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Kent A. Mason

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AN ANALYSIS OF CRUMMEY AND THE ANNUAL EXCLUSION

KENT MASON*

I. INTRODUCTION

Section 2503(b) of the Internal Revenue Code (I.R.C.) allows a taxpayer to exclude $10,000 of his gifts to each donee from his total taxable gifts for each year. Generally, to qualify for this exclusion, a gift must meet two basic requirements. First, the gift must be of a present interest. Second, the taxpayer must show with reasonable certainty that the present interest is worth at least the amount excluded.

In 1968, the Ninth Circuit in *Crummey v. Commissioner* held that if a person has the right to compel immediate distribution from a trust of $X, and is legally capable of exercising the right either on his own or through a natural or legal guardian, the person has a present interest to the extent of $X. So if a donor contributes $10,000 to a trust and gives the beneficiary the right to demand the $10,000, the full exclusion

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* B.A., Amherst College, 1976; J.D., University of Pennsylvania, 1980; Law Clerk to Judge Phyllis Kravitch, Fifth Circuit Court of Appeals, 1980-81. Mr. Mason is an associate in the firm of Long, Aldridge, Heiner & Stevens, Atlanta, Georgia.

1. I.R.C. § 2503 (West Supp. 1981) provides in relevant part:
   (b) Exclusions From Gifts — In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person.


4. If the latter has to be appointed, this has to be legally possible for the right holder to accomplish, though he may do so indirectly. For example, in *Crummey* the court suggested that the beneficiary could simply demand his share from the trustee. The trustee would have a duty to petition the court for the appointment of a legal guardian. Furthermore, a breach of this duty by the trustee “would not . . . vitiate the demand” even if the beneficiary was unable to sue. *Id.* at 87.

is available to the donor due to the existence of the demand right.

There has been little law defining the scope of the demand right rule articulated in Crummey. Thus, many questions remain unanswered or inadequately addressed. This article will both identify important issues that have been resolved and discuss those which need resolution.

Examination of these issues reveals Crummey to have substantial potential as a device for gift tax avoidance. In light of this potential, an amendment to section 2503 is proposed which would deny exclusions based on demand rights. This article also analyzes whether the annual exclusion should be limited to present interests and concludes that this limitation actually works contrary to the government's interest in administrative convenience, the purpose for which the limitation was included in the statute. Finally, the appropriateness of having the exclusion apply to each donee is critically examined and it is proposed that the annual exclusion be changed to a flat dollar figure encompassing gifts to all donees.

II. THE ANNUAL EXCLUSION IN GENERAL

With respect to the present interest requirement, there are two main points which are important as background to a discussion of the Crummey rule. First, a present interest must be an absolute right. If a trustee has discretion to withhold from the donee of the 'demand right part or all of the transfers to the trust otherwise subject to the right, then the part of the transfers subject to that discretionary power is not a present interest.\(^6\) Second, to have a present interest, one must have present "use, possession, or enjoyment" of the underlying assets.\(^7\) For example, the right to demand distribution of a re-

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6. See, e.g., Treas. Reg. § 25.2503-3(c)(1) (1972); Fondren v. Commissioner, 324 U.S. 18, 21 (1945); Hamilton v. United States, 553 F.2d 1216, 1218 (9th Cir. 1977); Street v. Commissioner, 261 F.2d 666 (5th Cir. 1958); Hockman v. United States, 327 F. Supp. 332 (D. Md. 1971); see also I.R.S. Private Letter Ruling 8213074 (Dec., 1982). But see Morgan v. Commissioner, 42 T.C. 1080 (1964) (circumstances indicate the discretion will be exercised to produce a steady flow of income).

remainder interest in real property is not a present interest even though the remainder interest might be readily marketable.  

Most of the law interpreting the second requirement necessary to qualify for the annual exclusion — that the taxpayer show with reasonable certainty that the present interest is worth at least the amount excluded — arises in the context of income interests. A brief discussion of the law in this area is necessary to analyze the relevance of this requirement to the Crumney rule. There are two ways for a taxpayer to show that an income interest is worth the amount excluded. First is to demonstrate that due to the nature of the corpus a specific amount of income will be produced. The alternative means of valuing an income interest is through use of the valuation tables. To be entitled to use the tables for purposes of the exclusion, a taxpayer must show with reasonable certainty that the trust will produce income during a predictable period of time and that the rate will not be fixed below that assumed in the tables; this showing is necessary

8. See Fondren v. Commissioner, 324 U.S. 18 (1945). One "exception" (although not admitted to be such) to this principle is a contractual obligation. Where a contractual obligation, such as a note, bond, annuity or insurance contract is given outright, the gift is one of a present interest under the regulations even though the obligation is not due until sometime in the future. Treas. Reg. § 25.2503-3(a) (1972).

9. For example, the donor may give the donee the income interest in a trust which is funded by a bond paying a certain rate of interest. If the trust instrument compels the trustee to keep the bond, not to sell and reinvest it under any circumstances, then the value of the income interest must be calculated based on the interest paid by the bond. See Rev. Rul. 77-195, 1977-1 C.B. 295, 299 (valuing an interest not for exclusion purposes, but for taxation).

10. For the government to establish that a rate is "fixed," it need not show that the rate will definitely be a certain figure (such as the bond example, supra note 9): reasonable certainty is sufficient. For example, if the trust compelled retention of stock of a company with an established dividend policy of paying no more than two percent, this, too, could be viewed as a fixed rate. See Christ v. Commissioner, 480 F.2d 171 (9th Cir. 1973).

11. The I.R.S. test for use of the tables for purposes of taxation instead of exclusion is slightly different. But cf. Vernon v. Commissioner, 66 T.C. 484 (1976) (citing exclusion valuation cases in a case valuing a gift for taxation purposes). When the I.R.S. is valuing a gift to determine its value for purposes of taxation, again any fixed rate of income must be used, but otherwise the tables must be used if it is realistically possible that the trust will produce income at the statutorily assumed rate. For example, if A transfers to B an income interest in nonincome producing property, the tables must still be used if the trustee has the power to sell the property and reinvest in income producing property. Rev. Rul. 79-280, 1979-2 C.B. 340. See also Christ v. Commissioner, 480 F.2d 171 (9th Cir. 1973) (for taxation purposes, tables must be used unless they would produce a "result substantially at variance with the facts");
to demonstrate that the figure derived from the tables is a "fair approximation" of the value of the income interest.\(^\text{12}\)

One aspect of this "reasonable certainty" standard is relevant outside the context of income interests to the valuation of all gifts, including present interests: where valuation requires consideration of probabilities incapable of mathematical proof, the courts and the Internal Revenue Service (I.R.S.) often refuse to engage in such speculation and hold the value not to be reasonably ascertainable.\(^\text{13}\) The test implicitly guiding them in each such determination is whether the administrative burden of considering such probabilities outweighs the need to consider them in order to maintain a realistic and effective tax system.\(^\text{14}\) This test is generally applicable to valuations in the annual exclusion context, including valuation of Crummey demand rights.

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Weller v. Commissioner, 38 T.C. 790 (1962) (for taxation purposes, tables must be used unless the figure derived would be "unrealistic and unreasonable"); Rev. Rul. 77-195, 1977-1 C.B. 295. The rationale behind this rule is probably that it prevents evasion of the gift tax through a transfer of an income interest in nonincome producing property which the donor knows will be immediately sold and the proceeds reinvested in income producing property.

12. See Berzon v. Commissioner, 534 F.2d 528 (2d Cir. 1976).

13. See, e.g., Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir. 1968) (refusal to speculate on manner in which the trustee would exercise his absolute discretion); Rev. Rul. 75-415, 1975-2 C.B. 374 ("[s]ince such a volitional act [terminating enrollment in college] . . . is not mathematically predictable," no proof will be accepted concerning it (implicitly holding)); see also Treas. Reg. § 25.2511-1(e) (1973) (gift of partial interest which cannot be valued by generally accepted valuation principles is valued as if entire interest transferred); but see Morgan v. Commissioner, 45 T.C. 1080 (1964). The need to avoid excessive administrative burdens has led to such rulings. However, in many circumstances, courts do make valuations which cannot be supported by mathematical proof. For example, in determining whether use of the tables is appropriate, courts must speculate as to whether dividends will be paid on stock. See generally Christ v. Commissioner, 480 F.2d 171 (9th Cir. 1973). Neither the courts nor the I.R.S. articulates any criteria for when valuations based on nonmathematical probabilities should be undertaken. However, as noted in the text infra, the implicit rule must be based on a weighing process: such valuations should be made when they are so essential to the proper functioning of a realistic and effective tax system that the administrative burden is justified. Whether a valuation is essential should be governed by two factors: how common the type of interest is and the purpose of the valuation, i.e., whether the valuation is of a taxable gift or of an amount the taxpayer would like to exclude from or offset against taxable gifts. Compare Treas. Reg. § 25.2511-1(f) (1973) with Treas. Reg. § 25.2511(e) (1973).

