Reform the Gift Tax Annual Exclusion to Raise Revenue

By Bridget J. Crawford


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In this article, Crawford proposes limiting the gift tax annual exclusion to outright transfers and transfers in trust that will be included in the beneficiary's gross estate.

This proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop proposals to raise revenue. The Shelf Project is intended to raise revenue without a VAT or a rate hike in ways that will improve the fairness, efficiency, and rationality of the tax system. An overview of the Shelf Project is found in ''How to Raise $1 Trillion Without a VAT or a Rate Hike,'' *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*. Congress enacted its first Shelf Project in March 2010. Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

A. Current Law

Annual exclusion gifts are a staple of estate planning. Under section 2503, a donor can make tax-free gifts up to a set dollar amount each year ($13,000 per donee in 2011) to an unlimited number of people.[1] If a taxpayer's spouse agrees to ''gift split,'' the annual exclusion may be up to $26,000 per donee.[2]

If annual exclusion gifts are made on a regular basis, a donor can transfer a substantial amount of wealth out of his taxable estate. To illustrate, assume that a senior generation family member has three adult children, each of whom is married and has two children. She transfers $26,000 to 12 individuals: the adult children, the children's spouses, and the six grandchildren. Her spouse agrees to gift-split. If that pattern were to continue for 10 years, the taxpayer would reduce the size of her gross estate by more than $3 million. Consistent annual giving is a powerful estate planning technique.

The annual exclusion is available for two types of transfers: transfers to minority trusts under section 2503(c)[3] and transfers of present interests in property.[4] To qualify as a minority trust, a trust must have a single beneficiary under age 21 and must terminate when the beneficiary turns 21 or dies. If the beneficiary dies before turning 21, the trust property must be paid to the beneficiary's estate or pursuant to the beneficiary's exercise of a general power of appointment. The trustee's ability to expend trust assets for the benefit of the beneficiary must be free from substantial restriction.[5] If the beneficiary has the right to withdraw all the trust property at age 21 but the trust continues if the beneficiary does not do so, the trust will still qualify for the annual exclusion.[6]

A present interest is an ''unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain).''[7] A present interest commonly takes one of two forms. The first is an outright transfer. The transfer of $13,000 by Person

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[1]Under section 2503(b)(2), the amount is subject to a cost of living adjustment. The annual exclusion amount initially was $5,000 from 1932 to 1938 and became $13,000 in 2009. For simplicity purposes, assume that the annual exclusion is $13,000 for 2009 and after.

[2]''Gift-splitting'' refers to an election under section 2513(a) to have a transfer made by either spouse to be treated as if each of them contributed one-half.

[3]Section 2503(c).

[4]Section 2503(b)(1).

[5]Reg. section 25.2503-4(b)(1). *See also* Rev. Rul. 69-345, 1969-1 C.B. 226 (requirement that trustee must consider the minor's situation and resources constitutes a substantial restriction on trustee's authority).

[6]Rev. Rul. 74-43, 1974 C.B. 285.

[7]Reg. section 25.2503-3(b).

A to Person B is a transfer of a present interest for purposes of section 2503(a). A transfer to a trust other than a minority trust can also qualify as a present interest if at least one beneficiary has the right to withdraw a minimum amount of trust property. Transfers to that type of trust, typically called a *Crummey* trust,[8] are treated as transfers of present interests. The withdrawal right — a *Crummey* power — gives rise to a legal fiction that the grantor made a transfer directly to the beneficiary.

Well-drafted *Crummey* trusts typically limit the withdrawal right to the annual exclusion amount (less $1,000 or so to allow for de minimis outright gifts during the year). Well-drafted trusts also provide for an automatic lapse of any withdrawal right by the greater of $5,000 or 5 percent of the value of the trust estate. Why? A power of withdrawal is a general power of appointment under section 2041.[9] The lapse of a power of appointment is usually considered a release of the power (and a taxable transfer for estate and gift tax purposes).[10] Further, a power holder is treated for income tax purposes as the owner of that portion of the trust over which he has a withdrawal right.[11] The lapse of withdrawal rights can have multiple negative tax consequences for the power holder. Those consequences are somewhat mitigated by a gift and estate tax rule that provides that the lapse of a withdrawal right will not be treated as a release (that is, it will not be subject to estate or gift tax) if the lapse is limited to the greater of $5,000 or 5 percent of the aggregate trust property.

