficiary or one who holds administrative powers. The IRS appears to have taken the position that the lapse of the *Crummey* power equates to a "contribution" to the trust by the powerholder, making him or her a grantor of that portion of the trust for purposes of current and future income taxes. PLRs 8521060, 8517052 and 200022035. The powerholder is treated in this manner because, when the powerholder allows a power of withdrawal to lapse, the economic result is the same as if the powerholder removed property from the trust and then immediately transferred that same property back to the trust. In the latter situation, the powerholder would clearly be deemed the owner of

that portion of the trust that was withdrawn and then recontributed. When the powerholder in this situation is considered the grantor of a portion of the trust, the income taxation of the powerholder will then be determined like any other grantor of the trust - under IRC §§ 673-677 - not under IRC § 678. See Charles E. Early, Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status, 62 J. of Taxation 198 (1985); David Westfall, Lapsed Powers of Withdrawal and the Income Tax, 39 Tax Law Review 63 (1983). In many *Crummey* trusts, lapses occur annually, and the application of this "recontribution rule" to the powerholder may be increasing each year. Because there is no regulation or ruling of general application that addresses this situation, the outcome of this issue remains unresolved.

(b) Grantor vs. the Beneficiary as Trust Owner. IRC § 677(a)(3) treats a grantor as the owner of any portion of a trust whose income can be used to pay premiums on insurance policies on the grantor's life. If Section 678 also treats the beneficiary as the owner of the same portion of the trust because of a power of withdrawal, one must question who really owns the trust for income tax purposes. This conflict is resolved in favor of the grantor's ownership because IRC § 678(b) states that, if the grantor is otherwise treated as the owner under IRC §§ 673-677 and the beneficiary holds an IRC § 678 power over the same income, the beneficiary's power is disregarded, and the grantor is taxed as the owner of the trust income.

➔ **Planning Point:** Thus, to avoid income tax consequences to *Crummey* powerholders (along with the uncertainties and complexities of IRC § 678(a)), the governing instrument of a *Crummey* trust could be intentionally drafted to create a trust as to which the grantor is treated as the owner of all trust income and principal. After the grantor dies, however, the *Crummey* beneficiaries may find themselves the owners of a significant portion of the trust as a result of prior lapses that occurred while the grantor was alive.

f. Advantages and Disadvantages. The advantages and disadvantages of a *Crummey* trust are as follows:

(1) Advantages. The main advantage of a *Crummey* trust is the potential transfer tax savings without requiring the termination of the trust at a certain age. Transfers to a *Crummey* trust will qualify for the gift tax annual exclusion to the extent of the annual exclusion amount ($13,000 in 2010 or $26,000 if gifts are split). If structured correctly, transfers to a *Crummey* trust will also qualify for the annual exclusion for GST tax purposes to the extent of the annual exclusion amount. The transferred funds (and appreciation in value of or income generated by the transferred funds) will be removed from the donor's gross estate.

(2) Disadvantages. The main disadvantage of a *Crummey* trust is the amount of administration involved (*e.g.*, sending notices to *Crummey* powerholders each year).