III. DRAFTING CRUMMEY DEMAND RIGHTS

It is not the purpose of this article to provide a comprehensive guide to drafting Crummey demand rights. However, certain key drafting issues — those necessary as background for the policy proposals and those which have been inadequately treated in the commentary — are analyzed herein.

A. Means of Exercising the Right to Compel a Distribution

The obvious concern of a drafter of a trust attempting to create an exclusion is: what trust attributes are required for a right to compel a distribution from a trust to fall within the Crummey rule? One issue, often overlooked, is the means the trust may require for the donee to compel the distribution from the trust. In other words, is the exclusion available if the beneficiary must, to compel the distribution, do more than simply demand it?

If the donee of a right to compel a distribution from a trust may only exercise it by the performance of an act of independent significance, such as terminating enrollment in college, Revenue Ruling 75-415 holds that such a right is not a

15. For a survey of drafting issues and problems, see Simmons, Drafting the Crummey Power, 15 INST. ON EST. PLAN. ¶ 1700 (1981). There is, in addition, one area which the I.R.S. has recently spotlighted for further study. Rev. Proc. 81-32, 1981-34 I.R.B. 22 adds a provision to section 5 of Rev. Proc. 81-10, 1981-1 C.B. 647. Section 5 is entitled: Areas Under Extensive Study in which Rulings or Determination Letters Will Not Be Issued Until the Service Resolves the Issue Through Publication of a Revenue Ruling, Revenue Procedure, Regulations or Otherwise. The provision added reads:

Section 2503 — Taxable Gifts — Whether the transfer of property to a trust will be a gift of a present interest in property when (1) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (4) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (5) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under sections 673 to 677.

present interest and thus the donor would not be entitled to exclude any transfers to the trust based on the demand right. This position has not been challenged in court. If it were, the denial of the exclusion would probably be sustained, but would be better supported by a holding that the value of the right is not reasonably ascertainable, rather than a finding that the right is not a present interest. The hypothetical gift used in the Revenue Ruling 75-415 illustrates the valuation problems. The donee had the right to a portion of the trust income when he stopped attending college. It was within the beneficiary's power to exercise the right presently, so that the interest appears to be a present interest. However, its value could only be determined by subtracting from the value of an unrestricted income interest the value to the beneficiary of attending college, the condition which must be met before the right can be enjoyed. Clearly, valuing the subjective worth of attending college is an impractical administrative task. Even valuing the objective value of going to college at that time, considering the beneficiary's talents and opportunities, is difficult, speculative and time consuming.

As noted, the courts and the I.R.S. have repeatedly held that avoiding such burdens justifies denying the taxpayer an

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17. Rev. Rul. 75-415, 1975-2 C.B. 374, does not explain why the I.R.S. does not consider the demand right to be a present interest. One could argue that there is no present interest based on the requirement that a present interest be an "unrestricted right." Treas. Reg. § 25.2503-3(b) (1972). What the regulations mean by "unrestricted" is unclear. For instance, if A gives B real estate worth $100,000 subject to a $40,000 mortgage, there is no doubt that there is a present interest transferred of $60,000, despite the fact that the right to the real estate as a whole is in a sense "restricted" by the existence of the mortgage. The point is that the excess value, $60,000, is "unrestricted." The same analysis is appropriate with respect to the hypothetical gift in the text.

The "unrestricted" requirement does not seem appropriate even in the context of restrictions directly on the right to use, such as restricting the use of transferred real estate to residential purposes. A transfer of such real estate is clearly a present interest to the extent of its value. Perhaps the "unrestricted" language was aimed at efforts of the donor to control the beneficiary's use in ways which rendered the property incapable of valuation, such as a restriction which required the beneficiary to house any relative who asked for a room. This reading would merge the valuation requirement into the present interest requirement in this context. If this was the aim of the "unrestricted" language, the regulation could be used in the situation described in the text. However, it would be more sensible to simply find that the value of such a "restricted" gift is not reasonably ascertainable than to rely on such a strained reading of "unrestricted."
opportunity to present evidence on the question of valuation when valuation of the interest at issue is not essential to the maintenance of a realistic and effective tax system. An analysis of the factors relevant to a determination of whether a valuation is so essential\textsuperscript{18} indicates that valuation of the interest at issue in Revenue Ruling 75-415 is not so essential.\textsuperscript{19} This requirement, that the act triggering the right to receive a distribution not have independent significance, is the only restriction which has been placed on the type of demand that may be required under the terms of the trust.\textsuperscript{20}

\subsection*{B. \textit{Time and Notice Requirements}}

No case has discussed how much time and notice must be given the beneficiary to exercise the demand right. Revenue Ruling 81-7,\textsuperscript{21} however, has articulated a general rule requiring timely notice.\textsuperscript{22} In Revenue Ruling 81-7, the beneficiary of the trust, \(A\), had a right to demand, with respect to any donor's contribution, the lesser of $3,000 or the donor's contributions during the year. The right lapsed if not exercised by December 31 of any given year. \(G\) created and funded the trust near the end of the year;\textsuperscript{23} neither \(G\) nor the trustee informed \(A\) of his demand right. The I.R.S. held that \(G\) was not entitled to an exclusion for the year in which the trust was created:

\begin{quote}
In failing to communicate the existence of the demand right and in narrowly restricting the time for its exercise, \(G\) did not give \(A\) a reasonable opportunity to learn of and to exercise the demand right before it lapsed. \(G\)'s conduct made the demand right illusory and effectively deprived \(A\) of the power.

[The grant of a demand right does not create a present interest] if the donor's conduct makes the demand right illusory and effectively deprives the donee of the power.
\end{quote}

\begin{flushleft}
18. \textit{See supra} note 13 and accompanying text.
19. The gift at issue in Rev. Rul. 75-415, 1975-2 C.B. 374 is relatively uncommon; moreover, the valuation would have been for exclusion purposes.
22. There is, however, no indication that actual knowledge is not an adequate substitute for timely notice. \textit{See} Simmons, \textit{supra} note 15, at \$ 1708.3.
23. The ruling does not indicate precisely when the funding occurred.
\end{flushleft}
Both before and after this revenue ruling, the same principle has been applied in private letter rulings. The rulings make clear that the beneficiary must not only have notice of the demand right, but also of any addition to the trust subject to his demand right.

Revenue Ruling 81-7 does not specify how much time is necessary to provide a reasonable opportunity to exercise the demand right. However, private letter rulings and common sense can be relied on to flesh out the time requirement.

I.R.S. Private Letter Ruling 7922107 holds that if a natural guardian cannot, under applicable state law, make the demand, the beneficiary must be given sufficient time to exercise his right so that it is legally possible for him to have a legal guardian appointed before the right expires.

The private letter rulings have not articulated any further criteria for determining whether the donee has been given sufficient time to exercise his demand right. In fact, only one has indicated a possible minimum required time. In I.R.S. Private Letter Ruling 8111123, the I.R.S. refused to express an opinion as to the availability of the exclusion if a transfer were made after December 21 and the donee had only until the end of the year to exercise the right. In other private letter rulings, the I.R.S. has affirmed the availability of the exclusion where the time allowed ranged from four weeks from the contribution to ninety days from receipt of notice of the

25. See, e.g., I.R.S. Private Letter Rulings 8121069 (Feb. 26, 1981), 8121051 (Feb. 26, 1981), 8111122 (Dec. 19, 1980), 8051128 (Sept. 26, 1980), 8044080 (Aug. 11, 1980), 8019038 (Feb. 12, 1980), 8007080 (Nov. 26, 1979) and 8006048 (Nov. 16, 1979). If the contributions are to be made in the form of premium payments to the insurance company which issued the policy which is the corpus of the trust, it appears that the trustee may simply provide the beneficiary with a payment schedule. See, e.g., I.R.S. Private Letter Ruling 8138102 (June 25, 1981).

If the beneficiary is a minor, all notices of contributions (and of the demand right) must be sent to his guardian. Id. (The ruling specifies the natural guardian: presumably, if the natural guardian is, under state law, incapable of exercising the demand right, he could petition for the appointment of a legal guardian).

