Ed Morrow on Mikel v. Commissioner: Tax Court approves the mother of all Crummey trusts with 60 beneficiaries

Executive Summary

In *Mikel v. Commissioner*, the Tax Court ruled, on summary judgment, that $1,440,000 of gifted property valued at $3,262,000 qualified for the gift tax annual exclusion, based on 60 beneficiaries' withdrawal rights of $24,000 each (the annual exclusion being $12,000 per year per spouse at the time of gift). This is despite the property apparently being illiquid, many beneficiaries being minors or spouses of immediately family and the trust containing an ambiguous forfeiture clause and complicated religious binding arbitration panel.

This decision is contrary to a prior IRS Chief Counsel Memorandum issued in 2012. It gives further encouragement to practitioners to exploit *Crummey* trusts to the maximum extent, not only for taxpayers with taxable estates, but for those with non-taxable estates who would use such trusts for income tax and asset protection reasons. Conversely, it will also give further ammunition to current Administration "Greenbook" proposals to limit such annual exclusion gifts to $50,000 per donor - no matter how many donees.

Facts of the Case:

The Mikels, husband and wife, gifted three properties in Brooklyn and one in Florida to an irrevocable trust in 2007, with a total value of $3,262,000, the value of one property reported as "on the 2007/2008 New York City Real Property Tax Assessment Rolls" – which apparently the IRS did not contest. The trust contained a fairly standard "*Crummey*" provision which:

- granted each beneficiary the right to withdraw property, including the property transferred, by pro rata formula, limited to "the maximum federal gift tax exclusion under 2503(b)", which was $12,000 at the time;
- required the trustee to give notice of the withdrawal right to all beneficiaries or their guardians within a reasonable time;
- caused the withdrawal right to lapse if not exercised in writing within 30 days of receipt of such notice;
- permitted the trustee to distribute cash or property or borrow to satisfy any demand right;
- included a savings/construction clause outlined the settlors' intent to qualify for the federal gift tax annual exclusion;
- permitted the trustee to exclude beneficiary withdrawal rights with respect to future contributions of property.

The above points are common to nearly every *Crummey* trust drafted since 1968 when the *Crummey* case was decided. However, the last provision is usually an option left with the settlors rather than the trustee. It is not clear whether the trust had "hanging powers" - this was not discussed in the case. The attorney and trustee both signed uncontested affidavits that notices were sent four months

after funding to each beneficiary/guardian pursuant to the trust. Neither the Tax Court nor the IRS argued this four month delay was unreasonable and the actual notice was not an issue for the Court.

The more interesting twist that caused the IRS to argue the annual exclusion failed the present interest requirement is that the trust had an arbitration panel for trust disputes and an *in terrorem* clause. The trust required a beneficiary to submit any dispute that might arise over interpretation of the trust to a *beth din*, which is Hebrew for an arbitration panel comprised of three Orthodox Jewish persons. If the *beth din* issued an adverse ruling, the beneficiary could go to state court. You would think this would be a positive factor to the IRS based on their arguments in prior memoranda, to ensure an enforceable right, but the government argued that exercising this right would trigger an *in terrorem* clause, causing the beneficiary to forfeit all rights in the trust. If true, this would undercut any claim that the beneficiary had a "present interest" in the withdrawal right and make any such present interest "illusory". Let's review the actual clause:

> "In the event a beneficiary of the Trust shall directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner, then in such event the provision herein made for such beneficiary shall thereupon be revoked and such beneficiary shall be excluded from any participation in the Trust Estate * * *."

The Tax Court completely disagreed with the IRS interpretation of the *in terrorem* clause, finding that the clause only bars a beneficiary from enjoying benefits of the trust if he/she files suit to challenge distributions of trust property to another beneficiary, not mandatory ones triggered by a "Crummey" withdrawal request. Because the trust document required the trustee to comply with a beneficiary's exercise of a withdrawal right, required the *beth din* to follow state law and the *in terrorem* clause did not impair a Crummey withdrawal right, $1.44 million of the trust qualified for the annual exclusion.

Commentary

Don't forget the basic garden variety *Crummey* trust!

