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"BARE"LY LEGAL: THE EVOLUTION OF NAKED CRUMMEY POWERS AND A CALL FOR REFORM

PATRICK T. NEIL*

I. INTRODUCTION

It is often said that there are two sure things in life: death and taxes. Sometimes the two converge, and together form what is hatefully referred to as the "death tax."[1] For as much as the average American grimaces at the twenty or thirty percent taken from their paycheck each month, they downright despise the fact that the same money could be taxed again at their death. With that, some Americans fear the knocking of the Internal Revenue Service (IRS) at their deathbed just as voraciously as they do the grim reaper. As a result, taxpayers and their very able tax advisors have toiled to formulate

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* J.D. Candidate, May 2003, Florida State University College of Law; B.A. Florida State University, 1998. Special thanks to my best friend and tax guru, Jesse Little, whose patience and advice on this Comment (and so much more) has been invaluable to me. Thanks J-Lit, I couldn't have done this without you.

1. Mike Allen, *Rove Urges "War" for Permanent Repeal of Estate Tax*, WASH. POST, June 14, 2002, at A5.

numerous trap doors and escape routes through the endless maze of tax codes, revenue rulings, and case law, all in the name of avoiding the dreaded "death tax."

One of the more ubiquitous of these tax avoidance tools is the Crummey power. Named after the 1968 Ninth Circuit case, *Crummey v. Commissioner*,[2] Crummey powers have morphed from a mechanism originally designed to level the estate tax playing field[3] into a powerful estate planning tool, used by some to siphon off large portions of their estate free and clear of any estate or gift tax implications. On its face, such a tool seems to be plainly at odds with the purpose and design of the estate and gift tax structure. Despite this seemingly obvious abuse, in the thirty-four years since *Crummey*, the IRS has been relatively ineffective in leveling an attack of any significance against the massive estate tax avoidance precipitated by the advent of Crummey powers. As a result, the Crummey power has become a firmly entrenched tool in the estate planners' arsenal; and without any significant structural change to the Crummey mechanism itself, the federal fisc will continue to watch as large chunks of potential estate tax revenue are siphoned away, $11,000 at a time.

II. OVERVIEW OF THE ESTATE AND GIFT TAXES

First enacted in 1916, the federal estate tax was intended to serve a two-fold purpose. In addition to the fundamental goal of raising revenue, it was hoped that the imposition of the estate tax would break up large concentrations of wealth. Although some have argued that the estate tax has failed on both counts,[4] its presence nonetheless continues to be a major target of disdain and abuse.

Despite imposition of the estate tax in 1916, taxpayers were relatively unaffected by the tax, for it was easily avoided by gift transfers made during one's life. To correct this formidable loophole, Congress enacted the gift tax in 1932. As the House Ways and Means Committee and the Senate Finance Committee aptly explained:

> The gift tax will supplement both the estate tax and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax.[5]

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2. 397 F.2d 82 (9th Cir. 1968).
3. *See infra* Section V.
4. Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361, 368-69 (1993).
5. H.R. REP. NO. 72-708 (1932), *reprinted in* 1939-1 C.B. (part 2) 457, 477; S. REP. NO. 72-665 (1932), *reprinted in* 1939-1 C.B. (part 2) 496, 525.

In practice, the federal gift tax was established to provide a "safety net" for the estate tax.[6] To prevent taxpayers from depleting their estates prior to death, thereby considerably reducing their estate tax liability, the gift tax, subject to certain limitations, imposes a tax upon all transfers or gifts, whether "direct or indirect, and whether the property is real or personal, tangible or intangible."[7]

Notwithstanding the enactment of the gift tax, significant advantages remained available to taxpayers who chose to use inter-vivos transfers to convey their estate to third parties. Initially, the gift tax was levied using a completely different schedule than the estate tax (set at roughly three-fourths the estate tax maximum)[8] and was tax-exclusive while the estate tax remained tax-inclusive.[9] Most important, for the purposes of this Comment, the gift tax contained an annual exclusion provision that allowed donors to make tax-free, inter-vivos transfers, while the estate tax contained no such provision, thereby providing considerable incentive for taxpayers to "gift away" their estates during their lifetime.

In an attempt to remove the preferences within the gift tax that served to thwart the purpose and utility of the estate tax, Congress adopted a unified transfer tax system in 1976.[10] As part of this unified transfer tax system, Congress enacted the Unified Credit against the estate tax.[11] Intended to mitigate some of the exposure faced by small and medium-sized estates subject to the estate tax,[12] the Unified Credit serves to remove most taxpayers from the reach of both the estate and gift taxes. Under the current Unified Credit, the first $1,000,000 of estate property ($2,000,000 for married couples) is

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6. *See* Dickman v. Comm'r, 465 U.S. 330, 338 (1984) (holding that "one of the major purposes of the federal gift tax statute [is to protect] the estate tax and the income tax").

7. I.R.C. § 2511(a) (2002).

8. John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 111 (1993).

9. *Id.* The tax-exclusive/tax-inclusive distinction, although subtle, nonetheless creates an inherent advantage to those taxpayers who choose to transfer wealth during their life as opposed to at their death. As a tax-inclusive levy, the estate tax is imposed upon the total amount of the decedent's gross estate (including those assets used to pay the tax). Whereas, the gift tax, which is tax-exclusive, is imposed only upon those assets transferred to a beneficiary, and not upon the assets used to pay the tax. For example, assuming a flat transfer tax of 50 percent, if Wyatt were to make an inter-vivos transfer of $1,000,000 to his brother Chet, the gift tax would be imposed on the amount that Chet received *after* the tax was applied (50% of $500,000) thereby giving Chet a net gift of $750,000. On the other hand, if Wyatt were to wait and transfer that same amount at his death, the estate tax would be imposed on the $1,000,000 *before* it is transferred to Chet (50% of $1,000,000) thus leaving Chet with a net transfer of only $500,000. *See* IRA MARK BLOOM ET AL., FEDERAL TAXATION OF ESTATES, TRUSTS AND GIFTS § 2.03 (3d ed. 2002).

10. Smith, *supra* note 4, at 375-77.

11. I.R.C. § 2010 (2002).

12. *Id.* Currently, the Unified Credit under I.R.C. § 2010 is set at $1,000,000. However, that amount is set for a phased increase up to $3,500,000 by 2009. I.R.C. § 2010(c) (2002).

exempted from the estate tax.[13] Despite the imposition of the unified transfer tax system, limitations and loopholes remained abundant, thereby affording the savvy taxpayer ample opportunities to gift away their estate free from gift taxation, and reduce their subsequent estate tax burden in the process.

One of the more obvious limitations on the reach of the gift tax is the exclusion that applies to payments made by a taxpayer to satisfy the education or medical expenses of another.[14] This exclusion does not require that the taxpayer and beneficiary have any specific relationship; nor is there any limitation on the amount that may be exempt from taxation when used for the specific purposes outlined in section 2503(e). Further, the removal of these "basic needs" from the reach of the gift tax effectively increased the value of the annual exclusion for those taxpayers who had previously exhausted their available annual exclusion to meet the financial needs of their adult children in school and/or elderly parents or relatives in need of medical care.[15]

III. OVERVIEW OF THE ANNUAL EXCLUSION

Although the stated purpose of the gift tax was to prevent estate tax avoidance, the taxation of *all* gifts, no matter how inconsequential or small, would certainly prove unduly burdensome to the average taxpayer. To avoid that result, Congress enacted an annual exclusion to the gift tax:

> [t]o obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other [hand], to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts.[16]

The rationale behind this exclusion is rather basic: If the government required every small, customary gift (i.e., Christmas, birthday, etc.) to be accounted for and subsequently taxed, massive noncompliance and collection problems would result, thereby eroding the credibility of the voluntary tax system as a whole.[17]

Originally set at $5,000 per donee, per year in 1932, the annual exclusion was later reduced to $4,000 in 1939, and $3,000 in 1942.[18] The exclusion remained at $3,000 until 1981, when Congress enacted the Economic Recovery Tax Act (ERTA) which, in one fell swoop, in-

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13. *Id.*
14. *See* I.R.C. § 2503(e) (2002); Steinkamp, *supra* note 8, at 116.
15. Steinkamp, *supra* note 8, at 116.
16. S. REP. NO. 72-665, at 41 (1932); *accord* H.R. REP. NO. 72-708, at 29 (1932).
17. *See* Steinkamp, *supra* note 8, at 118.
18. *Id.* at 118-19.

creased the exclusion to $10,000.[19] The legislative history behind the reductions of the annual exclusion in 1939 and 1942 indicate Congressional concern that taxpayers could use the exclusion as a device to transfer significant portions of their estate free from the reach of the estate and gift taxes. Thus, the reduction of the exclusion amount in those years was intended to maintain the exclusion at a level that kept with the spirit behind its original enactment, without allowing taxpayers to avoid the estate tax with sizeable annual tax-free gifts given to heirs and potential beneficiaries. Given the legislative history behind the original passage of the annual exclusion in 1932, and the subsequent reductions in 1939 and 1942, it is relatively clear that Congress did not intend for the annual exclusion to be used as an estate-planning tool. Rather, from its inception, the annual exclusion was designed as nothing more than a means of reducing the potential administrative burden and taxpayer discontent associated with the accounting and taxation of the most basic, everyday gift transfers.

A. Present Interest Requirement

Because Congress intended for the annual exclusion to cover only minor, routine gifts, which are customarily transfers of present interests, it follows that the exclusion "does not apply with respect to a gift to any donee to whom is given a future interest."[20] Whether or not a given transfer will qualify under the exclusion is often determined by how the Service will characterize the transfer: If the transfer is deemed a "present interest," the annual exclusion will apply; if a "future interest," the exclusion will not be applicable and the taxpayer must pay gift tax on the transfer.

The present interest requirement arose out of concern over the applicability and abuse of the exclusion. On the one hand, Congress recognized the potential difficulty that could arise in "determining the number of eventual donees and the value of their respective gifts"[21] if gifts of future interest were allowed to qualify for the exclusion. More importantly, by limiting the exclusion to only present interest transfers, Congress intended to ensure that its use would apply only to those transfers it was originally meant to cover—routine, ordinary gifts.[22] However, when using the exclusion as an estate-planning tool, taxpayers often "double dip" by using the full amount

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19. *See* Smith, *supra* note 4, at 383-86. Currently, the rate established under section 2503(b) has been indexed for inflation and is now set at $11,000. I.R.C. § 2503(b) (2002).