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In making its decisions in the private letter rulings, the I.R.S. undoubtedly tacitly applied one rule: the donee must have time to make the demand on the trustee in a normally acceptable fashion, such as by mail. Furthermore, the I.R.S. may be silently applying another rule: the beneficiary and guardian must be given, after notice of the demand right and of a contribution, sufficient time to carefully assess the tax and nontax effects of allowing the assets to remain in the trust. If the I.R.S. is indeed applying such a rule, this raises several issues. First, there is no reason that the time for assessment should have to follow the transfer to the trust. For example, why couldn't a donor notify a donee on November 1 that a transfer to the trust would be made on December 20, thereby giving the donee sufficient time to consider his op-


31. One issue is whether any notice or time for mature assessment should be required. Realistically, the demand right is meaningless, i.e., it is hardly ever created unless it is clear the right will not be exercised (or unless it is clear that the right will only be exercised to the extent necessary to cover the donee's tax liabilities arising from possession of the right). Since this is so, it does not matter whether the donee has notice or time to reflect. However, the crucial point is that recognition of the meaninglessness of the demand right is inconsistent with the grant of an exclusion based on it. See infra note 65 and accompanying text. Thus, if exclusions are granted based on demand rights, time for reflection should be required.

The right is largely meaningless because if one wants another person to have a choice for a very short time, such as five or six weeks, of taking money or not, there is little reason to spend the extra time and money on formal transfers to and possibly from a trust or to expose the offeree to the effects of a demand right. The possession of a demand right may have adverse income tax and estate tax effects on a donee, while lapse of a demand right may have adverse gift tax and estate tax effects on him. See infra notes 36, 41 & 43-48 and accompanying text. These problems would be avoided if the donee were given, instead of a demand right, an informal choice as to whether to accept a gift. (Possession of such an informal offer, not binding on the offeror, should not give rise to any of the adverse effects described supra.)

One possible instance where the right is not meaningless is where the donor wants the assets out of his possession immediately, possibly to avoid imminent appreciation and the accompanying increase in gift or estate tax. In this instance, he may want to have A have the choice, but if A does not want the assets, the donor may want them to go to B. Here A would have a real choice, but such circumstances are probably rare. Another possible situation where a short-lived demand right would be exercised is where the trust has liquid assets, the beneficiary needs money, the trustee cannot invade the trust assets and the settlor can only transfer nonliquid assets he does not want sold. In such a rare situation, the donor would (after transferring the nonliquid assets to the trust) notify the donee, for the donee's exercise is the purpose of the transfer. Furthermore, in such a situation time to assess the need for the liquid assets is unnecessary.
tions prior to a December 31 expiration date? Furthermore, the logical extension of this argument is that the demand right itself may precede the contribution. For instance, a trust could provide that a right to demand the lesser of $X or the donee's pro rata share of the donor's contributions during the year arises on November 1 and lasts until December 31. The donee would have two months to consider his options and to exercise the right if that were his decision. The contribution itself could be made as late as December 31; the only function it would serve would be to fix the amount the donee would be entitled to receive pursuant to his demand, if made. (Because such an arrangement has not been directly

32. A rule approving such a structure would have particular application to insurance trusts where the contributions are in the form of premium payments and the trustee gives the donee a schedule of future payments. See supra note 25. (It is in insurance trusts that Crummey demand rights are most often used. See generally Simmons, supra note 15, at ¶ 1711.) A payment could be due on December 20 as in the example in the text.


34. Id. One problem with such a trust would be that transfers made prior to November 1 would not be present interests. Transfers made after November 1, however, would be present interests even though they did not trigger the demand right. To analyze why this latter assertion is so, one must understand why the demand right creates an exclusion. The transfer of the right itself is not necessary: in the years after the creation of the trust, no such transfer occurs and yet an exclusion is allowed based on the contribution. This is so because the contribution in conjunction with the existence of the demand right creates the present right in the donee of the demand right. Because the contribution creates a present interest in the donee, it is considered to be a transfer of a present interest to that donee. However, it should not be necessary that the contribution create the present right. A contribution which gives value to a present right that already exists should also be considered a transfer of a present interest, because in real terms giving value to an existing right is actually a transfer of a right.

To solve the first problem — that transfers made before November 1 would not be present interests — one could provide that the demand right exists all year. The difficulties encountered in having demand rights last for an extended period is discussed infra notes 43-48 and accompanying text.

An additional issue is the applicability of I.R.C. §§ 678 and 2041 (1976 & West Supp. 1981), discussed infra notes 43-48 and accompanying text, to the period during which the right may be exercised but no contribution has been made. This application is uncertain due to the lack of authority. However, it appears that theoretically § 678(a)(1) should not be applicable until the contribution is made; thus, there is a significant advantage to use of an arrangement like the one described in the text. (The application of § 678(a)(2) is unchanged.) The result under § 2041 — if the donee dies while the right is outstanding but before the contribution is made — is difficult to predict due to the valuation issue. The § 2041 problem could, of course, be avoided by having the donor refrain from making contributions for that year; however, this
addressed by the I.R.S., the discussion hereafter is based on the more conventional trust provision, under which the contribution triggers the demand right.)

Finally, an argument could be made that after the initial year, no time for assessment need be allowed. The argument would be that in the first year the donee has the opportunity to determine in general the tax and nontax effects of allowing the right to lapse or of exercising it. In the ensuing years, the donee is able to monitor the factual variables which would influence his decision if at any time a demand right were to be triggered by a contribution. Whether it is realistic to expect a donee to constantly perform such monitoring is, however, doubtful; thus, following the first year it should be expected that the I.R.S. may require that some short time be allowed for deciding whether or not to exercise the right.35

C. Demand Rights Which Are Effective During Two Years

An additional drafting consideration involves confining the period during which the demand right is valid to the taxable year in which the donor made his contribution. Two potential problems arise if the period extends into a subsequent year. First, there is a possibility that the exclusion will be denied. If the contribution is made December 31, the demand right, even if valid for sixty days, is illusory in the year of the contribution; the right is not a present interest until the following year when the donee presumably has sufficient notice and time to exercise it. However, if the contribution were made early enough, December 1, for example, the fact that the demand right extends beyond the end of the year would not render the right illusory during the initial year.

The second problem would be that under I.R.C. sections 2041(b)(2) and 2514(e),36 the lapse of the donee’s demand

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35. This entire discussion assumes that it is realistically possible that A will exercise his demand right. Although this assumption may not be accurate in practice, see supra note 31, the I.R.S., in sustaining exclusions based on demand rights, implicitly finds that the assumption is appropriate; otherwise no exclusion should be available based on a demand right.

36. I.R.C. § 2514 (1976) provides in relevant part:

(b) Powers Created After October 21, 1942. The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.
right — which is a general power of appointment — would occur in the subsequent year when his right expired.\textsuperscript{37} Under

\begin{itemize}
\item (c) Definition of General Power of Appointment. For purposes of this section, the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power (hereinafter in this subsection referred to as the "possessor"), his estate, his creditors, or the creditors of his estate; except that —

(1) A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.

(2) A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.

(e) Lapse of Power. The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

Under the regulations, it does not appear that the legal incapacity of the holder of the demand right to exercise it is relevant if the holder has a guardian (or can have one appointed) capable of exercising it on his behalf. Treas. Reg. § 25.2514-3(c)(4) (1972) ("In any case where the possessor of a general power of appointment is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, \textit{and the power may not be validly exercised or released on his behalf}, the failure to exercise or release the power is not a lapse of the power.") (emphasis added). Despite the apparent meaning of this regulation, a number of commentators have read it to mean that regardless of the existence of a guardian capable of exercising the right, a minor's failure to exercise a power is not a lapse of that power. \textit{See}, e.g., Lischer, The Crummey Trust, 1979 Est. Gifts & Trns. J. 17, 20. Cf. Simmons, supra note 15, at ¶ 1712.2 (noting, however, that the I.R.S. will probably follow Rev. Rul. 73-405, 1973-2 C.B. 321 "instead of" Treas. Reg. § 25.2514-3(c)(4) (1972) on this issue).

I.R.C. § 2041(b)(2) (1976) is virtually identical to I.R.C. § 2541(e) (1976). Its significance is explained \textit{infra} in the text.

37. Treas. Reg. § 25.2514-3(c)(4) (1972) provides: "[W]here the failure to exercise the power, such as the right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year." This regulation could be read to mean that the release occurs in both years. However, this is not a sensible reading of the regulation. The right clearly was not released or exercised in the first year (either a release or an exercise would be deemed a transfer under I.R.C. § 2514(b) (1976)). Furthermore, the right did not lapse in the first year, but only in the second year. The passage of the year without the exercise of a demand right is not the equivalent of a lapse of the right. \textit{See} Treas. Reg. § 20.2041-3(f) (1958) (Example 2 describes a cumulative power which does not lapse by virtue of the year ending without it being exercised; I.R.C. § 2041 (1976) is the estate tax counterpart to § 2514).

