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Avoid *Crummey* Mistakes: Take Care in Structuring Trust Withdrawal Powers

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In *Crummey v. Commissioner*, 397 F.2d 82, 88 (9th Cir. 1968), the Ninth Circuit held that a gift in trust qualified for the gift tax annual exclusion because the trust's beneficiaries had the power to withdraw a portion of the gifted assets. Since then, including such withdrawal powers in trusts has become standard operating procedure for estate planners. Despite their advantages, such "Crummey powers" complicate trust drafting and can cause tax problems that extend beyond eligibility for the annual exclusion. Common mistakes include (i) conditioning *Crummey* powers on the beneficiaries' receipt of written notice; (ii) unclear descriptions of the powers; and (iii) failing to address adverse tax consequences caused by releases of such powers.

Crummey Powers Conditioned on Notice

The "*Crummey* notice" has taken on near-talismanic status among estate planners. Certainly, the trustee of a *Crummey* trust should be directed (or at least strongly encouraged) to give each beneficiary holding a *Crummey* power a written notice specifically describing the beneficiary's rights over each transfer to the trust. However, the trust should never condition a beneficiary's withdrawal power on delivery of such notice. Indeed, some of the beneficiaries in *Crummey* likely were not aware of their withdrawal powers; nevertheless, the court ruled that all of the gifts to the trust qualified for the annual exclusion. After *Crummey*, the IRS announced its position that a gift in trust qualifies as a present interest (a prerequisite for the annual exclusion) only if the beneficiary has actual — not necessarily written — notice of the right. Rev. Rul. 81-7; see also PLR 80-22-048.

Since there are circumstances under which written notice may not be necessary, trusts should provide that withdrawal powers are created at the time of the grantor's gift, rather than the trustee's delivery of written notice describing the gift to the beneficiaries. If a trustee is delinquent in delivering *Crummey* notices — or fails entirely to do so — *Crummey* powers created by the grantor's gift may be respected as long as the beneficiaries can demonstrate their awareness of the powers. On the other hand, *Crummey* powers created by delivery of the trustee's notice will fail unquestionably, needlessly sacrificing the grantor's annual exclusions.

Unclear Description of Withdrawal Rights

Generally, grantors create *Crummey* powers solely to obtain the benefit of gift tax annual exclusion. Thus, in many cases, *Crummey* powers are limited by a formula referring to the annual exclusion amount (presently, $13,000 per year, indexed annually for inflation). Regardless of whether the drafter employs a formula or fixed dollar amount, the amount subject to a *Crummey* power must be ascertainable at the time it is exercisable. See Treas. Reg. Section 25.2503-3(c), Ex.(3). If a drafter attempts to base a *Crummey* power on other elements of the grantor's estate plan, the power may fail to achieve its tax objective.

For example, some practitioners condition the amount of each beneficiary's withdrawal right on whether the grantor and his spouse elect to split gifts for the year of the gift: if they elect gift splitting, the withdrawal amount is twice the annual exclusion amount; if not, the withdrawal amount is limited to the annual exclusion amount. At the time of the gift, it is unknown whether the grantor and his spouse will split gifts, since that

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election is made on returns filed after the end of the year in which the gift is made. Consequently, one cannot say at the time of the gift whether the beneficiary will have the right to withdraw the annual exclusion amount or twice the annual exclusion amount; thus, at least half of the desired present interest gift should be disqualified.

If the grantor is married and plans to split gifts, the power should be drafted to permit withdrawal of up to twice the annual exclusion amount, without adjustment for a failure to elect gift splitting. Under such a provision, the beneficiaries' withdrawal rights are easily ascertainable. At worst, the grantor will not split gifts, in which case the withdrawal right is twice as large as necessary — typically not a problem.