20. S. REP. NO. 665-72 (1932), *reprinted in* 1939-1 C.B. 496, 526; H.R. REP. NO. 708-72 (1932), *reprinted in* 1939-1 C.B. 457, 478.

21. S. REP. NO. 665-72 (1932), *reprinted in* 1939-1 C.B. 496, 526; H.R. REP. NO. 708-72 (1932), *reprinted in* 1939-1 C.B. 457, 478.

22. Given this, it is rather apparent that Congress did not intend for the annual exclusion to be used as an estate planning device.

of their exclusion for estate planning purposes, while at the same time giving those same beneficiaries the normal, everyday gifts meant to be covered by the exclusion.[23] This practice is a clear subversion of the intent behind the exclusion, and is exacerbated by the use of family members in Crummey trust situations (who are most likely to receive the normal, ordinary gifts meant to be covered by the exclusion).

Despite the importance placed upon the characterization of the transfer, neither "future interest" nor "present interest" are defined in the Internal Revenue Code. Treasury Regulations have defined "future interest" as "includ[ing] reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which [is] limited to commence in use, possession, or enjoyment at some future date or time."[24] However, courts have interpreted the distinction between present and future interests in a manner that is vague and contradictory, thereby leaving the taxpayer without a consensus as to what truly qualifies as a future interest for the purpose of the annual exclusion.

In most situations, the distinction between whether an interest is considered "present" or "future" for purposes of the annual exclusion is directly correlated to the *type* of interest transferred to the donee. For example, outright gifts of property will almost always be considered transfers of present interest because the beneficiary is given the ability to immediately enjoy the gift. In contrast, transfers in trust are almost always intended to provide for a beneficiary's future welfare, and often contain restrictions that strictly prohibit a beneficiary's immediate enjoyment of the gift.[25] Thus, a transfer in trust will

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23. Smith, *supra* note 4, at 394-95; *see infra* Section VIII.A.

24. Treas. Reg. § 25.2503-3(a) (as amended in 1983).

25. One exception to this rule are gifts made in trust for the benefit of a minor that meet the requirements of I.R.C. § 2503(c). Under I.R.C. § 2503(c), transfers made in trust will be considered present interests, and therefore subject to the annual exclusion, so long as: (1) the trust is limited to a single beneficiary under the age of twenty-one, and the trustee must be authorized to use the trust income and principal for the benefit of the minor beneficiary during his minority; (2) upon reaching age twenty-one, any portion of the trust corpus not expended during the beneficiary's minority must be distributed to the beneficiary in full upon turning twenty-one; and (3) if the minor dies before reaching age twenty-one, the trust property is distributable to the minor beneficiary's estate, or to whomever he appoints the property to under a general power of appointment. I.R.C. § 2503(c) (2002); Treas. Reg. § 25.2503-4 (a) (1958). Although I.R.C. § 2503(c) would seem to alleviate the need for Crummey powers, the transaction costs associated with creating a 2503(c) trust (e.g., separate trusts for each beneficiary), coupled with a beneficiary's right to absolute control over the entire trust corpus upon turning twenty-one, renders use of 2503(c) impractical when viewed in terms of the estate-planning goals of Crummey grantors. *See* Smith, *supra* note 4, at 391 ("Because the donor can control how property transferred into trust is used by selecting the trustee and trust terms, [Crummey] withdrawal rights encourage use of the annual exclusion to make transfers of property in a way that does not really give the donee control.").

generally be treated as a future interest for the purpose of qualifying for the annual exclusion.[26] Beyond the two previous examples, what will and will not qualify as a present interest for the exclusion is often determined by the amount of control that a donee exercises over the transferred property.

In *Fondren v. Commissioner*,[27] the United States Supreme Court established that determination of a present interest for the annual exclusion is:

> [A] question . . . of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him . . . that enjoyment makes the gift one of a future interest within the meaning of the regulation.[28]

In contrast, the Seventh Circuit in *Kieckhefer v. Commissioner*,[29] left no room for discretion when it established that it is not the actual enjoyment of an interest "which marks the dividing line between a present and future interest, but it is the right conferred upon the beneficiary to such use, possession or enjoyment."[30]

The best way to illustrate the subtle distinctions that often separate present from future interests is through example. If a beneficiary were to receive an annual income interest from the principal of a trust, it will likely be considered a present interest (and therefore qualify as a valid 2503(b) exclusion) under both *Fondren* and *Kieckhefer* because the beneficiary's right to demand immediate payment of that income interest is absolute. However, in an extreme example, if the same beneficiary was held hostage in a Chinese prison camp, then it can be said that a "barrier of a substantial period between the will of the beneficiary" and his enjoyment of that income interest[31] has been created by way of the beneficiary's unfortunate incarceration. Under *Fondren*, the once-present interest must now be characterized as a future interest, and thus is not subject to the annual exclusion.[32] Nevertheless, according to *Kieckhefer*, this unlikely scenario does nothing to the actual "right" conferred upon the beneficiary to use, possess, or enjoy the income interest (aside from the fact that it is difficult to withdraw money from a trust from within a bamboo cage on the other side of the globe). In turn, so long as that "right" stays intact, the transfer will remain a present interest and

26. *See* Treas. Reg. § 25.2503-3(c), ex.2 (as amended 1983); Phillips v. Comm'r, 12 T.C. 216 (1949); Rev. Rul. 79-47, 1979-1 C.B. 312.
27. 324 U.S. 18, 20-21 (1945).
28. *Id.* (citation omitted).
29. 189 F.2d 118, 121 (1951).
30. *Id.*
31. *See Fondren*, 324 U.S. at 20-21.
32. *See id.*

qualify for the annual exclusion.[33]

Most taxpayers do not want to have to make outright gifts in order to qualify for the annual exclusion. Because minors are the most likely target for lifetime gifting,[34] it is understandable that the donor in such a situation would want to maintain some control over the property to ensure that the funds are not wasted on youthful eccentricities. For this reason, gifts in trust are extremely useful to donors, in that they allow the donor to retain some control (via a dependable trustee and good tax advisor) over how the funds are managed and subsequently released.[35]

Yet despite this apparent advantage to giving gifts in trust, a twofold problem remains: First, gifts in trust are almost always considered transfers of future interest and therefore fail to qualify for the annual exclusion; and second, because these gifts are considered future interests, the funds will be subject to the gift tax when distributed to the trust. However, if a taxpayer is somehow able to characterize a gift in trust as a present interest, the taxpayer can take advantage of the annual exclusion, avoid both estate and gift taxation on the amount transferred,[36] and maintain control over how the property is managed. But how, près tell, can this be done? The answer lies in *Crummey*.

IV. HOW DOES A CRUMMEY POWER WORK?

As mentioned earlier,[37] a Crummey trust allows a taxpayer to maintain control over a gift (through a retention of power granted in the trust instrument itself),[38] while qualifying the gift as a present

33. *Fondren* and *Kieckhefer* represent only some of the subtle judicial distinctions between present and future interests.

34. Oftentimes, individuals will gift away most of their estates *during* their lifetime in an attempt to avoid the penal nature of the estate tax. *See* I.R.C. § 2001(c)(1) (2002).

35. In order for a gift in trust to be excluded from a donor's estate at death, the gift must be deemed "complete." *See* Treas. Reg. § 25.2511-2(b) (as amended in 1999). A completed gift is one where the donor has relinquished all dominion and control over the property transferred. *See id.* If the donor retains any interest whatsoever (no matter how small), that transfer will be considered incomplete, and the property will be included in the donor's estate upon death. Helvering v. Hutchings, 312 U.S. 393, 396 (1941); Rev. Rul. 67-396, 1967-2 C.B. 351, *clarified by* Rev. Rul. 84-25, 1984-1 C.B. 191.

36. This is still subject to the $11,000 cap on the annual exclusion in section 2503(b), as well as the "five or five" limitation under I.R.C. §§ 2041(b)(2), 2514(c). Under I.R.C. § 2041(b)(2), a beneficiary, upon lapse, is deemed to have released the general power of appointment granted to him via the Crummey power on any withdrawal amount greater than $5000 or five percent of the trust corpus. I.R.C. § 2041(b)(2) (2002).

37. *See supra* Section III.

38. There are many different ways that a donor may retain an interest over the trust corpus. For instance, a donor may preserve the power to add and remove beneficiaries of a trust at will or maintain power over the management of the funds kept in trust. Ultimately, the methods by which a donor may retain control over a Crummey trust, and still qualify for the annual exclusion, are virtually limitless.

interest, thereby allowing the taxpayer to utilize the annual exclusion. To accomplish this estate planning "two-step," the donor establishes a trust (usually in the name of the intended beneficiaries); and in each year that the exclusion is sought, confers upon the donee a lapsing power to withdraw a specified amount (usually up to either the "5 or 5" limitation, or the annual exclusion amount—whichever is greater). Simply granting the beneficiary the lapsing right to withdraw only gets the donor to the dance floor. To perform the "two-step" properly, the beneficiary must allow the power to lapse, thereby allowing the gift to revert to the trust and the donor to take the annual exclusion. If, however, the donee were to exercise his/her power to withdraw, the music stops and the purpose of the transaction is thwarted because the funds do not revert to the trust, but rather into the immediate possession of the beneficiary. Although the donor in such a situation does not lose the ability to claim the annual exclusion, any significant control over the funds is lost to "youthful eccentricities."[39]

So, how does a donor ensure that the withdrawal right is not exercised? An easy answer is to simply not inform the potential beneficiary that they have a right to begin with. After all, you cannot demand what you do not know exists.[40] Another potential method to ensure non-exercise is to make the demand period so unreasonably short that a beneficiary could not exercise his right even if he wanted to.[41] To combat these types of abuse, the IRS, in numerous post-*Crummey* private letter rulings,[42] established that a beneficiary must be given proper, written notice and a reasonable opportunity to exercise his demand right (thirty days or more).

Even with proper notice and opportunity to exercise, donors may nonetheless control the situation through an agreement, either express or implied, that makes certain the beneficiary will not exercise his demand power. Within the context of these "lapse agreements" lies the crux of the Crummey problem from the viewpoint of both the

39. *See supra* Section III.