Practically speaking, *Crummey* powers are rarely, if ever, exercised. Indeed, if one were to survey 1,000 estate planning lawyers, it is unlikely that any could report firsthand knowledge of the exercise of a *Crummey* power. In the past, the IRS has tried to attack *Crummey* powers on the grounds that the withdrawal right was not meaningful,[12] an objection that is easily defeated by well-advised taxpayers who keep careful records or send regular *Crummey* notices of contributions to the trust, and when the trust provides for a reasonable window of time for the power's exercise.[13]

For purposes of section 2503, other transfers that are treated as present interests include some life interests or terms of years in a trust[14] and transfers to college tuition savings programs (also known as 529 plans).[15]

The annual exclusion from gift taxes is broader than its generation-skipping transfer tax counterpart. The GSTT annual exclusion is available only for an outright transfer to a natural person who is in a generation two or more generations below the transferor,[16] or for a transfer in trust when the trust property may be used only for the benefit of a single individual (and no portion of the trust property may be distributed to or used for the benefit of any other individual) and if the trust terminates during the beneficiary's lifetime, the trust assets must be includable in the beneficiary's gross estate.[17] Thus, the GSTT annual exclusion is more limited than the gift tax annual exclusion, and transfers to skip persons that are nontaxable under section 2503(b) may nevertheless be taxable under section 2642(c).[18]

B. Reasons for Change

The primary reason for the annual exclusion is to eliminate record-keeping associated with customary holiday and other gifts.[19] The law treats minor birthday gifts and anniversary presents as a form of personal consumption of sorts, not estate-depleting transfers that should be subject to wealth transfer taxation. Presumably, the present interest requirement of section 2503 serves two purposes. First, it makes it easier for the transferor (and the IRS) to value the gift, insofar as present interests are easier to value than future interests. Second, the transferor (and the IRS) must be able to identify the transferee with certainty, because the annual exclusion is available on a per *donee* basis. It is not clear, however, that those purposes can be accomplished only through a present interest rule requirement.[20]

The present interest requirement has caused taxpayers (and their advisers) to create trusts with overly complex terms that serve no meaningful distributive purpose. Consider the following sample language from a *Crummey* trust:

[8] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result*.

[9] Section 2041(b)(1)(A).

[10] Section 2041(b).

[11] Section 678.

[12] *See, e.g.*, Rev. Rul 81-7, 1981-1 C.B. 474.

[13] Rev. Rul. 83-108, 1983-2 C.B. 168 (45-day exercise period after receipt of notice was reasonable).

[14] Reg. section 25.2503-3(b). *See also Fondren v. Commissioner*, 324 U.S. 18 (1945) (the interest in trust must not be subject to defeat or defeasance). *See, e.g.*, *Prejean v. Commissioner*, 354 F.2d 995 (5th Cir. 1966).

[15] Sections 529(c)(2)(A)(i) and 530(d)(3).

[16] Sections 2642(c) (GSTT annual exclusion for some direct skip transfers), 2612(c)(1) (direct skip is transfer to a skip person), and 2613 (definition of skip person).

[17] Section 2642(c).

[18] *Id.*

[19] H.R. Rep. No. 72-708 (1932), at 29; S. Rep. No. 72-665 (1932), at 41.

[20] The code, for example, employs a variety of formulae in the valuation of some future interests. *See, e.g.*, sections 2701 et seq.

4.1 Power of Withdrawal of Grantor's Descendants and Their Spouses.

In the calendar year of establishment of this trust and in any calendar year during which additional property is transferred to the trust estate whereby the Grantor and/or her spouse has made or is deemed to have made a lifetime gift, each of the Grantor's descendants and spouses of descendants (each of such descendants and spouses of descendants herein referred to as a ''Beneficiary'' and collectively as the ''Beneficiaries'') living at the time of the transfer shall have the power, commencing with the time of creation of the trust or the time of such additional transfer, as the case may be, to withdraw property from the trust, including the property transferred. With respect to all transfers to the trust during any one calendar year by the Grantor and her spouse, the value of the property subject to a power of withdrawal by each Beneficiary, as the case may be, shall be the lesser of the following amounts:

1. an amount equal to the product of (a) the value of the property transferred; and (b) the fraction of which the numerator is one (1) and the denominator is the sum of (i) the number of the Beneficiaries living when the property is transferred less (ii) the number of the Beneficiaries who have been excluded from having a right of withdrawal with respect to such transfer pursuant to the other provisions of this Article; or

