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# ‘Crummey” Powers Survive Attack by IRS: A Test Case

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## The IRS Response –The Prearrangement Issue

In 1994, the IRS denied annual gift exclusions stemming from Crummey powers granted to 16 members of the Kohlsaat family.

## The Kohlsaat Test Case

The *Kohlsaat* test case was argued in the United States Tax Court in early 1996 and the verdict was rendered in May 1997. The Court held that the taxpayer was entitled to all 16 annual gift tax exclusions and rejected the IRS’ request that the Court infer an understanding that the contingent beneficiaries had agreed with the grantor not to exercise their Crummey rights.

However, until the IRS abandons its general opposition to Crummey trusts, insurance and financial services professionals would be well-advised to remain prudent, to advise their clients of the possible audit and legal risks involved, and to design and operate Crummey trusts carefully to meet the formalities of the law.

## Facts

Lieselotte Kohlsaat, a great-grandmother residing in New Jersey and part of a family long active in the real estate business, created the Kohlsaat Trust in March 1990, three months prior to her death.

The Kohlsaat trust provided Crummey rights to 18 beneficiaries in all, a class consisting of two children, seven grandchildren, eight great-grandchildren and one daughter-in-law. For 30 days from the date of each contribution to the trust, each Crummey beneficiary had the right to withdraw an amount up to $10,000. Only one contribution to the trust was ever made: a commercial real estate building valued at $155,000. Each beneficiary (or a guardian, if applicable) received written notice of his or her right to withdraw, and each opted not to exercise his or her Crummey power.

Based on the 18 separate Crummey rights, the taxpayer claimed entitlement to annual gift exclusions sufficient to shelter the entire value of the building free from gift tax. Several years later in 1994, the IRS disallowed all but the two exclusions related to the two children, creating a tax deficiency, and leading to the litigation in the Tax Court.

## IRS Argument

The main thrust of the IRS’ position in *Kohlsaat* was that the form of the Kohlsaat Trust granting Crummey rights to all 18 beneficiaries must not overshadow its substance as a transfer to the two children primarily.

In *Kohlsaat*, the IRS argued by analogy that if substance over form analysis was appropriate, it was appropriate for situations involving Crummey trusts. In fact, the IRS argued, in spite of the *Crummey* and *Cristofani* rulings, that substance over form analysis was doubly applicable to Crummey trusts because intra-family transfers are looked upon with an extra dose of suspicion.

The IRS argued that the purported form of the transfer, the granting of Crummey rights to a class of family members, and everyone’s non-exercise of such rights, was in substance a transfer of property to the primary beneficiaries of the trust only.

The IRS further argued that if there were a “prearrangement” or “understanding” that the Kohlsaat Trust Crummey beneficiaries would not exercise their withdrawal rights, then the Crummey rights were never “bona fide” and no annual exclusions should be available.

Engaging in rampant speculation about the Kohlsaat clan, and by extension most families with Crummey trusts, the IRS inferred that all of the “prearrangement” or “understanding” factors applied. Otherwise, there was no way to reasonably explain why every grandchild or great-grandchild with immediate access to $10,000 would pass up the $10,000.

Finally, appealing to public policy considerations, the IRS theorized that Congress surely never intended to allow wealthy taxpayers to escape estate and gift taxes via unlimited Crummey powers. When the gift tax exclusion was originally enacted, it was aimed primarily at exempting taxpayers from reporting birthday presents, Christmas gifts, and the like. It was not contemplated that life insurance and estate planning professionals would develop and proliferate the Crummey power to such an extent.

## Tax Court Decision

The *Kohlsaat* court held that each of the Kohlsaat Trust contingent beneficiaries held a present interest in trust property qualifying for the annual gift tax exclusion. Citing *Crummey* and *Cristofani* as precedent, the Court stated that "where trust beneficiaries, including minor and contingent beneficiaries, are given unrestricted rights to demand immediate distributions of trust property, the beneficiaries *generally* are treated ...as possessing present interests in property." Then, turning to the specific allegations of the IRS that an understanding existed between the decedent and the contingent beneficiaries that the beneficiaries would not exercise their Crummey rights, the Court found that the taxpayer met its burden of proving otherwise.

Very importantly, the Court rejected outright the core of the IRS argument, namely, that the parties' common actions or inactions in failing to exercise their rights to receive the $10,000 implied an unspoken prearrangement.

> **Unimpressed by any such notion, the Court ruled that:**
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> **"The fact that none of the beneficiaries exercised their rights or that none of the beneficiaries requested notification of future transfers of property to the trust does not imply to us that the beneficiaries had agreed with decedent not to do so, and we refuse to infer any understanding."**

The Court also dismissed any thought that the beneficiaries failed to exercise their Crummey powers out of fear, ignorance, or lack of notice, finding no evidence in support thereof. In the Court's view, the decedent fully intended to benefit the contingent beneficiaries, her relatives.