40. Prior to Revenue Ruling 81-7, it was common for a beneficiary to never receive notice of his right to withdraw. *See* Crummey v. Comm'r, 397 F.2d 82, 88 (9th Cir. 1968) (admitting that some, if not all, of the beneficiaries of the trust had no idea that they had a demand power). *Cf.* Rev. Rul. 81-7, 1981-1 C.B. 474.

41. *See* Rev. Rul. 81-7, 1981-1 C.B. 474 (establishing a minimum period for a demand right to remain available to a beneficiary in order for the "transfer" amount to be excluded from the grantor's estate under I.R.C. § 2503(b)).

42. *Id.* In Revenue Ruling 81-7, the IRS addressed a trust that granted an adult beneficiary a demand right scheduled to lapse on December 31. *Id.* However, the donor did not make the actual gift until two days prior to the lapse (December 29) and failed to notify the beneficiary regarding the existence of the power until after the demand period had expired. *Id.* As a result, the IRS deemed the power to be "illusory," and refused to recognize the transfer as a present interest and the annual exclusion was denied. *See id.*

Service[43] and the courts.[44] If the donor and beneficiary have a prearranged agreement to allow the demand power to lapse, then the power is "illusory" and the annual exclusion should be denied.[45] However, since these arrangements are informal, and often implied, their existence is very difficult to prove with any degree of objectivity.[46]

V. PRE-*CRUMMEY* PRECEDENT—NON-LAPSING DEMAND POWERS

One of the most significant and oft-cited cases dealing with demand powers and the annual exclusion is the United States Supreme Court decision in *Fondren v. Commissioner*.[47] In *Fondren*, the Court was faced with the question of whether taxpayers who had established seven separate trusts for their seven infant grandchildren, could exclude the first $5000 of contributions made to each trust in the years 1935, 1936, and 1937.[48] To the extent that no present interest is given to a beneficiary, gifts to an irrevocable trust are future interests, and thus cannot be excluded. However, the taxpayers in *Fondren* argued that the withdrawal power given to the trustee to distribute funds from the trust corpus to provide for the support, education, and maintenance of the beneficiaries on the basis of need[49] was sufficient to establish that the beneficiaries had, at the moment of each gift, a present right of enjoyment.[50] The *Fondren* Court acknowledged that the exclusion cannot apply simply because the "donee has vested rights."[51] Rather, the donee must receive a "right to [a] substantial present economic benefit," as determined by the present right to "use, possess or enjoy the property," in order for the exclusion to apply.[52] Furthermore, the Court took special note of the language in the trust instrument which explicitly stated that the donor did not foresee the trustee having to invade the income or corpus of the trust because the beneficiaries already had "adequate and sufficient means of support."[53] The Court recognized that the "circumstances surrounding the donors and the donees . . . made enjoyment [of the gifts] contingent upon the occurrence of future events, not only uncertain, but by the recitals of the instrument itself improbable of occurrence."[54] Consequently, the Court in *Fondren* found that the

43. *See* Tech. Adv. Mem. 97-31-004 (Aug. 1, 1997); Tech. Adv. Mem. 96-28-004 (July 12, 1996); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).

44. *See infra* note 143.

45. Rev. Rul. 81-7, 1981-1 C.B. 474.

46. *See infra* Sections VIII.E, IX.D.

47. 324 U.S. 18 (1945).

48. *Id.* at 19-20.

49. *Id.* at 22-23.

50. *Id.* at 24.

51. *Id.* at 20.

52. *Id.*

53. *Id.* at 23.

54. *Id.* at 24.

circumstances surrounding the creation of the trust, coupled with the language of the trust itself, ultimately rendered the withdrawal power unlikely to be exercised. Thus the gifts were considered future interests and, therefore, non-excludable.[55]

Despite the Supreme Court's recognition that surrounding circumstances were to be considered in determining the probability of withdrawal,[56] the circuit courts remained split on whether to accept such a test. For instance, the Seventh Circuit in *Kieckhefer v. Commissioner*[57] recognized that the court should not look beyond the "'explicit terms of the trust'"[58] to determine whether there exist sufficient "conditions and restrictions"[59] to establish that the donee had not received a present interest gift. The court focused upon the distinction between restrictions and contingencies that are imposed by the donor via the trust itself, and those that result from the incapacity of the beneficiary as a minor.[60] Ultimately, the *Kieckhefer* court found that if the restrictions that prevent withdrawal are imposed by law (as is the case with minority), that is not enough to transform a present interest into a future interest. Out of the same concern for reliability and administrative convenience, many courts, including the Ninth Circuit in *Crummey*,[61] used a similarly simple and predictable *Kieckhefer*-like approach to deal with the muddled distinction between present and future interests as applied to donee withdrawal rights.[62]

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55. *Id.* at 29. In a related case, *Commissioner v. Disston*, 325 U.S. 442 (1945), the Court was faced with a trust problem similar to *Fondren* and subsequently decided the case in favor of the Service using the same surrounding circumstances test used in *Fondren*. *See Fondren*, 324 U.S. at 24.

56. *See Fondren*, 324 U.S. at 24.

57. 189 F.2d 118 (7th Cir. 1951). The taxpayer in *Kieckhefer* established a trust for the benefit of his grandson (a minor) and named his son (the father of the beneficiary) as trustee. The trust instrument provided that the beneficiary could demand any or all of the trust estate at any time through his father (the trustee) or a legal guardian. The taxpayer sought to claim an exclusion for the initial gift made to the trust. The case ultimately hinged upon two questions: First, could the beneficiary (an infant at the time the trust was created) really make an effective demand? Second, will the fact that no legal guardian was appointed to the child at the time of the trust effectively hinder the beneficiaries' ability to make a demand so that the transfers will be considered future interests?

58. *Id.* at 120.

59. *Id.*

60. The court noted that the Service's argument—the fact that no guardian had yet been appointed who could transform the gift into a future interest—was fallacious due to "the [Service's] failure to distinguish between restrictions and contingencies imposed by the donor (in this case the trust instrument), and such restrictions and contingencies as are due to disabilities always incident to and associated with minors and other incompetents." *Id.* at 122.

61. *See* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

62. *See* Dora Arash, *Crummey Trusts: An Exploitation of the Annual Exclusion*, 21 PEPP. L. REV. 83 (1993).

However, not all courts were willing to sacrifice reality for "'simplicity and predictability.'"[63] Most notably, the Second Circuit in *Stifel v. Commissioner*[64] closely followed the approach taken by the Supreme Court in *Fondren*[65] and *Commissioner v. Disston*,[66] noting that "the Court, in reaching its determinations, did not irrevocably lock itself inside the 'four corners' of the writings [of the trust] but held that the key might lie outside."[67] The court clairvoyantly warned that if the surrounding circumstances were not considered, "a donor could make gifts which on paper were 100% present but in practice were 100% future."[68] In turn, the *Stifel* court found that because the minor beneficiaries of the trust had not been appointed guardians through whom they could legally exercise their withdrawal rights, their power to make a demand was impractical, thereby making the withdrawal rights future interests, rather than excludible present interests.[69]

VI. *CRUMMEY V. COMMISSIONER*—THE LAPSING DEMAND POWER

The most significant of the circuit court decisions dealing with characterization of demand powers for the purpose of annual exclusion was handed down by the Ninth Circuit in *Crummey v. Commissioner*.[70] The dispute in *Crummey* revolved around the creation of a trust instrument that provided that each of the four beneficiaries[71] could demand, at any time up until December 31st of that year, up to $4,000, or the amount transferred into trust in that year, whichever was less.[72] What made *Crummey* different from the cases previously

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63. *Id.* at 98 (quoting Jeffery G. Sherman, *'Tis a Gift to be Simple: The Need for a New Definition of "Future Interests" for Gift Tax Purposes*, 55 U. CIN. L. REV. 585, 589 (1987)).

64. 197 F.2d 107 (2d Cir. 1952).

65. Fondren v. Comm'r, 324 U.S. 18 (1945).

66. 325 U.S. 442 (1945).

67. *Stifel*, 197 F.2d at 110.

68. *Id.*

69. *Id.* at 110-11. The court, in dicta, noted that "it would then seem to be proper to consider the actual facts as to the father's influence on the guardian appointed" to determine whether the child was given a legitimate right to exercise their demand power or not. *Id.* at 110 n.5. One can logically infer that if a parent allows their power to lapse, inevitably they will do the same for their child. Thus, the benefit that is said to inure to the child is never actually realized by the child because the decision to exercise has been predetermined by their parent's decision to allow lapse to occur. If you grant an exclusion based upon the demand power given to these children, that right merely serves as a vehicle for multiplying the number of annual exclusions given to the parents because the powers are "conferred" upon the parent, not only for their own share, but for the share of their children as well. In turn, donors are thus able to mitigate the potential for any "strays" that may exercise their powers, because the Crummey powers are essentially consolidated into the hands of a few. *See infra* Section VIII.E.

70. 397 F.2d 82 (9th Cir. 1968).

71. At the time the trust was created, the ages of the four beneficiaries were twenty-two, twenty, fifteen, and eleven years-old.

72. *Id.* at 83.

discussed[73] was that the demand power granted to the beneficiaries did not continue for the life of the trust, but rather, lapsed at the end of each year it was given. Thus, by virtue of the trust language that afforded the beneficiaries the right to compel immediate distribution of the trust funds within a specified period of time, the taxpayer in *Crummey* claimed that under *Kieckhefer*[74] the transfers were gifts of present interest, and therefore qualified for the annual exclusion.[75] The IRS countered that the demand rights granted to the minor children, in light of the surrounding circumstances,[76] were not likely to be exercised, and thus the transfer could not constitute a present interest.[77]

In wrestling with how to characterize a lapsing demand power, the Ninth Circuit in *Crummey* opted for a middle ground between the *Kieckhefer* approach urged by the taxpayer, and the *Stifel* test argued by the Service. Closely following the 1956 Tax Court decision of *Perkins v. Commissioner*,[78] the Ninth Circuit determined that "all that is necessary [for the exclusion to apply] is to find that the demand could not be [legally] resisted."[79] Using this "right to enjoy"[80] criterion, the *Crummey* court found that the lapsing demand powers given to the beneficiaries in 1962 and 1963, although never exercised, "could not be [legally] resisted"[81] and thus the taxpayers were entitled to the annual exclusion for the gifts made to the four beneficiaries in both years at issue.[82] In its reasoning, the *Crummey* court rejected the approach taken by the IRS (relying on *Stifel*[83]) and established that whether or not a guardian had been expressly appointed by the donor has no relevance to the application of the annual exclusion, so long as the "demand power was valid and enforceable."[84]

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73. *See supra* Section V.