Treas. Reg. § 25.2514-3(c)(4) (1972) is referring to the lapse of a noncumulative power to withdraw a certain amount each year — such an example immediately preceded the sentence quoted above — not a power which extends into the following year.
I.R.C. sections 2041 and 2541, a lapse of a demand right is a taxable release to the extent that the money over which all such rights extend during the calendar year exceeds $5,000 or five percent of the trust funds. Thus, rights extending over two calendar years present a problem, raising the possibility that the donee may have to pay a gift tax (or use up his unified credit)\textsuperscript{38} and include trust property in his estate. The following example illustrates the problem. Suppose the donee may demand up to $5,000 out of a contribution for sixty days following such contribution. On November 15, 1982, a $5,000 contribution is made to the trust (which has less than $100,000 in it). The demand right is not exercised. Although the lapse of the demand right is not a “release” of the $5,000,\textsuperscript{39} any further lapses during 1983 of demand rights held by the donee will constitute releases by the donee under I.R.C. sections 2041 and 2514. Thus, if the donor wants to transfer additional funds to the trust in 1983, but does not want the donee to have to pay gift tax or use his unified credit (assuming the donee will not exercise his right), the donor will have to wait until November 2 to do so, so that the demand right does not expire until the following year. Waiting until November 2 would also avoid the estate tax part of the problem, which is that a release under section 2041 is considered a transfer of property.\textsuperscript{40} The property transferred would be includible in the donee’s gross estate to the extent that property transferred is includible under I.R.C. sections 2035 through 2038.\textsuperscript{41}

These potential problems can be solved in several ways. If the trust is drafted to allow a certain period of time regardless of whether that period extends into a subsequent year, contributions can be made at a date early enough so that the right

\textsuperscript{38} Of course, if the donee were also the sole beneficiary of the trust, there would be no gift. See Lischer, supra note 36, at 20.

\textsuperscript{39} I.R.C. §§ 2041(b)(2), 2514(e) (1976).

\textsuperscript{40} I.R.C. § 2041(b)(2) (1976).

expires before the end of the year. Second, the trust can be
drafted to restrict gifts subject to the demand right to those
made prior to a certain date, such as December 1, and to re-
quire that the demand right be exercised within the taxable
year of the contribution. Third, the trust could allow the right
to be exercised any time until a certain period beyond the tax-
able year of the contribution.42

The third solution (which actually only addresses the
problem under I.R.C. sections 2041 and 2514, since it obvi-
ously would work only if the gift is made early enough to al-
low the donee sufficient time to exercise it within the year of
contribution) requires careful drafting. Trusts involving de-
mand rights have often limited the total which "may be de-
manced in any one year" to $3,000 (or $5,000); such phrasing
would fail to accomplish its purposes. If in early 1982, B made
a demand for $3,000 due to a contribution made in 1981, B
would under the above terms have no further demand rights
in 1982. To avoid such a result, the trust instrument would
have to make clear that any demand is to be attributed to the
year in which the contribution giving rise to the demand right
was made.

There are, however, problems which are exacerbated by
the third solution because it will often mean that the demand
right is outstanding for a longer period of time. Explanation
of these problems requires a brief discussion of the estate and
income tax rules applicable to the holder of a Crummey de-
mand right.

If the donee of the demand right dies before the right
 lapses, the amount subject to his power is includible in his
estate.43 Therefore, the longer the demand right is outstand-
ing, the greater the risk of inclusion in the donee's gross
estate.44

The income tax problems arise because the grantor trust
provisions of the I.R.C. attribute to the holder of a Crummey

42. Such a provision was used in I.R.S. Private Letter Ruling 8121069 (Feb. 26,
43. I.R.C. § 2041(a)(2) (1976). This is probably so even if the holder of the right is
legally incapacitated to exercise it. See Simmons, supra note 15, at ¶ 1712.
44. If the demand right extends over more than $5,000 or five percent of the trust
anyway, extending the period it is effective makes it slightly more likely that I.R.C. §
demand right his proportionate share of trust income, deductions and credits. His proportionate share is determined by the ratio of the funds subject to his demand right to the value of all trust funds. This ratio is then adjusted appropriately if the donee held the demand right for less than the entire year. Because of this latter adjustment, the length of time the demand right is outstanding becomes important.

D. Trustee's Power to Expend Income or Principal

Another drafting issue which merits additional attention is the scope of the trustee's power or duty to expend income and invade principal for the benefit of someone other than the donee of the demand right. As explained below, if this power or duty is not subordinated to a demand right, then the demand

45. I.R.C. §§ 671, 678(a)(1) (1976). Such attribution is probably not made if the grantor of the trust is treated as the owner of the trust funds under I.R.C. §§ 671-79 (1976). I.R.C. § 678(b); see Simmons, supra note 15, at ¶ 1713.2 (despite statutory language, I.R.C. § 678(b) (1976) should not be limited to powers over income). Such attribution occurs even if the holder of the right cannot legally exercise the power without the appointment of a guardian. Rev. Rul. 81-6, 1981-1 C.B. 385; Simmons, supra note 15, at ¶ 1713.3.


47. See generally Lischer, supra note 36, at 19.

48. There is an additional income tax issue which requires the attention of drafters of trusts with Crummey demand rights. Under I.R.C. § 678(a)(2) (1976), the donee is treated as owning that portion of the trust with respect to which he has "released or otherwise modified" his demand right, if after such release or modification, he "retains such control as would within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof." This provision could easily present a problem. For example, if the donee is entitled to receive trust income in the discretion of a nonadverse party, as defined in I.R.C. § 672 (1976), he has retained sufficient control to trigger I.R.C. § 678(a)(2) (1976). (As with I.R.C. § 678(a)(1) (1976), § 678(a)(2) probably does not apply if the grantor of the trust is treated as the owner of the trust funds under I.R.C. §§ 671-79 (1976). See supra note 45.)

The reference to "release" indicates that I.R.C. § 678(a)(2) (1976) may not apply to lapsed powers, since in other instances where Congress wanted a lapse to be considered in part a release, it specifically so provided. I.R.C. §§ 2041(b)(2), 2514(e) (1976). Alternatively, I.R.C. §§ 2041(b)(2) and 2514(e) (1976) could be invoked by analogy so that a lapse would only be considered a release to the extent the funds subject to the power exceed $5,000 or five percent of the funds out of which the right can be satisfied. Finally, it is possible that a court would hold that for income tax purposes, any lapse is a release.

The first of the three theories appears the most compelling. However, because the income tax rules are independent from the gift and estate provisions (see, e.g., Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947)), which of the three rules will be applied remains an open question.
right may be a future interest within the meaning of I.R.C. section 2503(b).

Suppose B has, for a specified time after a contribution, a right to demand the lesser of $10,000 or the donor's contribution to the trust, but the trustee has absolute discretion to use income and/or principal for the benefit of C. Suppose further that this trust is construed as giving the trustee the power, even after receiving a demand from B, to use all trust funds for C's benefit: B's right to the trust funds would then be subject to the trustee's discretion. As noted above, if the donee's rights are subject to the trustee's discretion, the donee does not have a present interest under I.R.C. section 2503(b).

On the other hand, suppose the trust is construed as giving the trustee the power to use the funds for C unless the trustee has received a prior demand from B. Such a demand right is an interest which can expire in two ways: passage of the time for exercise specified in the trust instrument or depletion of the trust. In this case, if, in a year in which the donor contributed $10,000, $10,000 remains in the trust at all times that the demand right exists, the full exclusion is appropriate. But if, for example, a day after the demand right became effective, the trustee used all trust funds for C's benefit and there were no further contributions by the donor, then no exclusion would be allowed because the demand right was not effective for a long enough period.

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49. B's demand right would also be limited to a total of $10,000 with respect to contributions made during the year.
50. See supra note 6.
51. This assumes that B is the only one with a demand right. Suppose, however, that D also had a demand right for the lesser of $10,000 or the donor's contributions to the trust. Further suppose that the trust provided that if the demands exceeded the contributions, the contributions were to be split evenly between B and D and that in that case if either had already received more than one-half of the total contributions, he would be obligated to return the excess. (Alternatively, the trust could simply limit a donee's rights to his pro rata share of contributions.) In this situation a contribution of $10,000 to the trust would give rise to an exclusion of only $5,000 with respect to B (as well as to D). Rev. Rul. 80-261, 1980-2 C.B. 279. This rule is important if, for example, the donor had already during the same year transferred $10,000 outright to D and nothing to B.
52. See generally I.R.S. Private Letter Ruling 8126047 (Mar. 31, 1981) (for an exclusion based on a demand right to be appropriate, trust must have sufficient assets reducible to cash to satisfy the demand right).

The donor could argue with this result, maintaining that it was the trustee's con-
The more difficult question is whether the exclusion would be available if, for example, the trustee depleted the trust fifty days after a contribution to a trust which provided that the demand right would expire sixty days after a contribution. It is arguable that the exclusion should not be available because a reasonable donee could plan on waiting until the end of the period so as to maximize the information on which to base his decision as to whether or not to exercise his right. For this reason, effectively extinguishing the right before the full period would render the right to some extent illusory. However, if the donee were fully informed that such depletion was possible, then whether the exclusion should be available should turn on whether the time before depletion, here fifty days, was long enough in light of the factors already discussed (i.e., time to have a guardian appointed, to make the demand and to make a well-considered decision).