2. the maximum federal gift tax exclusion (less $1,000) under section 2503(b) of the Code in effect at the time of transfer (currently $13,000 per transferor) or twice the maximum federal gift tax exclusion (less $1,000) under section 2503(b) of the Code in effect at the time of the transfer if the transferor is married at the time of the transfer and if there is a provision in the Code permitting spouses to split gifts at the time of the transfer (currently $26,000);

provided that the total amount that any individual may demand with respect to all gifts made to the trust by the Grantor and/or the Grantor's spouse shall lapse on December 31 of each year (whether or not a contribution to the trust has been made that year) by the greater of (a) Five Thousand Dollars ($5,000) or (b) Five Percent (5%) of the value of the trust estate on December 31 of that year. To the extent that any power of withdrawal held by any Beneficiary has not lapsed in accordance with this Paragraph, such Beneficiary's power of withdrawal shall continue but may only be exercised with the consent of the Independent Trustee. Notwithstanding anything herein to the contrary, if any property has been transferred to the trust estate after October 31, the power to demand such property shall not lapse in accordance with the provisions of this paragraph until the second following December 31 and such Beneficiary's power of withdrawal may be exercised without the consent of the Independent Trustee until the second following December 31.

4.2 Notice.

The Trustees shall, promptly after a transfer of property is made to the trust during the Grantor's life, notify in writing any holder of a power of withdrawal, such notice to include a description of (1) the transferred property, (2) the respective right of withdrawal resulting from the transfer, and (3) the time limit on exercise of the right. In case any holder of a power of withdrawal is under a legal disability, notification shall be given to his or her legal guardian, committee, or conservator, or, if none, to his or her parent or to such other person or institution in a position to act on his or her behalf as the Trustees shall deem appropriate. Each holder of a power of withdrawal may exercise the power by a writing signed and delivered to the Trustees, except that in the case of a person under a legal disability, his or her power may be exercised by his or her legal guardian, committee or conservator, as the case may be. However, in no circumstance shall the Grantor or the Grantor's spouse exercise a power of withdrawal on behalf of a person under a legal disability.

4.3 Exclusion of Person From Having Power of Withdrawal.

Prior to the transfer of any property to the trust (including but not limited to the initial transfer), the Independent Trustee may exclude any one or more persons from having powers of withdrawal over that transfer and/or subsequent transfers, by delivering an instrument in writing to such holder of a power of withdrawal. No such instrument shall limit any powers of withdrawal resulting from transfers made prior to such instrument.

If, for example, the grantor of this trust were married and had three adult children, each with two children of their own, the grantor could transfer $312,000 to the trust tax free. This removes those assets from his gross estate. The trustee must send to each descendant and spouse of a descendant the notice of a right that no one has any intention of exercising. *Crummey* trusts are complex instruments that require substantial professional advice; provisions like those above are entirely tax-driven.

C. Explanation of the Proposal

Congress should reform the gift tax annual exclusion under section 2503. It should eliminate the present interest requirement and in lieu thereof, allow to qualify for the annual exclusion only outright transfers and transfers in trust that meet the requirements of section 2642(c). Adoption of this proposal will allow taxpayers to continue to make customary gifts, without having to keep records of every minor gift. The law would be clearer, because the gift tax and GSTT annual exclusions would be identical. The proposal also would simplify estate planning by obviating the use of *Crummey* trusts.

Under the proposal, the donee remains readily identifiable in the case of an outright transfer or a transfer in trust. For transfer tax purposes, the donee would be the person in whose estate the trust property would be included, if he dies before the trust terminates. Any valuation concerns could be minimized by adopting a present-value rule for all transfers to trusts that meet the requirements of section 2642(c).

The proposal does not curb a taxpayer's ability to make transfers in trust for the benefit of a minor in any way, and indeed, would permit entrustment beyond the age of 21, as long as the assets would be included in the beneficiary's gross estate.

The lack of harmony between the gift tax annual exclusion and the GSTT annual exclusion can be confusing for taxpayers and their advisers. Presumably, Congress wished to curb perceived abuses of the GSTT annual exclusion by making it more restrictive. It seems, however, that the gift tax annual exclusion's present interest requirement has given rise to the widespread use of *Crummey* powers, which the IRS seems to believe have potential for abuse.

To be sure, wealth transfer tax does not represent a large percentage of the government's tax revenue. Nevertheless, it is appropriate to consider proposals that achieve the dual goals of reducing complexity and raising revenue, however modest.