Another common mistake is to reduce a beneficiary's withdrawal amount by the amount of the grantor's other gifts to that beneficiary during the year. Unless such adjustments are limited to gifts that predate the creation of the withdrawal power, the grantor effectively is reserving the right to alter the withdrawal power, which not only disqualifies the trust gift from present interest treatment but also creates a potentially serious estate tax problem for the grantor. Even if the adjustments are limited to prior gifts, there remains a practical problem of notifying the trustee of such gifts. Absent special circumstances, it typically is not worthwhile to attempt such *Crummey* power tailoring.

One trust we reviewed provided that each beneficiary's *Crummey* power would lapse the day before the date of the beneficiary's bankruptcy or death. Absent a functioning crystal ball, there is no way to know that a beneficiary will not die (or declare bankruptcy) tomorrow. Thus, the power is not exercisable (and ineffective for tax purposes), since no one can know whether the power exists on any given date. Certainly, this is an extreme example, but the lesson for planners is to take great care in structuring *Crummey* powers to ensure that their scope is consistently ascertainable.

Lapse Problems

While the rules governing the creation and exercise of *Crummey* powers are generally straightforward, the rules governing lapses of such powers are extremely complex. Falling afoul of those rules can create major tax problems including generation-skipping transfer tax problems, which are beyond the scope of this article. Let us focus on two common mistakes: misapplication of the "5 and 5" lapse limit and failing to appreciate the difference between a nontaxable lapse and a taxable release.

The "5 and 5" Exception: Per-Beneficiary, not Per-Trust

The lapse of a withdrawal power is a taxable transfer "only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of … (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which … the exercise of the lapsed powers could be satisfied." This "5 and 5" exception is a per-beneficiary, not per-trust, cap on the amount of lapse that will avoid a deemed gift by the beneficiary to the trust. Rev. Rule 85-88. If a beneficiary has withdrawal rights in multiple trusts, the amount of lapse that will not cause a deemed gift must be calculated based on the aggregate amount available to satisfy the beneficiary's withdrawal rights under all such trusts.

For example, assume a beneficiary has a withdrawal right over two trusts: Trust A, which has a balance of $50,000, and Trust B, which has a balance of $100,000. In each trust, the beneficiary's withdrawal right lapses to the extent of the greater of $5,000 and 5 percent of the trust's assets as of the lapse date. The aggregate lapse is $10,000 ($5,000 in each trust) — which exceeds both $5,000 and 5 percent of the aggregate trust balance ($7,500). Thus, even though each trust individually applies the "5 and 5" limit, the beneficiary has made a $2,500 taxable gift.

To avoid this problem, drafters should design lapse provisions by taking into account all powers of withdrawal held (or to be held) by each *Crummey* beneficiary — even powers in trusts created by other grantors. Powers should be permitted to "hang" until they can safely lapse within the beneficiary's "5 and 5" limit. Ideally, all trusts should preserve the flexibility to alter *Crummey* powers (including lapse provisions) prospectively to account for other powers that may be created — and lapses that may occur — in the future.

Waiver of *Crummey* Powers

A *Crummey* power constitutes a general power of appointment because the beneficiary has the right to "appoint" trust assets to himself. The exercise or complete release of a general power is deemed a gift by the powerholder to the trust. As discussed above, an exception to that rule provides that a "lapse" (in which the power ceases to exist without any action by the powerholder) is not considered a taxable transfer to the extent of the "5 and 5" limit.

Typically, a *Crummey* trust provides that the beneficiaries' withdrawal powers lapse after a specified period of time. However, some practitioners have beneficiaries affirmatively waive their powers. Such a waiver of withdrawal powers constitutes a release, not a lapse — and is thus fully taxable without regard to the "5 and 5" exception. The distinction is clear: allowing powers to "die a natural death" can be safe; "killing" powers is not.

Conclusion

Crummey powers are an extremely popular and effective means of exploiting the gift tax annual exclusion. However, practitioners must take great care to avoid numerous tax traps in structuring and implementing those powers and the pace at which they lapse. ■