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Crummey Delivers Another Knockout Punch to the IRS

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In this article, Taite discusses *Mikel v. Commissioner*, in which the Tax Court addressed whether the donors qualified for the annual exclusion for gifts made to a trust with an *in terrorem* provision and a mandatory arbitration clause.

Mikel v. Commissioner[1] involved property transferred to the IEM Family Trust (IEM trust) by Israel and Erna Mikel (the petitioners) with Salomon Mikel as trustee. Petitioners were trust beneficiaries along with their children, lineal descendants, and their respective spouses. On June 15, 2007, petitioners transferred $3,262,000 to the trust, and each claimed $720,000 in annual exclusions.[2] At that time there were 60 beneficiaries, and many were under 18 years of age. The remaining $1,822,000 was reported as taxable gifts.[3]

The trustee was empowered to make discretionary distributions for the health, education, maintenance, or support of any beneficiary or family member. Any discretionary distributions made by the trustee were "absolute and unreviewable" and binding upon the beneficiaries and interested parties. If any beneficiary chose to dispute the discretionary distributions, that dispute was required to be submitted to a beth din.[4]

Also, the trust contained an *in terrorem* provision (also known as a no-contest clause).[5] The *in terrorem* provision stated that a beneficiary would cease to be a beneficiary if he directly or indirectly instituted, opposed, or participated in a challenge to a trust distribution or if he filed any action in a court of law.

When the petitioners transferred the property to the trust, they treated a portion as annual exclusion gifts. After the commissioner (the respondent) contacted them, the petitioners filed a gift tax return for various assets and claimed $720,000 in annual exclusion transfers for each of the trust's 60 beneficiaries. The respondent sent petitioners separate notices of deficiency, determining the petitioners were ineligible for the annual exclusions. The respondent contended the beneficiaries did not have a present interest in the gifts.

The petitioners consolidated their cases, filed a petition for partial summary judgment, and asked the court to determine their eligibility to claim the annual exclusion.[6]

The seminal case to determine whether beneficiaries have a present interest in trusts is *Crummey v. Commissioner*.[7] To satisfy the present interest test, a beneficiary must have an unconditional right to withdraw upon demand. Article V of the IEM trust granted each beneficiary the right to withdraw trust principal, including transferred property, in the amount of the annual exclusion.[8]

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[1] *Mikel v. Commissioner*, T.C. Memo. 2015-64.

[2] In 2007 the annual exclusion amount under section 2503(b) was $12,000.

[3] Neither petitioner filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," in 2007 reporting the transfers. In 2011 petitioners each reported $911,000 in taxable gifts by filing Form 709. In 2007 the applicable exclusion amount for gifts was $1 million; as a result, the petitioners did not owe any tax on the transfers.

[4] A beth din is a Jewish court consisting of a three-person panel. In this case the trust required the beth din to consist of three members of the Orthodox Jewish faith. The panel was directed to enforce the trust's provisions.

[5] An *in terrorem* clause is generally designed to discourage beneficiaries from challenging the trustees. There is no indication in the records whether any discretionary distributions were made or whether any dispute had arisen.

[6] *Mikel* at *4, citing *Sundstrand Corp. v. Commissioner*, 98 T.C. 518, 520 (1992), *aff'd*, 17 F.3d 965 (7th Cir. 1994). Under the Tax Court Rules of Practice and Procedure, Rule 121(b), a court may grant summary judgment for cases in which there is no genuine dispute as to any material fact, and a decision may be rendered as a matter of law.

[7] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

[8] The amount subject to withdrawal was the lesser of a formula-derived amount or the annual exclusion in effect during the tax year of the transfer. At the time of the transfer, the annual exclusion was the lesser amount.

Within a reasonable time after contributions, the IEM trust required the trustee to notify all beneficiaries (and guardians of beneficiaries) of their right to withdraw. Each beneficiary had to notify the trustee, in writing, of his intent to withdraw. The right to withdraw lapsed if not exercised within 30 days of the notice. On October 9, 2007, an attorney for the trust mailed the required notices to each beneficiary.[9] The trustee properly notified each beneficiary of his *Crummey* right to withdraw.