74. *See* Kieckhefer v. Comm'r, 189 F.2d 118 (7th Cir. 1951) (holding that so long as the explicit terms of the trust afford a beneficiary a present right to receive income from a trust, that alone is enough to establish a present interest gift).

75. *Crummey*, 397 F.2d at 84-85.

76. The IRS noted that no guardian had been appointed to make the demand for the minor beneficiaries thereby transforming the demand power into a non-excludible gift of future interest. *Id.*

77. The IRS relied heavily upon *Stifel* to make this point. *See* Stifel v. Comm'r, 197 F.2d 107 (2d Cir 1952).

78. 27 T.C. 601 (1956).

79. *Crummey*, 397 F.2d at 88.

80. *See* Gilmore v. Comm'r, 213 F.2d 520 (6th Cir. 1954).

81. *Crummey*, 397 F.2d at 88.

82. *Id.*

83. *See* Stifel v. Comm'r, 197 F.2d 107 (2d Cir. 1952).

84. Bradley E.S. Fogel, *The Emperor Does Not Need New Clothes—The Expanding Use of "Naked" Crummey Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L. REV. 555, 573 (1998). Moreover, the Ninth Circuit tacitly repudiated the *Kieckhefer* test by declining to acknowledge that postponed enjoyment due only to the minority of a beneficiary will nevertheless be considered a present interest. *See Crummey*, 397 F.2d at 88; Kieckhefer v. Comm'r, 189 F.2d 118, 119 (7th Cir. 1951).

The *Crummey* court expressly declined to even entertain the IRS argument that the likelihood of the beneficiary's demand should be considered when determining whether the transfer is a present or future interest.[85] In doing so, the court noted the inconsistency and unfairness to the taxpayer that could result from the IRS implementing such an approach due to the arbitrary nature of trying to interpret the subjective intent behind each decision to allow a demand power to lapse.[86] Ultimately, the court opted for the lesser of two evils, and determined that predictability for all taxpayers was of greater importance than the risk of occasional estate tax avoidance.

A. Public Policy Rationale for Crummey *Decision*

Despite what has become of *Crummey* today,[87] there nevertheless exists a sound policy rationale for the Ninth Circuit's decision. The desire to provide for one's offspring in the future is a time-honored and sacred human instinct throughout all levels of society. Often, the estate and gift taxes present a significant (but necessary) roadblock to an individual's realization of this cherished human goal. In some cases, the estate tax can mean the difference between truly *providing* for one's offspring in the future, and merely supplying a temporary windfall. With that in mind, the Ninth Circuit sought to level the playing field between taxpayers who did not have secondary concerns over their beneficiaries (i.e., beneficiaries who can be trusted to control the funds given to them),[88] and taxpayers with beneficiaries who cannot be trusted to effectively manage the gift in the same manner as beneficiaries without secondary concerns.[89] By allowing donors to

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85. *Crummey*, 397 F.2d at 87. The court went so far as to acknowledge that some, if not all, of the beneficiaries had no idea that they had the right to demand funds from the trust, and therefore it was "highly unlikely that a demand [would] ever be made" at all. *Id.*

86. *Id.* at 88.

87. The use of Crummey trusts as an estate planning tool has become a firmly entrenched in the tax planning arena largely because the IRS has failed to wage a significant attack upon the abusive uses of *Crummey*. *See generally* Fogel, *supra* note 84 (arguing that the Service's treatment of *Crummey* has been inconsistent and ineffective largely because of their insistence on taking a piecemeal approach of attacking only those decisions that expanded *Crummey* powers, rather than attacking the use of lapsing withdrawal powers on the basis of the *Crummey* decision itself).

88. The term "secondary concerns" is generally meant to encompass those situations where the donor is unable to freely make outright gifts to the beneficiary due to the fact that the beneficiary cannot be trusted to effectively manage the funds by virtue of the beneficiary's minority or other incapacity. On the other hand, those donors who wish to provide for beneficiaries without secondary concerns are free to transfer their estate to their intended beneficiary via outright gift and qualify for the annual exclusion, because those beneficiaries can be trusted to look after their own best interest in managing the funds.

89. Prior to *Crummey*, a taxpayer with minor children had only three routes to take: (1) make a complete gift in trust for the beneficiary (in which case the donor must relinquish total control over management of the funds to qualify for the annual exclusion—a risky proposition when your child's future well-being is at stake); (2) make an incomplete

utilize the lapsing demand power to establish a present interest gift, the *Crummey* court remedied the inequity faced by taxpayers with young children.[90] To take advantage of the annual exclusion prior to *Crummey*, these taxpayers had to either relinquish control over the funds meant to provide for their children's future support, or wait until those children were mature enough to manage those funds on their own. Thus, after *Crummey*, taxpayers were finally afforded a mechanism by which they could make a gift to trust for the benefit of a minor child, maintain some control over the funds in trust (through the language in the trust instrument), and still claim the transfer under the annual exclusion.

When framed in this manner, *Crummey* can certainly be seen as having served an important and justifiable policy goal. However, with the benefit of hindsight, it is now fairly obvious that the court in *Crummey* may have misconstrued the vastness of the beast it had unleashed. Although the policy behind *Crummey* was sound, the mechanism left behind was broad and pliable, thereby affording tax planners a significant amount of "wiggle room" with which the estate and gift tax could be avoided by means never envisioned by the Ninth Circuit. As a result, the Crummey power has become an effective estate-planning tool that affords taxpayers the ability to *legally* and systematically drain the value of their estates while side-stepping both estate and gift tax consequences on the amount transferred.

B. Naked and Semi-Naked Crummey Powers

The discussion thus far has operated under the assumption that the beneficiary of a withdrawal right maintains an interest in that right, even after lapse, because they have a vested interest in the trust corpus to which the demand right has reverted as a result of the lapse. Thus, one can logically presume that a beneficiary may refuse to exercise the demand power and take the money immediately

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gift in trust for the child (whereby the parent maintains control over the management of the funds, but is denied the annual exclusion and the funds are included in the donor's estate at death); or (3) simply hold on to the money and manage it themselves (in which case the funds are subject to the estate tax at the donor's death).

90. Leaving such a responsibility in the hands of another (even if a trusted fiduciary with strict guidelines) is a "dicey" proposition for any parent. In turn, it can be inferred that the Ninth Circuit's purpose was to limit its remedy to the problem before it, and *not* to create a mechanism by which individuals could utilize the annual exclusion through lapsing demand powers given to beneficiaries with a remote contingent interest in the trust corpus. *See infra* Section VII.

Thus, the Ninth Circuit in *Crummey* implicitly recognized the need for parents to maintain control over the funds to be used for *their* children's future, especially in those cases where the children are relatively young and cannot be expected to manage the funds in a responsible manner.

knowing that the gift is not lost, but postponed until the trust is payable to him.[91]

However, the same logic does not follow when the beneficiary of a demand power does not have any interest in the trust outside of the Crummey power, but nevertheless allows the withdrawal right to lapse. In such a situation, the beneficiary retains what is commonly referred to as a "naked" Crummey power,[92] that is, a lapsing demand right without any corresponding interest in the corpus of the trust. With naked Crummey powers, the beneficiary has no conceivable economic incentive to allow a lapse to occur because once the demand power has lapsed, the income from that demand right is gone forever.[93] Given this, it logically follows that the beneficiary of a naked Crummey power will not allow the lapse to occur, and thus the transfer will amount to nothing more than an outright gift, thereby affording the grantor with none of the estate-planning benefits normally associated with a Crummey power.[94] Yet, if a grantor could somehow ensure that a naked Crummey beneficiary will not exercise their demand right, then it follows that the number of annual exclusions that can be claimed under naked Crummey powers is limited only by the number of potential beneficiaries who can be entrusted to let the power lapse.[95] Without any limitation regarding the beneficiary's interest, or lack thereof, in the trust corpus, donors can merely pick and choose as many beneficiaries as necessary to reduce their taxable estate to zero. In addition, if notice and opportunity to exercise were not required (as was the case prior to Revenue Ruling 81-7) then a donor could simply open the phone book and transfer their entire estate into trust in one year without any gift tax consequences whatsoever. For example, assume a donor with an estate worth $11,000,000 has set up a trust with his only heir as the sole beneficiary. Without notice and opportunity to exercise, the donor can simply name as many naked Crummey power holders as it takes to relieve his estate from any estate tax consequences at his death. Any concern that the donor may have over potential exercise is remedied by the fact that the power holders cannot exercise what they don't know exists (because they never received notice). In this particular situation, the donor would simply divide $11,000 (the annual exclusion maximum) by the net worth of his estate (minus the unified credit

91. In such a situation, a beneficiary will likely have an economically rational motive for allowing his power to lapse. For instance, a beneficiary may, and often will, allow lapse simply because the trustee will better manage the trust property, thereby assuring the beneficiary a long-term source of future income.

92. *See generally* Fogel, *supra* note 84. The IRS has generally failed in its attempts to argue that naked Crummey powers are illusory. *See id.*

93. *See* Smith, *supra* note 4, at 390-91.

94. *See supra* Section IV.

95. *See* Fogel, *supra* note 84, at 583.

amount available to the donor) and the number he is left with is the amount of naked Crummey power holders he must name to siphon off his entire taxable estate in one year. Thus, if the donor were to die the following year, his entire estate will have passed to his sole heir free of any estate tax implications.[96] Ultimately, the most telling indicator of whether or not an agreement for such assurances has been made is the economic motivation of the beneficiary in allowing the Crummey power to lapse. As explained earlier, basic economic rationality establishes that naked Crummey beneficiaries will not let their power of withdraw lapse, unless there exists some other motivating factor *external* to economic considerations.[97]

As is the case with most areas of the law, there is a gray area between beneficiaries with an absolute, vested interest in the trust corpus, and naked beneficiaries without an interest in the trust whatsoever. Semi-naked Crummey beneficiaries are those individuals whose interest in the trust corpus, external to their Crummey power, is contingent upon the occurrence of some uncertain future event. Because the exact interest that semi-naked Crummey beneficiaries hold in the trust corpus is difficult to determine, so too is their motive for lapse. Unlike naked Crummey beneficiaries, whose motives to allow lapse are presumably non-economic, semi-naked beneficiaries are often motivated by a mixed bag of economic and non-economic concerns (which are ultimately dependant upon surrounding circumstances) and thus a presumption cannot be so easily reached with regard to their decision to lapse. Whether or not semi-naked beneficiaries decision to lapse is economically motivated, and therefore viable, is ultimately dependent upon the likelihood of the contingency occurring.[98]

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96. Assuming the donor in this example has not made any prior gifts against his unified credit during his lifetime and has no other credits or deductions available to him, he will avoid a total estate tax liability of $4,700,800 by engaging in the naked Crummey transaction.

