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The Case For Eliminating Crummey Powers

Law360, New York (May 28, 2014, 11:30 AM ET) -- The 2015 "Greenbook" — The U.S. Department of the Treasury's Explanations of the Administration's Revenue Proposal — contains a new proposal that would greatly simplify the process of making annual gifts to trusts without the use of any lifetime federal gift tax exemption. In particular, the new proposal would impact the continuing administration of irrevocable life insurance trusts, regardless of when the trusts were created. Although the details may require some modification, the proposal addresses an area that the IRS has been targeting for some time now. Therefore, practitioners should be aware of — and perhaps even support — this development.

About the Proposal

The annual exclusion from gift tax allows a donor to make gifts of up to $14,000 per donee each year, or $28,000 if the donor is electing to split gifts with a spouse.[1] The new Greenbook proposal would eliminate taxpayers' ability to utilize the annual exclusion from gift tax for gifts falling within a new category of transfers.[2] This new category would include transfers into trust (with a few minor exceptions) and transfers of interests in pass through entities and other interests that cannot be immediately liquidated by the donee. Instead, donors would receive a separate aggregate annual exclusion amount of $50,000 for gifts falling within this new category.

This proposal would affect many existing trust structures, most notably irrevocable life insurance trusts. Many life insurance trusts hold nothing more than life insurance policies, and these trusts currently depend upon the use of the donor's gift tax annual exclusion for payment of the insurance premiums. Under current law, utilizing the gift tax annual exclusion for transfers into trust can be complicated, with strict formalities that must be observed and potential tax traps that are often overlooked. The new proposal would eliminate many of these complications, and provide a simple method for annually funding trusts.

Life Insurance Trusts and the Payment of Insurance Premiums

Life insurance trusts are a staple among trusts and estates practitioners. If structured properly, the proceeds of an irrevocable life insurance trust can pass estate tax free on the death of the insured donor without using any of the donor's lifetime gift tax exemption. The insurance proceeds can be used to pay estate tax on the donor's death or provide the donor's heirs with a source of liquidity.

As mentioned above, life insurance trusts are often funded only with life insurance policies themselves, and thus these trusts depend upon continuing gifts from the donor to pay insurance premiums. Yet, the process of paying the insurance premiums is fraught with complications. For example, the gift tax annual exclusion is limited to gifts of a "present interest" in which the donee has the unrestricted right to immediate use, possession or enjoyment of the transferred property.[3] Generally, this "present interest" requirement causes transfers into an irrevocable trust not to qualify for the annual exclusion from gift tax.[4]

If, however, one or more of the beneficiaries are given the power to withdraw contributions made to the trust, the beneficiary is treated as having the right to the immediate use of the transferred property. As a result, regardless of whether the beneficiary actually exercises the power, the transfer to the trust is treated as a transfer of a "present interest," thereby becoming eligible for the annual exclusion from gift tax.[5] These withdrawal powers are often referred to as Crummey powers, a name referencing the U.S. Tax Court case which confirmed their effectiveness.[6]

The IRS has taken the position that for a valid Crummey power to exist, the beneficiary should be given prompt notice of the withdrawal power and a reasonable opportunity to exercise it.[7] While the IRS's position is not necessarily justified by the case law, it often aggressively seeks to enforce strict compliance with these requirements through audits of gift tax returns.[8] Given the IRS's penchant for examining Crummey powers, and the costs associated with defending a contrary position on audit, donors should transfer the funds for payment of the premiums to the trust (as opposed to submitting payment directly to the insurance carrier), and the trustee should then promptly send written notice of the power to the beneficiary.

Potential Adverse Impact on Beneficiaries

Granting a beneficiary a withdrawal power solves the potential gift tax problem for the donor, but this structure still could have adverse tax consequences for the beneficiary. First, under certain circumstances, the use of Crummey powers could result in a portion of the trust income being taxed to the beneficiary.[9]

In addition, to the extent that a beneficiary dies without having exercised the withdrawal power, the assets subject to the unexercised power will be includible in the beneficiary's estate for federal estate tax purposes.[10] To avoid this treatment, Crummey powers often lapse if not exercised within a certain period of time. However, because a beneficiary will be treated as making a taxable gift to the extent that the value of the assets subject to the lapsed power exceeds the greater of $5,000 and 5 percent of the trust value (the “five and five amount”), trusts often have a limit on the amount that will lapse.[11]

To the extent a withdrawal power exceeds the five and five amount, trusts often provide that the beneficiary continues to have a withdrawal power over the excess (a “hanging withdrawal power”). Hanging withdrawal powers will begin to lapse in years in which the transfers to the trust do not exceed the five and five amount. Again, if the beneficiary dies prior to the lapse of the hanging withdrawal power, this could cause the assets subject to such power to be included in the beneficiary’s estate for estate tax purposes.

Hanging withdrawal powers are especially common in life insurance trusts. Life insurance trusts initially hold only life insurance policies (which frequently have no value when contributed), and therefore the five and five amount is often $5,000 at the inception of the trust, even though the donor often needs to contribute more to the trust to pay the insurance premiums.

One way to avoid some of these complexities is to initially fund the trust with liquid assets in addition to the insurance policy. The liquid assets could then be used to pay the ongoing insurance premiums. Alternatively, sufficient liquid assets could be held and invested in the trust so as to cause the five and five amount to match or exceed the amount over which the beneficiary has a withdrawal power. Of course, funding the trust with sufficient liquid assets may require the use of a portion of the donor’s lifetime gift tax exemption. To the extent that the exemption is insufficient, the donor may be subject to gift tax with respect to the transfer of those assets to the trust.