Suppose that instead of having absolute discretion, the trustee has the power and, in fact, the duty, to use all trust funds only if needed by C in certain emergency situations. Suppose further that the trustee is empowered to recover, for this purpose, any amount paid to B during the year. Essentially, B's right would be subject to the contingency that C have no sufficiently expensive emergency within the year and would thus be a future interest. If, on the other hand, the trustee is to honor B's demand only if C has no current emergency, without the power to recall funds paid to B, then the availability of the exclusion depends on the occurrence and timing of any emergency and upon disclosure to B of the possibility of depletion of trust funds.

duct and not his which caused the premature extinguishment of the demand right, and that under Rev. Rul. 81-7, 1981-1 C.B. 474, it is the donor's conduct which is crucial. Such an argument should not prevail. First, despite any implication in Rev. Rul. 81-7 1981-1 C.B. 474, the focus under I.R.C. § 2503(b) (1976 & West Supp. 1981) is on the rights received by the donee, not on the donor's conduct. Maryland Nat'l Bank v. United States, 609 F.2d 1078 (4th Cir. 1979); Blasdel v. Commissioner, 58 T.C. 1014, 1018 (1972), aff'd per curiam, 478 F.2d 226 (5th Cir. 1973); Rev. Rul. 79-280, 1979-2 C.B. 340. Second, even if the donor's conduct were crucial, it was the donor who empowered the trustee to effectively extinguish the demand right.

53. See Rev. Rul. 80-261, 1980-2 C.B. 279 (exclusion is only available with respect to funds which cannot be recalled by the trust).

54. I.R.S. Private Letter Ruling 8213074 (Dec. —, 1981) rules on a trust under which if a beneficiary has an emergency, the trustee has discretion to invade the trust corpus for the benefit of that beneficiary. The I.R.S., however, analyzes the trust as if
These problems involving automatic or potential loss of the exclusion can be avoided, if that is what is desired, by making it clear that the demand right has priority over the trustee’s powers or duties to use the trust principal or income for other purposes. Alternatively, the right could only have priority over invasion of principal if the donor is satisfied that the principal will not depreciate below the desired exclusion before the demand right has been effective for a sufficient period of time.

E. Who May Be the Donee of a Demand Right?

To assess whether the Crummey demand right rule is appropriate, one must first analyze the most important Crummey drafting issue: must the donee of a demand right have any relationship to the trust other than as possessor of a demand right? In other words, could A obtain an exclusion for C’s demand right by setting up a trust under which B gets the income annually and the corpus in ten years, and C is given a right to demand $10,000?

Only one case has addressed this issue. In Jacobson v. United States, the trustee had the absolute discretion to use income and principal for the care, comfort, support, health, maintenance and welfare of the adult children of the grantor. All trust funds were to be distributed to the children when the youngest reached age thirty-five, which would occur, barring deaths, in 1982. If a child died, his share became the subject of a new trust for the benefit of his children. Finally, each child of the grantor had a special power of appointment to have his share of the trust transferred outright to his children, the grantor’s grandchildren.

The grantor claimed an exclusion, asserting that the special power of appointment was the equivalent of the Crummey demand right. The court denied the exclusion, essentially holding that for an exclusion to be appropriate, the “principal
beneficiaries” of the trust must have an immediate right to the use or enjoyment of trust assets. The court then found that the children of the grantor, not the grandchildren, were the principal beneficiaries. (Even if the grandchildren had been the “principal beneficiaries,” this should not necessarily have entitled the grantor to exclusions.) The court explained this finding by noting that the provisions for the grandchildren depended on contingencies which might not occur and that the grantor listed the children and their wives as donees on his gift tax return. This explanation of how the court determined the principal beneficiaries is inadequate. The adult children’s interests are contingent just as the grandchildren’s are: contingent upon the trustee’s exercise of discretion and upon survival until 1982. Why the listing on the gift tax return is relevant is unclear. So what criteria were really being applied to determine who was a “principal beneficiary”? And what criteria should be applied? Perhaps the likelihood of the interest vesting should be multiplied by the value of the interest. Then how is the likelihood to be determined if it is dependent on the trustee’s discretion? And how many principal beneficiaries may there be? Where is the line between principal beneficiaries and other beneficiaries? The questions are endless because the court has established a vague test — “principal beneficiaries” — and articulated no guidelines on how to apply it.

The I.R.S., in its private letter rulings, has tacitly adopted a more sensible and theoretically sound approach: the donee of a demand right need not have any other relationship with the trust. In I.R.S. Private Letter Ruling 8003152, for example, a trust is set up under which the donor’s descendants are to receive distributions of corpus (life insurance policies on the donor’s life) and income according to an “external, ascertainable” standard. Upon the lapse of a policy or the termination of the trust (which was to occur within three years after the donor’s death), the donor’s wife was to have a special

58. Even if the grandchildren were the “principal beneficiaries,” the court would have had to find that the special power of appointment was exercisable only on the grandchildren’s behalf and in the capacity as guardian of the grandchildren, since a right in A on his own behalf to direct funds to B is not a present interest in B. The court does not appear to recognize this.

power of appointment to designate among the descendants of the donor and their spouses, widows or widowers who shall receive the assets. Also, at the time of each contribution all descendants and their spouses would have a right to demand up to $5,000. The I.R.S. held that because of the demand right, exclusions were available with respect to all descendants and their spouses. However, the I.R.S. did not discuss the value of the spouses’ interests in the contributions once the demand right expires. In fact, all of the spouses’ interests in the trust (aside from the demand right) were incapable of valuation: none could show that his or her interest had any value, since nonmathematical proof concerning the wife’s probable exercise of her special power of appointment would not be allowed.60 This ruling thus supports the theory that the donee of a demand right need not have any other relation to the trust. Even if the I.R.S. is assuming that each spouse could, and would be allowed to, show that his or her interest in the trust after the expiration of the demand right has some value, the I.R.S. does not discuss the possibility that the value is less than the annual exclusion. If the donee’s interest in the trust other than the demand right can be worth less than the annual exclusion, why cannot the donee have no other interest in the trust?

As discussed above, the rule tacitly adopted in the I.R.S. private letter rulings is theoretically sound.61 Ownership of a future interest in property does not determine whether one has a present interest in that property. Crummey ruled that a present right to demand $3,000 is a present interest worth $3,000. If Crummey is correct, the transfer of a demand right alone should qualify for the annual exclusion — the fact that the donee does not also have a future interest is irrelevant. (The income beneficiary is not required to have the remainder interest also before the donor is allowed an exclusion.) Logically, the finding of a present interest cannot be conditioned on the existence of a future interest.

60. See supra notes 13-14.
61. Cf. Simmons, supra note 15, at ¶ 1705.3 (allowing exclusions for demand rights given to third parties appears theoretically correct, but “fails by the smell test”).
IV. THE APPROPRIATENESS OF THE DEMAND RIGHT RULE

Now that the outlines of the demand right rule have been explored, the appropriateness of the rule can be examined. As explained above, the rule undermines the present interest requirement and could conceivably be used to evade the gift tax generally. For example, suppose a donor wishes to set up a trust under which his minor child will get the accumulated income and corpus at age twenty-five. Clearly, this is a future interest for which the donor is not entitled to an exclusion. However, by including a demand right which he knows will not be exercised, he is able to obtain an annual exclusion. Mere form allows him an annual exclusion on what is realistically a future interest.

Furthermore, due to the fact that the donee of a demand right need have no other relationship to the trust, the demand right rule enables the donor to avoid the gift tax altogether. Suppose, in the above example, the corpus was worth $50,000. By giving $10,000 demand rights to his brother, sister, parents and the beneficiary, the donor could exclude the entire $50,000 transfer under I.R.C. section 2503(b), thus avoiding all gift tax on the transfer.6 In other words, one can, without altering the intended disposition in a real way,6 obtain as many exclusions as one can find people who will not exercise their demand right.64 It is true that where such a tacit under-
standing concerning nonexercise exists, the right in reality

example, a donee with a right (lasting a month) to demand $10,000 would be liable for one-twelfth of the trust's income on $10,000 which might be $1,200, making the donee's income from the trust $120. This hardly creates a burdensome income tax liability. Moreover, the donee could make a demand for a sum equal to his expected income tax liability. Whether the distribution, pursuant to the partial exercise, can constitute income to the donee is an open question. Compare Simmons, supra note 15, at ¶ 1713.5 (distribution can be income in a complex trust) with Covey, The Estate Planning Benefits Available Via a "$5,000 and 5%" Withdrawal Power, 34 J. Tax. 98, 99 (1971) (open question). This issue would need to be resolved so that the donee would know how much to demand to cover his income tax liability. Moreover, an adverse resolution of this issue could make slightly less attractive the distribution (in complex trusts) of demand rights to taxpayers in high income tax brackets. A favorable resolution renders the income tax problem almost nonexistent, for even if the donee is in a high income tax bracket, his demand for an amount equal to his extra income tax liability would result in an almost de minimis decrease in trust assets as compared to there being no demand right. If there is a favorable resolution and the donee is in a low income tax bracket, there may be no overall decrease. See also supra note 34.