97. External factors can include, but are certainly not limited to: the desire to maintain good favor with the donor to protect the donee's separate interests in the donor's estate, apart from the trust or demand power; intra-family pressure; and prearranged agreements between the donor and donee. *See* Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).

98. Although the Ninth Circuit in *Crummey* refused to engage in such a likelihood analysis, other courts have been willing to engage in a determination of the probability of contingency. Most notably, the Supreme Court in *Commissioner v. Disston*, 325 U.S. 442 (1945), addressed this very issue when the taxpayer in that case created a trust equally divided for the benefit of each of his five children, including his nineteen year-old son, who was given a one-half interest in the corpus of the trust. The nineteen-year-old's interest, however, was held in trust until he reached forty-five, at which time he was to receive his entire one-half share. The trust instrument itself failed to provide for a beneficiary of the one-half share should the nineteen year-old fail to reach the age of forty-five. Thus, the Court concluded that it was too tenuous to assume that the nineteen year-old would live to forty-five, and as such, the gifts that comprised that half of the corpus were gifts of future interest and therefore did not qualify for the annual exclusion. Moreover, the trust failed to provide for the future beneficiary of the second half of the trust corpus. The taxpayer argued that because that portion of the trust could be invaded (up to ten percent of the cor-

For example, a common Crummey trust scenario will provide lapsing demand powers for the grantor's children *and* grandchildren. Often, the children of the grantor are the sole primary beneficiaries of the trust, leaving the grandchildren with only a remainder interest contingent upon the death of their parent beneficiary before a certain age. Moreover, even in cases where the contingency is remote, at best, these transfers are made between family members with significant economic interests external to the lapsing withdrawal power and the trust corpus, thereby making maintenance of good favor with the donor a much more valuable commodity than the relatively small $11,000 annual gift. In these situations there often exists an implied "you scratch my back, I'll scratch yours" understanding between the grantor and beneficiary where the grantor gets the present benefit of the annual exclusion through the lapse, and the beneficiary maintains their future interest in the grantor's estate by allowing the lapse. From an economic rationality standpoint, because the contingency upon which these grandchildren's interest relies is unlikely to occur, the grandchild, like their naked Crummey power counterparts, should exercise their demand power due to the fact that they will likely never see that money again. Assuming that a donor has five grandchildren, the net estate of that donor is decreased by $55,000 annually without having to give away anything "real." On its face, the $55,000 a year seems a bit paltry in the grand scheme of things. However, if the number of beneficiaries with semi-naked Crummey demand rights are increased to twenty or thirty,[99] and then multiplied over twenty-five years; what at first blush seemed to be an insignificant loss for the fisc, suddenly becomes quite a hemorrhage in estate tax revenue.

VII. *CRISTOFANI V. COMMISSIONER*: ABUSE OF THE ANNUAL EXCLUSION

As discussed earlier,[100] the *Crummey* court left tax planners with broad latitude to use the annual exclusion as a device to avoid the estate tax.[101] As such, tax planners did not disappoint, and continued to

pus) in cases of emergency, the beneficiaries received a present benefit thereby justifying the exclusion. Nevertheless, the Court recognized that the mere possibility that an emergency may arise was not sufficient to turn a future interest into a present interest. In the same vein, the mere possibility that a beneficiary could have a future interest in a trust by virtue of a remote contingency is not enough to allow taxpayers to utilize the Crummey power for the sole purpose of multiplying their tax advantage under the annual exclusion.

99. Anyone who grew up in an Irish-Catholic family can attest that this is a real possibility. *See* Tech. Adv. Mem. 91-41-008 (Oct. 11, 1991) (denying a donor the annual exclusion who claimed exclusions for the Crummey powers held by each of her three primary beneficiary children and thirty-two contingent remainder grandchildren).

100. *See supra* Section VI.

101. *Id.*

push the limits of *Crummey*[102] beyond its originally intended parameters.[103] The most significant Tax Court case to deal with the expansion of the *Crummey* precedent[104] was *Cristofani v. Commissioner*.[105] The controversy in *Cristofani*[106] was centered around annual exclusions claimed by Maria Cristofani for gifts made to her two children and five grandchildren (all minors) in 1984 and 1985. As is the case in a Crummey trust situation, the two children and five grandchildren were each given a lapsing power to demand up to $10,000 of the trust income in the year it was given.[107] In *Cristofani*, however, only the two children of the grantor were named as primary beneficiaries of the trust.[108] The five grandchildren, on the other hand, retained a future interest in the trust only if their parent failed to outlive the donor by one-hundred-twenty days.[109] Due to the tenuous nature of the Cristofani grandchildren's contingent interest,[110] the IRS refused to recognize the transfers made to them as gifts of present interest and denied the annual exclusions for all five grandchildren in both years in controversy.[111] Relying on the definition of a present interest promulgated in *Crummey*,[112] the taxpayer in *Cristofani* argued that, so long as the grandchildren's right to demand payment "could not be [legally] resisted,"[113] the annual exclusion should apply.[114] The IRS countered by establishing that *Crummey* was inapplicable to the situation in *Cristofani* because the beneficiaries in *Crummey* possessed "'substantial future economic benefits' in the trust corpus and income," while the grandchildren in *Cristofani* retained no such future interest because the contingency was unlikely to occur.[115] Ultimately, the *Cristofani* court sided with the taxpayers and found that the demand power held by each of the grandchildren was indeed a present interest and therefore subject to the annual exclusion.[116]

102. *See* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).
103. *See supra* Section VI.A.
104. *Crummey*, 397 F.2d 82.
105. 97 T.C. 74 (1991).
106. *Id.*
107. *Id.* at 75. The beneficiaries were only given fifteen days within which to exercise their demand power. *Id.* at 76. That is fifteen days less than the amount mandated under the notice requirements in Revenue Ruling 81-7. *See supra* note 41 and accompanying text.
108. *Cristofani*, 97 T.C. at 74.
109. *Id.*
110. The *Cristofani* court recognized the unlikelihood of the contingency ever being met, noting that both of the donor's children were in good health upon her death. *Id.* at 83.
111. *Id.* at 78.
112. Crummey v. Comm'r, 397 F.2d 82, 88 (9th Cir. 1968).
113. *See Cristofani*, 97 T.C. at 80 (quoting *Crummey*, 397 F.2d at 88).
114. *Id.* at 80-81.
115. *Id.* at 82.
116. *Id.* at 84-85.

In reaching its decision, the *Cristofani* court expanded the reach of *Crummey* far beyond what was contemplated by the Ninth Circuit, reading *Crummey* as follows:

> We do not believe, however, that *Crummey* requires that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the section 2503(b) exclusion.[117]

Although this seems to be a rather egregious expansion of *Crummey*, it can nevertheless be argued that the *Cristofani* court made its decision within the parameters of the procedural structure left by the Ninth Circuit. *Crummey* involved a trust instrument that provided:

> [W]ith the exception of the yearly demand provision, the only way the corpus can ever be tapped by a beneficiary, is through a distribution at the discretion of the trustee.[118]

If construed broadly, because the beneficiaries' interest in the trust corpus was dependent upon the discretion of the trustee, then it would seem that *Crummey* too involved beneficiaries with contingent interests in the trust corpus, thereby opening the door for courts to uphold *Cristofani*-like abuses of the annual exclusion. However, to read *Crummey* in such a broad manner distorts the reality of the circumstances surrounding the beneficiaries' interest in the trust corpus.

On the one hand the contingency in *Crummey* was predicated upon the discretion of a trustee, who, as a fiduciary, must give effect to the donor's will (as outlined in the trust instrument). Given the language in the *Crummey* trust instrument, coupled with the legal obligation of a fiduciary to carry out the terms of that trust instrument, it was likely, if not certain, that the beneficiaries would receive a share of the trust corpus at some point in the future.[119] In contrast, the contingency in *Cristofani* was based upon the occurrence of an uncontrollable outside event (the death of *both* trustees within 120 days of the death of the decedent) that, given the nature of probabili-

117. *Id.* at 83.
118. *Crummey*, 397 F.2d at 88.
119. The trust instrument in *Crummey* provided that "the trustee was authorized to invade the trust corpus of a beneficiary's trust 'up to the whole thereof' . . . [for the] 'proper care, maintenance, support and education'" of each beneficiary. Crummey v. Comm'r, 25 T.C.M. (P-H) 144, 146 (1966). Given this language, it is fair to say that the beneficiaries in *Crummey* retained a vested economic interest in the trust corpus, even after lapse of their demand power. Furthermore, the Crummey trust language comports with the Ninth Circuit's implicit policy goal in *Crummey*, that is, to allow grantors the benefit of the annual exclusion when providing for the future support of their minor children. *See supra* Section VI.A.

ties, would likely never occur.[120] To assume that a contingency based upon the death of two healthy individuals within four months of another is as likely to vest as one based upon a trustee's discretion (which is guided by specific parameters outlined in a trust instrument) is the logical equivalent of saying that you are as likely to get struck by lightning as you are to stub your toe.[121] Given this distinction, *Cristofani* improperly applied the *Crummey* precedent to a class of beneficiaries never contemplated by the Ninth Circuit's opinion. In turn, *Cristofani*'s reliance upon the reasoning in *Crummey* without a corresponding analysis of the probability of vesting in each case was unjustifiable and warranted much greater scrutiny than it received.

More fundamental than the *Cristofani* court's failure to recognize the different vesting probabilities was its overly broad reading of the *Crummey* decision. By focusing its analysis upon the facts presented before it, the Ninth Circuit in *Crummey* implicitly intended to limit its decision to those facts.[122] The purpose of the *Crummey* opinion was not to create a new mechanism of estate tax avoidance, but to eliminate an inherent inequity in the tax treatment of gifts to minors and adults.[123] Despite this goal, the Tax Court in *Cristofani* chose to engage in an analysis and application of the *Crummey* decision without recognizing the Ninth Circuit's implicit attempt to control the breadth of its opinion.[124] The *Cristofani* court in turn interpreted the Ninth Circuit's *silence* in the broadest sense possible, finding that *Crummey* did not require "that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the 2503(b) exclusion."[125]

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120. The *Cristofani* court went so far as to recognize that each of the primary beneficiaries had, and at all times prior to and after the death of the decedent, been in perfect health. *Cristofani*, 97 T.C. at 84-85.