After clearing away the smoke of *in terrorem* clauses and religious arbitration panels, the result remains that the taxpayers were able to transfer illiquid assets into a trust and qualify for $1.44 million of tax-free gifts (this would translate to $1.68 million in 2015 with the exclusion now adjusted to $14,000 per donor per donee). Assuming the taxpayers remain New York residents, these tax-free gifts may save the family not only 40% federal tax, but may save 16% NY estate tax as well.

The *Crummey* provisions not only included minors as beneficiaries, but spouses of family members as well. There was no discussion as to whether such spouses would continue or be removed as beneficiaries of the trust in the event of a divorce (aka "floating spouse provisions"), which might have also been a logical line of IRS attack.

Should practitioners use forfeiture and in terrorem clauses for Crummey trusts? To interpret the above *in terrorem* clause, the Tax Court resorted to a canon of construction known as *noscitur a*

sociis, a Latin phrase meaning "it is known by its associates". Anytime a court resorts to obscure Latin canons, there is probably an opportunity to draft a clearer trust. Attorneys should draft any such clause to make it crystal clear that any forefeiture/*in terrorem* clause does not apply to impair the withdrawal right. However, narrowly crafted *in terrorem* and forfeiture clauses can be acceptable in *Crummey* trusts. For instance, a practitioner may want any hanging power or other mandatory right aside from a current Crummey power to be eliminated in the event of a creditor attack. While this may cause a minor gift tax event in the event of a hanging power, this may be the lesser of two evils compared to the corpus being seized by a creditor.

The taxpayers did not report the gifts until 2011, after an IRS inquiry. Late filing would not normally be recommended – had the taxpayers not prevailed the late filing penalty would have added $67,238 to their tax bill. Perhaps the taxpayers had initially treated the transfers to the trust as incomplete gifts, since the facts of this case are eerily similar to CCM 2012-08026, discussed in prior LISI #2097, *Jeff Pennell on ILM 201208026 and the Lessons of Rachal v. Reitz*

Could this be the last hurrah for million-dollar *Crummeys*? The IRS has disliked the *Crummey* case and its ever more expansive (abusive?) progeny for decades. In the 2015 Greenbook, the Obama Administration has heard their pleas and argued for passage of a new provision that would greatly simplify, but undercut, the use of such provisions. Under the new proposal, the annual exclusion gift would be expanded and increased to $50,000/yr – and the "present interest" requirement currently in §2503(b) would be eliminated. This would be a boon to small families, greatly simplifying trust administration and compliance – *Crummey* powers would no longer be needed. To quote the Greenbook, "the cost to taxpayers of complying with the Crummey rules is significant, as is the cost to Internal Revenue Service (IRS) of enforcing the rules." However, the new and improved annual exclusion would be a total annual cap of $50,000 per donor– not per donee. For a family like the Mikels, this would mean reducing the annual exclusion benefit from $1.68 million per year to only $100,000 per year.

Another reason the Administration may see this case as ammunition for change is the less obvious loophole that *Crummey* and its progeny create to avoid *income taxes*. For instance, even if the Mikels had a non-taxable estate (perhaps they do now), they can transfer $1.68 million (and increasing) in property to trusts, gift tax free, and grant older beneficiaries, or themselves (with limitations of reciprocal trusts and other issues), powers that would cause selective estate inclusion upon any beneficiaries' death up to the maximum amount that would not cause estate taxes. This allows a step up in basis upon any powerholder's death, including much older powerholders, which is not generally hampered by the same issues that may constrain a JEST, Estate or Community Property Trust. For a separate white paper discussing those loopholes and comparing the various strategies to achieve more expanded adjustments to basis, see the additional material cited below.

Cite as:

Citations:

Mikel v. Commissioner, T.C. Memo 2015-64, *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968) General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (aka "Greenbook"), p 170 at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf. For a discussion of the use of Crummey trusts for income and asset protection aside from the estate tax, see "The Upstream Optimal Basis Increase Trust", CCH Estate Planning Review May 22, 2014, or Section V of the longer white paper entitled "The Optimal Basis Increase and Income Tax Efficiency Trust" at www.ssrn.com