Third, to the extent that the demand right exceeds $5,000 or 5% of the trust, the donee (who is not a sole beneficiary) must normally be willing to be subject to a gift tax or use part of his unified credit.

A fourth burden is that to the extent the demand right exceeds $5,000 or 5% of the trust, the donee (who is not a sole beneficiary) runs a risk under I.R.C. § 2035 (1976 & West Supp. 1981). See supra note 41 and accompanying text. However, as discussed previously, the risk can be reduced by choosing donees who are young or do not have substantial assets. Furthermore, the amount included under § 2035 would hardly be substantial.

With regard to the third and fourth burdens described in this note, it should be pointed out that if the donee has another power of appointment which he allows to lapse, there may be a problem with regard to the $5,000 or 5% limitations. The reason is that the $5,000 or 5% limitations apply to all of a taxpayer's powers lapsing during a year.

There are, however, possible means to avoid the third burden. One way would be for the trust to provide that with respect to the excess over $5,000 or 5% of the trust corpus, the demand right expires 30 days after the final day of the year. Thus, there would be no "release" in either year under I.R.C. § 2514(e) (1976). Szarwark, supra note 33, at 493. There are two drawbacks to this solution. First, extending part of the demand right exacerbates the estate and income tax problems. See discussion supra this note and notes 43-48 and accompanying text. Second, this solution does not work if the transfer is made pursuant to a plan under which similar contributions are to be made each year to the trust. This is so because, assuming the trust has less than $100,000 in it and assuming the demand right is for $10,000, the donee would have a full $5,000 lapse in the first two years solely due to the first contribution. The lapse of any additional right in the second year would be a taxable release.

Another means to avoid the third burden assumes different facts. Suppose a donor wants to give $200,000 to a beneficiary outright. He could transfer the $200,000 to a trust and give demand rights of $20,000 to the beneficiary and to each of nine donees not including his spouse. He could split the ten $20,000 transfers with his wife, so that the entire transfer would be excluded. Furthermore, the trust could provide that upon lapse of the demand right the money is to be distributed outright to the benefi-
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does not exist, and if the right does not really exist, the exclusion should not be available. But the problem is that the burden of proving the existence of such an understanding is currently on the government and this is a difficult burden to sustain, which may be why the I.R.S. has not been challenging the demand rights. The result is that taxpayers are currently using Crummey to obtain annual exclusions to which they should not be entitled and are thereby avoiding the gift tax. (Such an abuse would be a problem even if there were no present interest requirement.)

ciary. Because the money is to be distributed outright to the beneficiary, the donees' release of the demand rights would be transfers of present interests; thus $10,000 of the $20,000 would be excluded. The other $10,000 would not be treated as a transfer under I.R.C. § 2514(e) (1976), since 5% of $200,000 is $10,000.

The above discussion is based on an important assumption, i.e., that under Treas. Reg. § 25.2514-3(c)(4) (1972) the "aggregate value, at the time of the lapse, of the assets out of which" the demand rights could be satisfied is $200,000. If the demand rights lapsed simultaneously, the assumption would appear correct under a technical reading of the regulation, since at the moment of lapse, the trust contained $200,000. However, if the donees' demand rights expired at different times, each surviving demand right should be considered a contingent liability. Whether and how to value such contingent liabilities has not been explored in the case law or rulings. Cf. 3 A. CASNER, ESTATE PLANNING 1268 (4th ed. 1980) (noting the problem of valuing a corpus with contingent liabilities).

One commentator has asserted that the value of the "assets out of which" the demand right could be satisfied is the value of the contribution. Lischer, supra note 36, at 22 n.26. This supposes that the trust is drawn to restrict the assets available for distribution (pursuant to the exercise of the demand right) to the contribution. This is not only not required, but not advisable. See Szarwark, supra note 33, at 491 (advising that trusts provide that the trustee may "borrow against, sell or distribute any asset held by the trust . . . to satisfy the beneficiary's withdrawal rights"). See also Treas. Reg. § 25.2514-3(c)(4) (1972).

65. See generally Rev. Rul. 81-7, 1981-1 C.B. 474 (demand right must not be illusory).

66. Analogous case law indicates that the government has this burden. Under I.R.C. § 2036(a)(1) (1976), the issue often arises as to whether a decedent who had transferred his residence but continued to live there until his death had an understanding with the transferee at the time of transfer that he could continue to reside there. Implicit in the cases is the premise that the government must prove the understanding: the courts speak of "adequate grounds for inferring an agreement," Estate of Linderme v. Commissioner, 52 T.C. 305, 307 (1966), while if the taxpayer had the burden of proving the nonexistence of an agreement, the courts would discuss the "lack of evidence to refute the existence of an agreement."

67. See, e.g., I.R.S. Private Letter Ruling 8003152 (Oct. 29, 1979); Huff, The Five and Five Power, 15 INST. EST. PLAN. ¶ 700, ¶ 704.2 (1981) (the "expectation is that such power of withdrawal will not be exercised"); Henszey, Crummey Power Revisited, 59 TAXES 76, 77 (1981) (the demand power is a sham in most cases).

68. If there were no present interest requirement, the donor in the example in the
With these observations in mind, the question becomes: should *Crummey* be judicially overruled or modified to prevent the abuse? And, if so, on what grounds? The demand right meets the requirements of a present interest set out in the regulations — the donee has an unrestricted right to the immediate use of the money subject to the demand right.\(^6\)

Moreover, this regulatory definition is reasonably consistent with I.R.C. section 2503(b) and has arguably been approved by Congress' failure to establish a different statutory definition of a present interest. Because of these factors, a court would be in error in striking down the regulation.\(^7\)

However, in light of the significant potential for abuse of the *Crummey* demand right, a court could put the burden of proving the nonexistence of an agreement concerning nonexercise on the taxpayer. Because it is so difficult to prove a negative, this would make exclusions based on demand rights difficult to sustain. In light of the fact that the demand right is hardly ever included for valid reasons (i.e., where there is a real chance the right may be exercised\(^7\)), such a rule does not appear unreasonable. However, it is the position of this author that a court should not create such a rule for the reasons discussed below.

The problems with shifting the burden of proof are twofold. First, the practical effect would be uncertain. There is no certainty that the I.R.S. would take an aggressive litigating position with respect to demand rights even if a court were to shift the burden of proof. The I.R.S. has been strangely dormant in this area and it is difficult to determine whether shifting the burden of proof would arouse it. If the I.R.S. were not aggressive, abuse of the demand right would continue, punctuated perhaps by I.R.S. challenges to particularly egre-

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gious abuses. All that would be accomplished would be an increase in taxpayer uncertainty.

The second and more important problem with shifting the burden of proof is that the Crummey demand right rule, as currently formulated (including the burden of proof issue), is too firmly established to permit such a judicial modification. The I.R.S. has accepted the rule and innumerable trusts have been written in reliance on it. At a certain point, which Crum- mey has reached, a rule of law becomes so widely accepted and relied upon that it is no longer appropriate for a court to alter it. Such a rule must be changed, if at all, by Congress. The Supreme Court articulated this policy in United States v. Byrum. 72

The holding [at issue] . . . may have been relied upon in the drafting of hundreds of inter vivos trusts. The modification of this principle now sought by the Government could have a seriously adverse impact [upon those who relied on it] . . . . Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning. 73

As noted, the Crummey demand right is universally used and has been fully accepted by the I.R.S. The Byrum policy appears clearly applicable. Thus, it is to the potential congressional remedies that this article now turns.

Congress, in fashioning a means of curbing the abuse, has two primary choices. First, it could statutorily shift the burden of proof. However, as noted, such a reform might not be effective due to the uncertainty of I.R.S. enforcement. More-

73. Byrum, 408 U.S. at 135.
over, if the I.R.S. were aggressive and taxpayers persisted in trying to meet the burden of proof, the administrative burden on the I.R.S. and on the courts would be heavy because of the factual analysis required.