121. Despite this obvious factual inconsistency, the *Cristofani* court, relying heavily upon the reasoning in *Crummey*, flatly rejected any consideration of the probability of future vesting. Rather, the court focused solely upon the beneficiary's legal right to exercise their demand power as the only relevant factor in determining whether a transfer of present interest was made. (In fact, the *Cristofani* court even went so far as to recognize the fact that each of the primary beneficiaries had, and at all times prior to and after the death of the decedent, been in perfect health.) Such a simplistic test may have been warranted regarding the rather benign contingency in *Crummey*, but the court's application of the same test, without more, to the contingency interests in *Cristofani* represents a complete disregard for the fairly blatant factual distinctions between *Crummey* and *Cristofani*.

122. The Ninth Circuit rejected the opportunity to establish a bright line rule (taken from a lower court decision), believing that it did not fit the facts in its case. *See Crummey*, 397 F.2d at 88 ("In another case we might follow the broader *Kieckhefer* rule since it seems least arbitrary and establishes a clear standard."). Moreover, throughout the *Crummey* opinion, the Ninth Circuit made constant references to "our" case, implicitly limiting the scope of its holding to the specific facts presented before the court. *Id.*

123. *Id.*

124. *See supra* note 89.

125. *Cristofani*, 97 T.C. at 83.

By turning a blind eye to the obvious circumstantial distinctions between its case and *Crummey*, as well as the implicit limits placed upon the *Crummey* precedent by the Ninth Circuit, the *Cristofani* decision expanded the class of eligible Crummey beneficiaries far beyond what was contemplated by the court in *Crummey*. Affording a grantor the opportunity to take advantage of the annual exclusion in a situation where the beneficiary of the Crummey power has little or no opportunity to receive a share of the trust corpus (other than the annual demand power) is a subversion of both the policy rationale behind *Crummey*,[126] and the general purpose of allowing an annual exclusion in the first instance.[127]

VIII. PROBLEMS WITH THE CURRENT SYSTEM

Although thirty-six years of jurisprudence has solidified acceptance of the Crummey power as a viable estate-planning tool, the practical use of the Crummey power is fundamentally at odds with the underlying goals of the tax system as a whole.

A. Crummey Powers Are a Subversion of the Annual Exclusion

The first, and most basic flaw recognized by many commentators is that Crummey powers represent a clear subversion of the Congressional purpose behind allowing an annual exclusion. In creating an annual exclusion to the gift tax, Congress intended to only cover small, customary gifts to "obviate the necessity of keeping account" of such gifts for tax purposes.[128] When viewed in this context, Crummey powers, even when granted to vested beneficiaries, certainly tend to subvert the spirit behind the exclusion. If the annual exclusion was intended to cover only relatively small, customary gifts one normally provides for friends and family during the course of a year, it is hard to imagine how Crummey powers fall within those parameters.

For instance, picture a suburban Chicago Christmas, and little, four year-old Maggie makes her way down the stairs to find two gifts from her Grandma Willie under the tree: a shiny red bicycle with a bow on it and a wrapped box with a gleaming piece of paper notifying her that she has thirty days to exercise an $11,000 Crummey withdrawal right. Although Maggie is intelligent beyond her years, it is safe to say that she only views one as a "gift." Why? Because a bike is something that the average person would see as a regular, run of the mill Christmas present. A bike at Christmas is no different than a doll for her birthday, a $100 savings bond for her first communion, or $5,000 for her college graduation. The $11,000 withdrawal right, on

126. *See supra* Section VI.A.
127. *See supra* Section III.
128. S. REP. NO. 72-665, at 41 (1932); *accord* H.R. REP. NO. 72-708, at 29 (1932).

the other hand, is clearly not considered a "gift" in the same sense by Maggie—or anyone else for that matter.[129] Yes, Maggie has a thirty day "right" to that $11,000, but what is "ordinary" about such a right? Even an $11,000 bicycle at Christmas and a thirty-day lapsing withdrawal right are certainly not "ordinary" in the same sense. Using this reasoning, many argue that the Crummey power is not a "gift" recognized under the annual exclusion, and as such should be considered a gift of future interest.

B. Horizontal Inequity Created Between Grantors Who Use and Do Not Use Crummey Gifts

Maggie's situation illustrates a related problem with Crummey powers. Assuming that Grandma Willie's $11,000 "Crummey" Christmas present to Maggie is considered a gift for purposes of the annual exclusion, then the threshold amount for annual gifts allowable under the exclusion is met, thereby rendering any additional gift from Grandma Willie to Maggie during the same year taxable as an inter-vivos transfer.[130] Under this scenario, Grandma Willie would owe gift taxes on the value of the bicycle given to Maggie (in addition to the total value of any other gifts to Maggie made throughout the year for her birthday, Easter, and other holidays or special occasions). Gift taxes are rarely, if ever, paid on the value of incidental gifts given to a beneficiary *in excess* of the annual exclusion amount used to cover the value of the Crummey withdrawal right. Thus, in an ironic twist of fate, the very same gifts that Congress intended to cover with the annual exclusion are not taxed when, in fact, they should be. This problem of Crummey grantors "double dipping" at the annual exclusion effectively blurs the amount excludable under I.R.C. § 2503(c) into an indeterminate number, amenable to the needs of each individual Crummey grantor.

As a result of "double dipping," a horizontal inequity problem is created between those who grant lapsing withdrawal rights and still give those beneficiaries "ordinary" gifts (Crummey taxpayers), and those taxpayers that only give "ordinary" gifts (regular, non-Crummey taxpayers). Because Crummey taxpayers can effectively increase the amount of the annual exclusion available to them by "double dipping," they are placed at a significant tax advantage when

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129. After all, if Maggie wanted to be careful and leave her new bike untouched until spring, would her parents take it back after thirty days? Of course not. That is not what a gift is about. On the other hand, if Maggie wanted to wait until March to exercise the withdrawal right she received at Christmas, she would find that the "gift" was removed from her reach until some point in the distant future. When Maggie's right to the $11,000 is not absolute, how can she say that she has "received" anything?

130. *See* I.R.C. §§ 2501(a), 2001(c) (2002).

compared to taxpayers who do not utilize a lapsing withdrawal power.

For example, imagine two taxpayers, Arnold and Willis, each with $5,000,000 estates. During the course of a year, Willis gives his granddaughter Kimberly three gifts totaling $16,000. At tax time, Willis claims all three gifts to Kimberly. Because of the annual exclusion, Willis will not be taxed on the first $11,000 of the gifts to Kimberly, but will incur gift tax liability on the $5,000 in excess of the exclusion amount. Not to be outdone, Arnold gives his grandson Abraham incidental gifts (on his birthday, Christmas, Arbor Day, and so forth) totaling $5,000. In addition, Arnold has set up a Crummey trust naming Abraham as sole beneficiary. Each year Arnold grants Abraham an $11,000 withdrawal right that Abraham allows to lapse. When tax time rolls around, Arnold claims the $11,000 lapsing demand power under the annual exclusion, but never claims the $5,000 in incidental gifts to Abraham because, as he says, "How can normal gifts be taxable?" Arnold is partially right. Ordinary gifts are not supposed to be taxable; they are meant to be captured by the annual exclusion. However, when the full annual exclusion amount has already been exhausted by a lapsing demand right to a beneficiary, the value of ordinary gifts to that same beneficiary should theoretically be considered a taxable inter-vivos transfer.[131]

Unfortunately for the fisc, the Arnolds of the world do not count the ordinary gifts made to beneficiaries in excess of the $11,000 claimed for the lapsing demand power; and therein lies the inequity to taxpayers like Willis. While Willis is taxed on the excess $5,000 given to Kimberly, Arnold, who gifted the same total amount to Abraham, is not taxed because incidental gifts are never claimed and, by extension, never taxed. As a result, two similarly situated taxpayers are afforded different tax treatment due to one taxpayer's utilization of the Crummey power.

C. Horizontal Inequity Between Crummey Grantors With Differing Beneficiary Pools

In addition to the horizontal inequity created by "double dipping," Crummey powers also create horizontal inequity between similarly situated Crummey grantors. Again, by way of example, assume that two similarly situated taxpayers, Bo and Luke, each want to gift $55,000 into a trust for the benefit of their Uncle Jesse (who cannot be trusted with a demand right) while claiming the entire amount under the annual exclusion. Bo, who has five children, can simply grant each of his children a contingent remainder interest in the

131. *Id.*

trust and a corresponding demand power to achieve his of annually adding $55,000 into the trust under the I.R.C. § 2503(b) exclusion. Luke, on the other hand, has only two minor children and, thus, can only claim $22,000 under the annual exclusion (with the remaining $33,000 still includible in his estate).[132] As a result, two similar taxpayers with the same goal are treated differently under the Tax Code simply because one individual has more children that he can trust not to exercise the demand power.[133]

D. Parent Beneficiaries Who Act as Guardians for Minor Beneficiaries of the Same Trust

One of the more abusive situations involving Crummey powers occurs when a beneficiary of a Crummey trust simultaneously serves as guardian over his minor child who has a contingent remainder interest in the same trust.[134] In such a situation, the minor beneficiary cannot be expected to make an effective demand, and thus the parent, as guardian, makes the minor child's decision to lapse for him. The problem in this scenario is that the parent cannot be expected to make an impartial decision for his minor children because the parent retains a vested interest in the trust corpus.

To illustrate, assume that a Crummey grantor, Howard Cunningham, grants a $10,000 lapsing Crummey withdrawal right to his two sons, Richie and Fonzi. In addition, he grants a lapsing withdrawal right to Richie's two children, Joanie, age four, and Chachi, age six. Under the trust instrument, Richie and Fonzi are the primary beneficiaries, each to receive half of the accumulated trust corpus upon the death of the grantor. Further, if the grantor outlives both primary beneficiaries, Richie and Fonzi, then Joanie and Chachi share in Richie's half of the corpus and Fonzi's surviving issues get his share.