The respondent conceded that the trust language had the requisite withdrawal rights but contended the beneficiaries still did not have a present interest. The respondent based its contention on the trust's *in terrorem* provision. The provision discouraged beneficiaries from challenging discretionary acts of the trustees and provided that any dispute must be submitted to a beth din. Based on those two terms, the respondent asserted a beneficiary might be reluctant to go to court to exercise his rights.

In reaching its decision, the court compared this case with *Cristofani*,[10] in which the determination of a present interest was based not on the likelihood that a beneficiary would exercise his rights, but rather whether the beneficiary had a legal right to demand.[11] Because the minor beneficiaries had a legal right to demand and could legally withdraw from the trust, the court concluded that there was a present interest for the purpose of section 2503(b).

In 1992 the IRS published an action on decision acquiescing only in the result of *Cristofani*.[12] The IRS indicated it would continue to challenge annual exclusion rights that ''indicate a greater abuse of the *Crummey* power than those of *Cristofani*.''[13]

In 1996 the IRS provided another action on decision explaining its position, stating that the IRS ''does not contest annual gift tax exclusions for *Crummey* powers where the trust instrument gives the power holders a *bona fide* unrestricted legal right to demand immediate possession and enjoyment of trust income or corpus.''[14] The IRS made it clear that simply creating a withdrawal right would not be enough. If the demand rights were illusory, the IRS would challenge the annual exclusion.[15]

In *Mikel*, the respondent contended the withdrawal right was illusory because an attempt to legally enforce the right could lead to adverse consequences. The court disagreed. Because the beneficiaries had a right to a beth din, which was directed to give the beneficiaries the same rights they would be entitled to under state law, the court concluded that the beneficiaries had sufficient enforcement power.

While the respondent conceded that the beneficiaries had a remedy in state court, it claimed that the right was illusory because of the *in terrorem* provision. The court again disagreed, concluding that the *in terrorem* provision was meant to discourage challenges to the trustee's discretionary distributions.

Because the trustee did not have discretion to deny a timely made withdrawal demand, the *in terrorem* provision did not apply to the demand right. Thus, the right to judicially enforce it was not illusory. Because the beneficiaries had an unconditional right to withdraw, they had present interest in the trust. Accordingly, the court granted petitioners' motion for partial summary judgment.

Analysis and Conclusion

The annual exclusion is a regular and integral part of most estate plans for high-net-worth clients. Because clients want to maximize tax-free distributions without giving up too much control, estate planners are pushed to find creative ways to exploit the *Crummey* powers.

In this case, it is clear the petitioners trusted their trustee and wanted specific control over a beneficiary's right to oppose the trustee's discretion. Clients often want to exert as much control over beneficiaries as possible to facilitate a specific vision they have for their property. This certainly could have been accomplished without tying the language to the *Crummey* rights.

In large part, the IRS challenged the provision because the drafters did not make it clear that the *in terrorem* provision did not apply to the right to demand. Although inartfully drafted, *Crummey* won again. Maybe it's time for the IRS to ''throw in the towel'' and concede because *Crummey* is too formidable an opponent. That certainly encourages estate planners to continue to be creative and push the envelope.

However, the IRS has remained true to its word in challenging any annual exclusion that threatens the absolute right to withdraw. Maybe the lesson for estate planners is to draft standard language regarding the demand right. It is unnecessary to get creative; the boilerplate is enough. Understanding that clients, at times, want extra guarantees that the beneficiary will not withdraw the money, it seems an unnecessary risk to tinker with something that already works extremely well. In other words, when drafting annual exclusion language, it's best to leave well enough alone.

[9]There is no indication in the records whether any beneficiary had ever exercised his withdrawal rights.

[10]*Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991).

[11]*Id*.

[12]CC-1992-009.

[13]*Id*.

[14]CC-1996-010.

[15]*Id*.