The more workable solution would be for Congress to simply provide that the creation of a general power of appointment in another — which is what a demand right is — cannot give rise to an exclusion. Regardless of whether valid demand rights (that is, those which realistically may be exercised) should qualify for the exclusion, the fact is that the existence of such valid demand rights is rare.4

In response to this proposal, one could argue that the abuses described — generally, the use of accommodating third parties to increase the excludable part of what is essentially a gift to one donee — are not peculiar to Crummey. A donor could give present income interests each worth $10,000 to several people with the understanding that they would within the year give the income interest to the intended recipient.74 Such

74. See supra note 31.

75. This opportunity is more limited than the Crummey method. The main additional limitation is that this alternative structure is not completely effective when the donor does not want the beneficiary to have immediate enjoyment and so arranges that the conduit parties convey a future interest to the beneficiary. In such instances, the donees of the demand right would have to pay a gift tax or use their unified credit, unlike the Crummey situation where under I.R.C. § 2514(a) (1976) the donees of the demand right are treated as if they made no transfer if the amount released is small enough. See supra note 36. The conduits would probably agree to pay the gift tax in exchange for the brief use of the money, the retention of a small portion equal to the tax, or perhaps reciprocal favors. The abuse in such cases exists in the avoidance of the progressive rates (and/or the “use” by the donor of the conduit’s unified credit) which would have made the total tax higher if the gifts to the ultimate beneficiary had all come from one donor.

An additional limitation arises from the fact that under I.R.C. § 2041 (1976) the lapse of a demand right over the greater of $5,000 or 5% of the trust is not deemed to be a release, so that with respect to this part of the lapse, I.R.C. §§ 2035-38 (1976 & West Supp. 1981) cannot be triggered.

There may be additional limitations depending on the resolution of the issues raised supra in note 34 and accompanying text.

One advantage this method has over the demand right method is that there is no possibility for I.R.C. § 678(a)(2) (1976) to be triggered. See supra note 48. However, since grantors of demand rights can avoid the § 678(a)(2) problem to the extent it exists, by choosing the donees carefully, this advantage is not particularly significant. Another advantage is that I.R.C. § 2035 (1976 & West Supp. 1981) has broader application to the lapse of a demand right to the extent the right exceeds $5,000 or 5% of the trust than § 2035 does to actual transfers of a similar amount. See § 2035(d); see also Stephenson, supra note 41. However, this advantage will only have an effect in
an opportunity for similar abuse raises two questions. First, how can one theoretically justify a different rule for the two situations? If powers of appointment cannot give rise to exclusions, why should a taxpayer be able to exclude transfers of $10,000 each to A and to B, if B later that year transfers $10,000 to A? Second, if the effect of the proposed rule is to channel the evaders into this alternative abuse (the "conduit method"), would we be doing the law a disservice in that it may be more difficult to prove that the conduit method is being used, that is, that there is an agreement between the taxpayer and B?

The first problem, justifying a different rule for Crummey demand rights as opposed to the conduit method, can be solved by distinguishing the two situations. First, in Crummey situations, but not in the conduit method, there is a clear direct connection between the demand right transferred from the donor to the donee and the interest being released (by nonexercise of the demand right) to a trust beneficiary. This direct connection provides some basis for a different rule. Second, technical differences also exist. Unlike the conduit in the conduit method, the donee of the Crummey demand right, upon release of his right, is not considered, for either gift or estate tax purposes, to have made a taxable transfer to the extent his right did not exceed the greater of $5,000 or 5% of the trust assets. This distinction indicates that in this way the Crummey demand right abuse is more serious than the conduit method, creating a greater need for correction. Finally, and probably most importantly, there is, as noted above, rarely any valid reason for the demand right, whereas there may be many instances where for valid reasons A gives to B, C and D, and C and D later give to B.

rare instances. See supra note 64.

76. I.R.C. § 2514(e) (1976) (see supra note 36); I.R.C. § 2041 (1976). With regard to the gift tax issue, this means that to this extent, the donee of the demand right neither uses part of his exclusion with respect to the trust beneficiary nor pays gift tax (assuming prior use of the unified credit). Without the protection of § 2514(e), the donee of the demand right would, similar to the conduit in the conduit method, do one or the other depending on the disposition under the trust instrument of the funds upon release of the demand right. See supra notes 64 and 75 and accompanying text.

77. See supra notes 75-76 and accompanying text; see also supra note 64.

78. See supra note 31.
The next issue — whether denying exclusions based on powers of appointment will channel evaders into the conduit method which is more difficult to detect — arises from the direct connections and from the lack of valid reasons for the demand right. Because of those two factors, it is easier to prove the existence of an understanding when the Crummey right is used than when the conduit method is used. Why then, as a matter of policy, should we make more difficult the abuse we could more easily detect? The answer is that the conduit method will not be used as frequently as the demand right has been. Crummey stamped the demand right with official approval, stating that it did not matter that there was no realistic chance of exercise (though it did not approve an actual agreement not to exercise the right). With such encouragement, it is not surprising that the demand right has been used so frequently. On the other hand, there has been no such approval of the conduit method. Because of this lack of approval, and because of the very nature of the conduit method, many lawyers and taxpayers who use Crummey without hesitation would probably consider the conduit method an unethical scheme in which they would not participate. For this reason, shifting the burden under Crummey would not result in widespread use of an abuse which is more difficult to prove.

In summary, the proposed amendment, denying exclusions based on powers of appointment, is defensible both theoretically and in terms of protecting tax revenue. However, it is the position herein that such an amendment should not be enacted except in conjunction with two additional reforms: elimination of the present interest requirement and the replacement of the per donee exclusion with a flat exclusion of a certain value. These reforms, which are independently justifiable, should be enacted in conjunction with the proposed power of appointment rule so that established estate plans, created in reliance on the Crummey demand right rule, are not unfairly disrupted. This protection of estate plans is explained further following discussion of the two reforms.

V. THE PRESENT INTEREST REQUIREMENT

The appropriateness of the present interest test must initially be examined in light of the original purpose of the test and of the exclusion itself. The Senate Report accompanying
what was to become I.R.C. section 2503(b) stated in relevant part:

By subsection (b) of the House Bill a gift or gifts to any one person during the calendar year, if in the amount or of the value of $3,000 or less, is not to be accounted for in determining the total amount of gifts of that or any subsequent calendar year. Likewise, the first $3,000 of a gift to any one person exceeding that amount is not to be accounted for . . . . Such exemption, on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts. The exemption does not apply with respect to a gift to any donee to whom is given a future interest. The term “future interests in property” refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only insofar as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is indicated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts.79

The purpose of the exclusion, though not fully articulated, appears to have been to exclude most normal Christmas, wedding and birthday gifts, so as to reduce the record-keeping burden on the taxpayers, the supervisory burden on the I.R.S. and the time pressures on the crowded courts.80 The present interest requirement, in turn, was added because Congress did not want the exclusion, the purpose of which was to reduce the administrative burden, to increase the burden by requiring valuation of future interests. As will be explained, this rationale does not make sense.81

Valuation of future interests is not burdensome and presents no problems that valuation of present interests does

80. It is not consistent with this rationale to allow the first $3,000 to be excluded when the gifts exceed $3,000, for the burdens on the taxpayer, the I.R.S. and the courts are not thereby lessened. However, comparable taxpayers should be treated comparably: the donor of $3,500 should not be taxed on $3,500, while the donor of $3,000 is taxed on nothing.
81. Why Congress found it persuasive is unclear.
not present. Suppose A transfers $100,000 to a trust which is to distribute the income to B for twenty years and then distribute the corpus to C. The value of C's future interest can be ascertained by reference to the tables. Suppose B's interest lasts until his death. B's life expectancy may be ascertained in the tables, as can the value of his interest; one can refer to the remainder tables to determine the value of C's interest (based on B's life expectancy). Suppose that at the end of B's income interest, the principal goes to D, if alive, and, if not, to C. There are tables which estimate D's chance of surviving B; assume the tables say the probability is 25%. Then C's interest is worth 75% of what it was in the second hypothetical and D's is worth 25% of that same figure. Finally, suppose that at the end of B's interest, the principal goes to C, but if D is alive he gets one-half of the principal. C's interest is worth 87.5% (50% plus 75% of the other 50%) of what it was in the second hypothetical and D's is worth 12.5% of that figure. The hypotheticals represent basic types of future interests: after a term of years, after a life estate, a contingent remainder based on surviving another, and a vested remainder subject to open, respectively. All may be easily valued by reference to the tables. If, on the other hand, the conditions upon which the contingent remainders or vested remainders subject to open depend would require, for valuation of the future interests, consideration of certain probabilities incapable of mathematical proof, the value of the remainder interest would likely be held to be not reasonably ascertainable, and thus no exclusion would be available.

In short, in light of the valuation rules outlined above, there would be little administrative burden created by allowing gifts of future interests to be eligible for the exclusion. Moreover, any burden that would be created would be the

82. See supra notes 13-14 and accompanying text. Examples of such interests would be interests conditioned on the birth of children or the exercise of the trustee's absolute discretion. As noted supra, the fact that the valuation would be for exclusion purposes would render courts more likely to find the value not to be reasonably ascertainable.