Another solution is to expand the class of beneficiaries who are given withdrawal powers. If the intention is that the donor will contribute a fixed amount to the trust each year (typically, the amount needed to pay the insurance premium), the trust can include enough beneficiaries so that each would only need to be given a withdrawal power over $5,000 annually, thus negating some of the above described estate and gift tax concerns for the beneficiaries. However, the IRS has challenged this type of arrangement in the past, especially where a beneficiary is only included for purposes of increasing the class of persons who have Crummey powers.[12]

Rationale for Eliminating Crummey Powers

The IRS has a long history of strictly scrutinizing trusts utilizing Crummey powers.[13] Thus, it should be no surprise to find a proposal for the elimination of these powers in the 2015 Greenbook. In support of this proposal, the Greenbook cites significant compliance costs for donors, trustees and the IRS. For donors and trustees, there are administrative burdens and costs of giving notice, keeping records and making retroactive changes to a donor’s gift tax profile if an annual gift is disallowed. The costs for the IRS stem from enforcement efforts, primarily via gift and estate tax audits.

In addition to lowering costs, the proposal could raise revenue by limiting the use of the gift tax annual exclusion, thereby arguably subjecting more assets to estate and gift taxation. Estimates show that the Greenbook proposal could generate $2.924 billion in combined cost savings and revenue over 10 years, although it is not clear from these figures what portion would be attributable to the elimination of

Crummey powers, as opposed to the other aspects of the proposal relating to gifts of illiquid assets.[14]

The Greenbook also cites a concern that Crummey powers are being abused. Specifically, beneficiary classes are sometimes expanded primarily for the purpose of increasing the number of annual exclusion gifts a donor can make to a trust. While this is an area that the IRS has a history of challenging, with mixed success, passage of this proposal would have the effect of eliminating the possibility for this perceived exploitation of the rules.

Analysis of the Proposal

The new Greenbook proposal would greatly simplify the process for making annual gifts to a trust without having to use any lifetime gift tax exemption. It would also relieve donors and trustees of certain administrative burdens accompanying the use of Crummey powers, such as complicated record keeping, the need to provide the prescribed notices at each transfer and the need to defend against aggressive IRS gift tax audits. Instead, each donor would be entitled to contribute a fixed amount into trust each year. It's a simple bright line rule that is easy for the IRS to enforce, and would moot many of the potential tax traps that could otherwise impact the donor or trust beneficiaries.

Despite its benefits, the proposal in its current form is likely to be met with opposition from practitioners. First, while the aspect of the proposal which is primarily addressed in this article, namely the treatment of annual transfers into trust and the elimination of Crummey powers, provides the benefits outlined above, the proposal would further limit the use of the gift tax annual exclusion for gifts of interests in pass through entities and other illiquid assets. The inclusion of transfers of illiquid assets in the proposal is presumably an attempt to codify recent IRS success in this area.[15] While the Greenbook describes a host of administrative burdens, tax traps and perceived areas of abuse that accompany Crummey powers, it doesn't provide any rationale for including transfers of illiquid assets in the proposal. A proposal that simply addresses transfers into trust would likely garner more support.

In addition, there may be opposition to the absence of a grandfathering provision for existing trusts that depend upon the use of Crummey powers for payment of insurance premiums. However, grandfathering existing trusts would create dueling regimes, which would undermine one of the primary goals of the new proposal, namely simplicity. This concern may be allayed to some extent if practitioners are satisfied with the amount of the proposed annual exclusion for transfers into trust.

Under current law, the use of Crummey powers can, in many situations, enable the annual transfer of far more than $50,000. The amount of the exclusion may need to be modified to win support for this proposal among practitioners. Yet, it is worth noting that under this proposal, donors would presumably still be able to make use of the gift tax annual exclusion amount for gifts made outside of trust. Thus, depending on a donor's estate planning objectives, the new proposal could, in certain situations, actually allow more assets to be transferred to his or her beneficiaries gift tax-free on an annual basis — the annual exclusion amount outright to the beneficiaries as well as the new $50,000 annual exclusion to a trust for the benefit of the beneficiaries.

Conclusion

Although this particular proposal to eliminate Crummey powers is new to the Greenbook, it addresses an area that the IRS has been targeting for some time now, and is not likely to go away in the near future. While the proposal may require some modification, the concept of simplifying the process for making annual gifts to trusts, especially irrevocable life insurance trusts, without the use of any lifetime federal gift tax exemption, and eliminating the administrative burdens and complicated tax traps that accompany the use of Crummey powers, is one that practitioners should seriously consider supporting.

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[1] I.R.C. § 2503(b); Rev. Proc. 2013-35. These amounts are annually adjusted for inflation.

[2] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, 170-171 (March 2014).

[3] Treas. Reg. § 2503-3(b).

[4] See Treas. Reg. § 2503-3(c).

[5] Rev. Rul. 80-261.

[6] Crummey v. Comr., 397 F.2d 82 (9th Cir. 1968).

[7] Rev. Rul. 81-7.

[8] See, e.g., Turner v. Comr., T.C. Memo 2011-209.

[9] I.R.C. § 678.

[10] I.R.C. § 2041.

[11] I.R.C. § 2514(e).

[12] See, e.g., Cristofani Est. v. Comr., 97 T.C. 74 (1991); Kohlsaat Est. v. Comr., T.C. Memo 1997-212.

[13] Id.

[14] Fiscal Year 2015 Budget of the U.S. Government, 190 (2014).

[15] See Hackl v. Comr., 335 F.3d 664 (7th Cir. 2003), aff'g 118 T.C. 279 (2002); Price v. Comr., T.C. Memo 2010-2; Fisher v. Comr., 195 A.F.T.R.2d 2010-1347 (S.D. Ind., March 11, 2010).