In most situations, all four beneficiaries will allow their demand powers to lapse. Richie and Fonzi each make their own decision to lapse, while Joanie and Chachi's decision is made through their parent and legal guardian, Richie. By making the decision to allow Joanie and Chachi's Crummey power to lapse, Richie has effectively

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132. This hypothetical assumes that both Bo and Luke will only trust members of their immediate family with the demand power. For Luke to accomplish the goal of annually gifting away $55,000 tax-free, he would have to confer a demand power upon an extra-family beneficiary, incurring a greater risk of exercise because an extra-family beneficiary does not have the same type of external pressures to allow lapse that a family member does (i.e., to stay in the good graces of the grantor to maintain a potential inheritance).

133. This hypothetical illustrates yet another problem presented by lapsing demand powers: parental control over a minor child's Crummey power. *See infra* Section IX.D.

134. *See* Cristofani v. Comm'r, 97 T.C. 74 (1991).

increased his share of the trust corpus by $10,000.[135] Because Richie's interest in the trust corpus is vested, it is likely that he will receive his share of the corpus at some point in the future. That being the case, economic rationality demands that when an individual is presented with an opportunity to add to his overall wealth, he will exercise the choice that affords him with the greatest increase in that wealth.[136] For example, if an individual is presented with three bills on a table ($1, $20, and $100), the economically rational decision is to opt for the $100 bill. In much the same way, when Richie is presented with the opportunity to increase the amount in trust that will be payable to him in the future, economic rationality demands that he exercise that opportunity.

Thus far, the discussion has centered around the economic motivation behind Richie's decision to lapse Joanie and Chachi's demand power. What about Joanie and Chachi's economic motivation? After all, if their economic motivation to lapse is the same as Richie's, then what harm is done by allowing Richie to do what Joanie and Chachi would have done anyway? Unfortunately, it is not that simple. Remember, Joani and Chachi are *contingent* beneficiaries whose interest in the trust corpus is reliant on an outside event (the death of Richie within three months after the death of Howard) that in all likelihood will never occur, thereby making their probability of vesting unlikely at best. Once again, economic rationality tells us that, when placed in the situation of choosing between sure money in the present, or unlikely money in the future, an individual will always choose sure money in the present.[137] Therefore, under normal circumstances, Joanie and Chachi will always choose to exercise their de-

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135. To further illustrate how Richie's share is increased by allowing Joanie and Chachi's Crummey power to lapse, assume that Howard gifts away $10,000 per beneficiary for ten years and subsequently dies after the tenth year. If all four beneficiaries allow their power to lapse, the entire trust corpus would be composed of $400,000 ($200,000 for Richie and $200,000 for Fonzi). However, if Joanie and Chachi were to exercise their demand power in each of those years, then, at the end of the ten years Richie and Fonzi would only be left with $100,000 each. Thus, by allowing Joanie and Chachi's power to lapse, Richie effectively doubles the amount available for distribution between Fonzi and himself upon Howard's death.

136. An increase in wealth need not be immediate to be considered economically rational. For instance, a vested beneficiary will often allow a lapse of his Crummey power, and thus forgo the immediate increase in wealth, in order to keep the demand amount in the trust (which will likely produce a greater long-term rate of return on the $11,000 gift than could be achieved by a beneficiary if he were to invest it himself). Thus, the decision to lapse in that situation is economically rational and thus justified. *See supra* note 91; *cf.* Fogel, *supra* note 84, at 606-07 (arguing that the actuarial value of a vested beneficiary's lapsed demand right will always be less than the present value of the Crummey gift because when the same lapsed demand power is placed in trust, it must be discounted to reflect the possibility that the beneficiary will not reach the age requirement specified in the trust language).

137. Of course, this assumes that there are not any external circumstances that would warrant a lapse.

mand power.

Having established that economic rationality dictates that Richie will always seek to increase his share in the corpus by allowing Joani and Chachi's demand power to lapse, and Joani and Chachi will always choose to exercise their demand power (being contingent beneficiaries), how do we reconcile these conflicting desires? Given that Richie's economic interests are at odds with Joanie and Chachi's,[138] it simply cannot be said that Richie's decision to lapse on behalf of Joanie and Chachi is completely objective. Why, then do we allow Richie to make that decision for Joanie and Chachi? The answer for some lies, in part, on the nature of intra-family relationships.

Although it is a maxim of human existence that most every parental decision is made with the child's best interests in mind; as with everything else in life, there are plenty of exceptions to that rule.[139] As such, a minor child's best interests are not always represented when a parent beneficiary is the one responsible for making the decision whether to exercise a child's demand right.

E. Collusive Agreements Between Grantor and Beneficiary Used to Assure Lapse

A related problem with allowing a parent beneficiary to exercise his child's demand right is that such an arrangement effectively allows a donor to multiply the number of exclusions available to them without increasing the corresponding risk of exercise. In granting Crummey powers to beneficiaries to claim the annual exclusion, the only real risk to any donor is that a beneficiary will exercise their withdrawal right, thereby eliminating the primary advantage of a Crummey trust (i.e., gifts in trust being considered present interest gifts in order to take advantage of the annual exclusion). Thus, above all else, Crummey donors want to be sure that their beneficiaries will not exercise their withdrawal right. Using the same hypothetical above, by granting withdrawal rights and corresponding contingency interests to Joanie and Chachi, Howard effectively doubled the amount he could siphon off from his estate to his children under the annual exclusion. Moreover, because Richie effectively exercises the demand rights for not only himself, but Joanie and Chachi as well, Howard is able to "kill three birds with one stone" and multiply the amount excludible from gift tax without a corresponding risk of exercise.

138. This is only from a purely *economic* standpoint, without any consideration given to intra-family externalities.

139. *See*, *e.g.*, Rev. Rul. 87-4 (where a parent, as the sole primary beneficiary of a trust, consistently allowed her minor child's withdrawal right to lapse and upon the parent's death, she left nothing to her child (who was an adult by that time)).

Nevertheless, in order to preserve the tax effectiveness of his Crummey gifting plan, Howard must be assured that Richie and Fonzi will allow their Crummey powers to lapse. Otherwise, the gift is never placed in trust, and the transaction ultimately amounts to a roundabout method of gifting outright. As mentioned earlier, because Richie and Fonzi are the primary beneficiaries of the Cunningham Crummey trust, the decision to allow their Crummey powers to lapse has an economically rational justification because their future access to that property is not *eliminated* by the lapse, but merely *postponed*.[140]

However, if the facts in the Cunningham hypothetical are changed, and Fonzi's interest in the trust principal is made contingent upon his outliving Richie, Joanie, and Chachi by three months, then it follows that Fonzi will not allow his Crummey power to lapse because he will almost certainly never have access to that money again. Given this, how can Howard overcome the economic rationality that demands Fonzi exercise the $11,000 withdrawal right, and thus be assured that Fonzi will allow lapse? The easiest, and thus most often employed, solution to Howard's dilemma is to simply come to a prearranged "understanding" with Fonzi whereby Fonzi guarantees Howard that he will not exercise his demand right.[141] Thus, once he is assured that Fonzi will allow his Crummey power to lapse, Howard can safely convey an additional $11,000 (along with the $33,000 transferred to Richie, Joanie and Chachi) under the annual exclusion into the Cunningham trust meant to benefit only Richie and his heirs.

From the Service's perspective, the problem with these prearranged agreements is that Howard is afforded the benefit of the annual exclusion for the demand power given to Fonzi when, given the preexisting "understanding" not to exercise, Fonzi was not "really" granted the present right to the $11,000. Because Fonzi's "use, possession or enjoyment"[142] of his right to $11,000 is, for all practical purposes, eliminated by the prior agreement, then the demand right cannot be considered a present interest and the annual exclusion should be denied. Thus, the IRS would contend, the Crummey power given to Fonzi in this situation is illusory and should not qualify for the annual exclusion.

Despite the logic behind the Service's position, any attempt to prove the existence of such an "understanding" has proven difficult. This problem is exacerbated by the fact that these agreements are of-

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140. *See supra* notes 91 and 136.

141. Often this "understanding" is secured by a beneficiary's belief that he will be "penalized"—via a reduction or elimination of their interests in future gifts and/or bequests from the grantor—if he exercises his withdrawal right.

142. Kieckhefer v. Comm'r, 189 F.2d 118, 121 (1951).

ten implied between family members, leaving the government with very little tangible evidence with which to prove its case. As a result, courts have been reluctant to recognize the validity of the "lapse agreement" argument due to the subjectivity involved in making such a determination.[143]

IX. SUGGESTIONS FOR REFORM

Given the potential for abuse of the annual exclusion established by *Cristofani* and its progeny, it is relatively clear that a change to the structure of the annual exclusion is necessary if the IRS is to maintain the integrity of the gift tax. Only one question remains: What do we change?

A. Elimination of the Crummey Power

As an answer to *Crummey*'s subversion of the purpose behind the annual exclusion, some argue that the availability of the annual exclusion to all lapsing demand powers should be eliminated.[144] After all, if the donor truly intended to give a beneficiary a present interest in the property subject to the demand power, he would have simply given that beneficiary an outright gift. Moreover, such a solution would subsequently solve the horizontal equity problem faced by our friends Arnold and Willis.[145] However, such a remedy undermines the

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143. *See* Holland v. Comm'r, 73 T.C.M. (CCH) 3236 (1997). Despite having found that there was an "informal agreement" regarding the beneficiaries' decision to lapse their Crummey demand right, the *Holland* court held that so long as an agreement between the parties is not legally binding, the annual exclusion will not be denied on the basis of a prearranged "understanding" between the parties. *Id.* at 3237. Given that the vast majority of Crummey powers are conveyed in the intra-family context, any agreement between donor and donee to ensure lapse of that power will often, if not always, be informal in nature. As a result, the *Holland* court's insistence on legal enforceability is particularly damaging to the Service's ability to combat Crummey abuse through their prearranged "understanding" argument.