83. In some instances, an absolute minimum value of the vested remainder subject to open could be established — one-half the value of the full remainder interest in the example in the text. If the class which could share in the trust has no ascertainable limit, such as "D's living descendants," no such absolute minimum value could be established.
same as that involved in valuing present interests, for the same rules apply in valuing present interests. Valuation tables are available to value most interests and those which are incapable of valuation without consideration of nonmathematical probabilities are likely not eligible for the exclusion for that reason. Thus, there is no reason for Congress to distinguish present interests from future interests under I.R.C. section 2503(b). Because the existence of this distinction in the statute creates litigation and the accompanying administrative burden, and because at least some of the normal birthday and Christmas gift-giving is probably in the form of future interests, Congress' original purpose in providing for the exclusion would be better served by deleting the present interest requirement.

As discussed in Section VI, the annual exclusion has assumed an additional function in addition to its original purpose of excluding birthday and Christmas gift-giving. That new function is as an estate planning tool. Because this function is an inescapable part of the annual exclusion, amendments to the statute must be considered not only in light of Congress' original purpose, but also in terms of whether they are consistent with the exclusion's estate planning function. The issue with respect to any proposed amendment is thus whether it creates any inequities when considered in light of the fact that the exclusion will be used as an estate planning tool. The elimination of the present interest requirement creates no such inequities. Allowing exclusion of future interests does not unfairly benefit any particular group of people, nor does it conflict with either of the goals of the gift tax—protection of the estate and income tax. (The means by which a rule can create inequities is illustrated in Section VI's consideration of the "per donee rule.") Thus, the annual exclusion's function as an estate planning tool poses no obstacle to the proposed elimination of the present interest requirement.

84. For a discussion of some of the issues arising under the present interest requirement, see generally J. RASKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 51.11 (1981).

85. See, e.g., Crown v. Commissioner, 585 F.2d 234, 235 (7th Cir. 1978).
VI. The Per Donee Rule

Currently, the annual exclusion is applied separately to each donee. This rule had its foundations in the original purpose of the annual exclusion: exclusion of usual Christmas and birthday gifts ("normal gifts"). This original purpose, however, is not entirely consistent with current practice. Even a quick survey of the private letter rulings and gift and estate tax literature cited herein reveals that the annual exclusion is not regarded by the wealthy as statutory relief from the burdens of declaring normal gifts. Instead, the annual exclusion is regarded as an estate planning tool by which a donor may pass money to others without gift or estate tax. Undoubtedly these same donors engage in normal gift-giving in conjunction with full use of the exclusion pursuant to their estate plan.

In light of these circumstances, there are three primary alternative amendments to I.R.C. section 2503 which Congress might consider. First, the annual exclusion could be eliminated, since for many it appears to be serving a different purpose than the one for which it was enacted. This would be an unwise change. To some extent, elimination of the exclusion would trigger scrutiny by the I.R.S. of normal gifts and the corresponding record-keeping burdens on taxpayers, precisely the excessive administrative burdens which Congress sought to prevent. Furthermore, to a large extent, taxpayers would probably ignore the absence of the exclusion and not report small gifts; at the same time, the I.R.S. undoubtedly would not be diligent in tracking down de minimis gifts. Thus, disrespect for the law would be engendered. This disrespect would be much more widespread than it is now, because currently the only taxpayers giving — and probably not reporting — normal gifts in excess of the annual exclusion are the wealthy who use up the full exclusion pursuant to their estate plan. For the others, the exclusion serves its original purpose.

A second possible amendment to section 2503 would be to restrict the annual exclusion to outright gifts in an effort to limit the exclusion to its original purpose — normal gifts. This would allow exclusion of most normal gifts, especially since many taxpayers who currently make normal gifts in trust would alter their mode of gift-giving. The problems with this solution are twofold. First, the wealthy would, by altering their mode of gift-giving, undoubtedly continue to use the ex-
clusion as an estate planning tool, though admittedly this use would be slightly reduced because outright gifts lack the flexibility of trusts to suit the desires of the donor. The second problem would be that many donors would, as noted, alter their manner of gift-giving. To the extent that the altered manner of gift-giving would not reflect their wishes as a transfer to a trust would, the result would be dissatisfied taxpayers and in many cases unwise transfers.

The third alternative is based on a recognition that there must be an exclusion to exclude normal gifts. But there is no way to provide a statutory exclusion which would exclude normal gifts which would not be used by the wealthy as an estate planning tool. Such recognition leads to the conclusion that the statute should be drafted in such a way that the exclusion will be fair and appropriate as an estate planning tool. In this light, the per donee rule makes little sense. Why should the donor with one other family member be limited to use of the tool only to the extent of $10,000, while the donor with a large family can make perhaps $200,000 worth of use of the same tool?\(^8\) Not only is the latter donor able to avoid estate taxes more successfully, but he is also better able to avoid the progressive income tax rates by shifting more income-producing funds away from himself to those in lower brackets.

Thus, recognition that the annual exclusion is and will be used as an estate planning tool leads to the conclusion that the per donee rule should be replaced by a flat exclusion applicable to the sum of all gifts for the year.\(^7\) The figure could be, for example, $50,000. However, the choice of the precise figure should be based on policy decisions as to (1) what constitutes "de minimis" gift-giving (gift-giving not worth investigating for the I.R.S.), (2) the extent to which money should be transferable without tax,\(^8\) and (3) the extent to which es-

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86. This argument assumes that the Crummey demand right rule has been legislatively overruled, so that exclusions are only available based on real transfers of value.
87. One additional virtue of this proposed amendment is that it renders ineffective the conduit method as a means of avoiding the limit of the exclusion. In other words, because the exclusion would no longer be phrased in terms of each donee, one could not obtain extra exclusions by channeling transfers through third parties.
88. In making this decision, consideration must be given to the purpose of the gift tax: protection of the estate and income tax. See, e.g., Crown v. Commissioner, 585 F.2d 234, 235 (7th Cir. 1978).
tablished estate plans using numerous exclusions should be disrupted.\textsuperscript{89}

VII. TIMING OF THE REFORMS

It is this writer's position that an amendment denying exclusions based on powers of appointment should not be enacted except in conjunction with the elimination of the present interest requirement and the per donee rule. The reason is that unless the latter reforms are also enacted, elimination of the \textit{Crummey} demand right will undermine the effectiveness of estate plans which have been previously set up in reliance on the current state of the law. Public expectations should not control legislation, but where additional reforms which would protect valid expectations are independently justifiable, they should be enacted.

An example of a typical trust will illustrate how expectations would be protected. Suppose a life insurance trust has been established. The policy premiums, which are $5,000 a year, are currently paid by the grantor who excludes each year's transfer based on demand rights possessed by the trust beneficiaries. Under the terms of the trust, the trustee has, after the death of the grantor, discretion to invade corpus or to distribute income to provide for the needs of the beneficiaries, who are the grantor's spouse and three minor children. The spouse has a testamentary special power of appointment to direct the trust corpus and accumulated income to the grantor's descendants living at her death.

If the only reform enacted was that exclusions were no longer allowed based on demand rights, this estate plan could not accomplish its intended purpose. The grantor could not exclude his premium payments because they would not qualify as transfers of present interests to the beneficiaries. The trust, without other funds, could not pay the premiums (and could not borrow enough to pay all the premiums). The grantor would thus have the alternatives of using his unified credit with regard to transfers to the trust to pay the premiums or allowing the policy to lapse. Either alternative would be disruptive of the grantor's estate plan.

If, on the other hand, the present interest requirement and

\textsuperscript{89} See infra note 91.
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per donee rule were eliminated at the same time that the demand right rule was legislatively overruled, the grantor would be able to continue to exclude his premium payments. The elimination of the present interest requirement would render irrelevant the fact that none of the beneficiaries would have a present right to the $5,000 transfer. Deletion of the per donee rule would also be necessary; otherwise, no exclusions would be available because the value of each beneficiary's interest would not be ascertainable. Thus, only the simultaneous enactment of the three reforms would assure the continued effectiveness of many estate plans.

VIII. CONCLUSION

In light of the fact that the Crummey demand right is hardly ever used for valid purposes and could be used to substantially evade the gift tax, Congress should amend I.R.C. section 2503 to deny exclusions based on powers of appointment. In order to avoid disrupting estate plans created in reliance on current law, Congress should pass two further, independently justifiable amendments of I.R.C. section 2503, deleting the present interest requirement and the per donee rule.

90. See supra notes 13-14 and accompanying text.

91. Admittedly, some estate plans would be disrupted, i.e., those which currently use the exclusion in an amount exceeding the flat figure that would be set as the new limit. This should not, however, prevent enactment of the necessary reforms. Although legislators should consider legitimate expectations when contemplating new legislation, public expectations should not, as noted, control legislation. It must be recognized that all change upsets some valid expectations. Furthermore, the legislators could, to the extent desired, reduce the disruption by setting a high figure for the flat exclusion.