## Legal Analysis of Kohlsaat

The *Kohlsaat* result, on balance, is amply supported by case law, the facts of a typical Crummey situation, and wise tax policy. without adequate support for its position, the IRS' attempt to limit Crummey trusts rightfully failed. However, despite the Tax Court's favorable ruling in *Kohlsaat*, the decision technically represents a narrowing of prior precedent, although as a practical matter properly designed and operated Crummey trusts are as safe as ever.

## The Law Applied to Crummey Trusts

The language of *Crummey* and *Cristofani* is very explicit in support of the proposition that it is the legal right to withdraw that matters, not the underlying facts and circumstances.

The present interest gift exclusions were allowed because the beneficiaries' demand rights could not be denied. The facts, damning as they were, were irrelevant.

> **The Court stated: "As discussed in Crummey, the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test ... Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee'' right to legally resist...."**

## Crummey Powers Do Not Lack Substance

By dismissing the factual contentions of the IRS, the *Kohlsaat* court never had to apply the substance over form test directly: thus, that issue and its applicability to Crummey trusts remains something of an open question. Arguably, the substance over form doctrine should not apply except in extreme situations. Essentially, the IRS' victories in the substance over form cases are distinguishable because those cases involved fictional transfers and fraud, not the failure to exercise a property option.

The gulf between a case like Kohlsaat and the fictional transfer cases is unbridgeable. Perhaps a non-family Crummey beneficiary might be sufficiently extreme to justify a "substance over form" result, or perhaps expressed statements of collusion may come to light in a future case, but such situations are the exception rather than the rule.

## Crummey Trusts and Factual Proof

### Runaway Inferences.

As the *Kohlsaat* decision repeatedly emphasized, the facts in the case supported the taxpayer. In attacking the Kohlsaat Trust, the IRS engaged in runaway speculation and conjecture in its failed effort to show prearrangement. Indeed, unless a family is very indiscreet, the IRS will suffer from difficulties of proof in most Crummey rights cases.

> Case specific hard evidence was not a consideration. As summed up by the IRS:
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> "We do not know what winks, nods, promises, representations, concealment's, explanations, or tacit understandings took place. Maybe absolutely no words were said. But, in the end, the beneficiaries did what they were supposed to do – pass up the money."
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> It was "not clear how the understanding or prearrangement was reached ...or what the nature of that understanding was", but it was there, the IRS was certain, somewhere in the "entire record" of the case.

Obviously, such speculation did not impress the Tax Court. The fact that all 16 contingent beneficiaries passed up the money did not, in and of itself, constitute prearrangement. In the absence of a "smoking gun," such as a rare admission of prearrangement by one of the parties, the IRS will not prevail unless a court allows the IRS to liberally infer damaging facts. The *Kohlsaat* case indicates such a strategy will not succeed.

### Tax Policy and Procedure

Unless the Internal Revenue Code is changed to limit the excludability of Crummey rights, taxpayers should be able to reasonably assume that they may rely on nearly thirty years of legal precedent.

### Congress is the Proper Forum

The ultimate resolution of the Crummey trust controversy belongs in Congress. Since the *Crummey* decision in 1968, Congress has had many opportunities to overturn or narrow the holding that a Crummey right is a present interest eligible for the annual exclusion. Instead, Congress has chosen to leave the decision undisturbed. In requesting the Tax Court in *Kohlsaat* to change drastically the law, without support for such change in Congress, the IRS was overreaching.

### Practical Considerations

The *Kohlsaat* decision reflects and reinforces the present practice of utilizing Crummey trusts, and firmly demonstrates that the IRS overstated its position. Any change in direction in the law would probably emerge only from a future circuit court case, but the taxpayer victories in *Crummey*, *Cristofani*, and *Kohlsaat* offer little indication that change is imminent. Nonetheless, unless and until the IRS abandons its position articulated in *Kohlsaat* and administrative pronouncements, Crummey trusts should be utilized carefully by life insurance and financial planning professionals.

### What specific protective actions can financial advisers take for their clients?

Grantors and trustees should never, under any circumstances, state or imply to any Crummey beneficiary that his or her Crummey rights are illegitimate or that he or she is not free to choose. Written notice requirements must be scrupulously adhered to every year and a minimum 30-day exercise window is recommended. Also, never, under any circumstances, should a donor claim annual exclusions for Crummey trusts unless they are actually funded that year.

For a large trust such as the Kohlsaat Trust, Crummey beneficiaries could be given nominal vested rights. In addition, tax opinions and grantor supporting affidavits could be obtained.

Last, adequate disclosure of risks is vital. Based on the current state of the law, especially after Kohlsaat, Crummey trusts appear to be a well-calculated risk, but an adverse decision in a future case could lead to tax deficiencies.

### Conclusion

Based on the strong legal underpinning for Crummey trusts and the lack of a "smoking gun" in evidence, the taxpayer in *Kohlsaat* prevailed. Besides reassuring the many taxpayers in like situations, the *Kohlsaat* decision is both useful guidance and important authority for financial services and life insurance professionals navigating the tax and estate planning minefield. In a tax system reliant on predictability of results, nearly thirty years of uninterrupted legal precedent favoring Crummey trusts merits substantial deference and respect.