Cf. Kohlsaat v. Comm'r, 73 T.C.M. (CCH) 2732 (1997). Decided only a few months prior to *Holland*, the *Kohlsaat* court took a much more accepting view of the Service's prearranged "understanding" argument. Although the *Kohlsaat* court ultimately sided with the taxpayers and refused to infer an agreement from the surrounding circumstances, its decision was not based upon the legal enforceability of the agreement between donor and donee. Rather, the court refused to accept the Service's prearranged "understanding" argument because the record lacked sufficient evidence to prove the existence of such an agreement. *Id.* at 2734. Thus, the *Kohlsaat* decision seems to imply that in cases where there is sufficient evidence of a prearranged "understanding" not to exercise a Crummey demand right, the annual exclusion should be denied, regardless of the legal enforceability of such an "understanding." *See also* Trotter v. Comm'r, 82 T.C.M. (CCH) 633, 637 (2001) (finding that the terms of the trust, coupled with the circumstances surrounding its operation, were "supportive of an *implied understanding* that the withdrawal rights would not be exercised" (emphasis added)).

144. *See* Arash, *supra* note 62, at 111-12; Nicholas A. Vilestra, *Estate of* Cristofani v. Commissioner: *The Expanded Potential of Crummey Powers for Transfer Tax Avoidance*, 45 TAX LAW. 583, 595 (1992).

145. *See supra* Section VIII.B.

sound policy rationale for allowing donors the ability to take advantage of the annual exclusion through Crummey powers. As discussed earlier in this Comment, the purpose of the Crummey power is to right the inequity between taxpayers who can provide for beneficiaries through annual outright gifts (because those beneficiaries are mature enough to manage the property effectively) and those donors who wish to do the same for beneficiaries who cannot be trusted to manage the gift in an efficient manner.[146] Thus, when limited to those beneficiaries with a vested interest in the trust of equal or greater value than their cumulative demand powers, the Crummey power serves a rational public policy function that should not be eliminated on account of abusive situations that exist beyond that purpose.[147]

B. Change the Annual Exclusion From a Per Donee Model to a Per Donor Model

Another suggestion espoused by many commentators to eliminate abuse of the annual exclusion has been to base the exclusion on a "per donor" model rather than the current "per donee" system.[148] Under the per donor model, rather than cap the exclusion amount on the basis of gifts given to a single donee, the exclusion would be based upon the total amount gifted by a donor in a given year. Although the overall amount of the exclusion would likely increase, this solution would nevertheless create an absolute threshold on annual gifts and thus place a significant limit on potential abuse of the exclusion. Assuming that the annual exclusion is bumped up to $50,000 per donor, the horizontal inequity between our friends Bo and Luke would effectively be eliminated given that each would now be able to claim the entire $50,000 under the annual exclusion no matter how many children each had.[149]

The per donor model has significant merit when placed in the context of Crummey powers. Capping the amount of the annual exclusion based upon the donor, while raising the amount excludible in a reasonable manner, not only eliminates the potential for significant abuse, but also maintains the integrity of the policy rationale behind allowing Crummey powers.[150] In turn, such a reform serves as a justi-

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146. *See supra* Section VI.A.

147. Although this solution wins a blue ribbon for simplicity, it is nothing more than a knee-jerk reaction that reaches too far to solve a relatively narrow problem.

148. *See, e.g.*, Steinkamp, *supra* note 8.

149. Moreover, the per donor model has the added benefit of virtually eliminating abusive situations like *Cristofani* because a per donor limit of $50,000 would serve as the equivalent to a five beneficiary cap under the current per donee model.

150. *See supra* Section VI.A.

fiable middle ground between complete elimination of the Crummey power and the current system.

C. Creation of an Independent Fiduciary for Minor Beneficiaries

The examples presented earlier concerning the Cunningham clan are some of the more abusive and ubiquitous abuses of the annual exclusion through the use of Crummey powers.[151] By permitting a parent with a vested economic interest in the trust to allow his minor child's right to withdrawal lapse, the economic interests of the child are not met. In other legal arenas, when a child's best interests are not met by a parent, a court or statute will step in and appoint an agent to ensure that the minor child is properly represented.[152] Minor Crummey beneficiaries should be treated no differently. Therefore, rather than relying upon a parent beneficiary with an economic interest in their minor child's lapse, a statutorily mandated independent fiduciary should be appointed in cases where the exercise of a minor child's withdrawal right is dependent upon a parent beneficiary with a vested interest in the same trust. The fiduciary, guided by the circumstances surrounding the demand power, may be seen as the gatekeeper of economic rationality, ensuring that the integrity of the withdrawal power is kept intact.[153] Moreover, this remedy provides an added benefit to courts in that it removes the burden of having to subjectively determine why a particular demand was not made because the court may assume that a decision to lapse made by an independent fiduciary was in the absolute best interests of the child.

In addition, the presence of an independent fiduciary serves to curb abuse of the annual exclusion through the multiplication of contingent beneficiaries without any corresponding risk of exercise. As indicated by the Cunningham hypothetical, a Crummey grantor can increase the number of annual exclusions claimed in a given year simply by granting the children of each primary beneficiary a meaningless contingent interest in the trust and giving them a lapsing withdrawal right. Therefore, so long as the Crummey grantor can ensure that the parent will not withdraw, there is no increase in risk that the contingent beneficiaries will exercise their demand power either (because the parent will make the decision for them). However, the situation is drastically changed when it is no longer an economi-

151. *See supra* Section VIII.D.

152. For example, in large tort settlements in which the plaintiff is a minor, a court will often step in and appoint a guardian to oversee distributions of the settlement to ensure that the child's economic best interests are maintained.

153. After all, if the Crummey grantor truly intended to give the beneficiary an absolute right to demand, then actual withdrawal will have no unexpected consequence to the donor.

cally interested parent making the decision to lapse, but rather an independent fiduciary who will make a determination based upon the best interests of the child. In such a situation, a Crummey grantor cannot be certain that the minor beneficiary's demand power will be lapsed, thereby defeating the purpose behind granting the demand power to begin with. As a result, with the fear that an independent fiduciary will actually exercise a minor beneficiary's demand right, Crummey grantors will be less likely to grant minor beneficiaries demand powers coupled with meaningless contingency rights in trust, thereby reducing the number of "sham" annual exclusions claimed by grantors such as Howard Cunningham.

D. Establish a Five-Year Window of Review for All Trusts With Lapsing Demand Powers

Due to the reluctance of most courts to recognize the validity of the pre-arranged "understanding" argument, the Service has been relatively unsuccessful in combating the use of lapsing Crummey powers to multiply the amount that grantors may transfer into trust under the annual exclusion. For most courts, the problem with the pre-arranged "understanding" argument lies in the fact that it relies primarily upon a subjective assumption by the IRS—that is, absent an agreement between the grantor and beneficiary, the decision to lapse is illogical.[154] In turn, to remove the taint of subjectivity from its attack on abusive Crummey powers, the IRS should employ an objective mechanism that will not only effectively determine the validity of a Crummey beneficiary's decision to allow lapse, but also confine the availability of the annual exclusion to only those Crummey beneficiaries that are in keeping with the policy rationale underlying the Ninth Circuit's decision in *Crummey*.

One method by which the IRS may accomplish this two-pronged goal is through the creation of a five-year "look back" window that the Service can use to determine the validity of the annual exclusions claimed under a Crummey trust. Under this approach, the IRS will review all Crummey trusts five years after their creation and, in doing so, utilize three objective factors to determine whether the annual exclusions claimed by way of Crummey withdrawal powers were bone fide present interest gifts, and therefore justified.

First, the Service must look to the relationship between the grantor and the beneficiaries that received lapsing withdrawal rights during the first five years of the trust. Any decision to lapse made by a beneficiary that is a direct descendent (son or daughter) of the grantor will be considered genuine per se, so long as that beneficiary has

154. *See* Fogel, *supra* note 84, at 612.

an irrevocable vested interest in the trust principal. In turn, the annual exclusions claimed with regard to the Crummey powers granted to those beneficiaries will stand, thereby exempting them from any future "look back."

If, however, an annual exclusion is claimed for a lapsed demand power granted to a beneficiary other than a direct descendent, a five-year "look back" window will be triggered. Using this "look back," the Service will review the actual operation of the withdrawal rights granted to those beneficiaries. If it is determined that any of the non-exempted beneficiaries have failed to exercise their Crummey demand rights in more than two of the first five years of the trust's existence, then the annual exclusions claimed for those beneficiaries will be deemed illusory, and the grantor will no longer be afforded the benefit of the annual exclusion for any future lapsing demand powers given to that beneficiary. To prevent grantors from circumventing the purpose of the five-year "look back" by simply complying with the requirements for the first five years of the trust, the Service will again review the trust every ten years thereafter to ensure compliance.[155]

Finally, regardless of whether a beneficiary is exempted from the "look back" or not, at each point of review (five years from date of creation and every ten years thereafter) the Service will review each lapsing demand power to ensure that it fully complied with the notice and opportunity to exercise requirements set forth in Revenue Ruling 81-7.[156] Any lapsing withdrawal right granted to a beneficiary that fails to meet the notice and opportunity-to-exercise requirements will be deemed illusory and thus fail to qualify for the annual exclusion in each year where the requirements were not met.

Although far from perfect, this proposed solution avoids the pitfalls of the Service's current pre-arranged "understanding" argument by employing a mechanical test that is reliant only upon objective criteria to prove the genuineness of a Crummey demand right. Moreover, this answer maintains the spirit of *Crummey* by limiting the use of the Crummey mechanism to the beneficiaries that were of primary concern to the Ninth Circuit—the grantor's children.

X. CONCLUSION

When Crummey powers are utilized outside of their originally intended context, the potential for abuse of the annual exclusion is exponentially increased to a point that borders on inevitability. This abuse comes in all shapes and sizes, with the greatest opportunity for

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155. The ten-year review will require a beneficiary to have exercised his withdrawal right in six of the ten years reviewed in order for the annual exclusions to be deemed valid.

156. *See* Rev. Rul. 81-7, 1981-1 C.B. 474; *supra* text accompanying note 42.

abuse arising in the context of beneficiaries with a "naked" demand right. Despite this abuse, the Crummey power is a firmly entrenched legal tool with a sound policy rationale behind it. Due to the justifiable policy goals furthered by Crummey powers, *Crummey* need only be fixed, not eliminated altogether. In turn, the IRS and the legal community are best served by looking for specific solutions to the narrow problems created by the Crummey power, rather than pushing for an all out repeal of the *Crummey* decision.

By far, the most equitable of these specific reforms is the per donor annual exclusion model. It is the only solution that can both maintain the integrity of the annual exclusion, while at the same time preserve the justifiable policy rationale behind *Crummey*. Once instituted, such a policy will finally afford parents the opportunity to pass on to their children what is rightfully theirs, and render unto Caesar what is rightfully his.