Lapse of *Crummey* power need not result in taxable gift if hanging power is used

A hanging power, whereby the "taxable" part of a beneficiary's power to invade corpus is carried over until it becomes nontaxable, can avoid gift tax consequences, but is likely to meet IRS opposition. This article examines the future use of hanging powers and alternatives to such powers.

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SECTION 2503(c) provides an exception to the rule of Section 2503(b) that gifts of future interests do not qualify for the annual exclusion for gifts in trust to a minor if both of the following requirements are satisfied. Income and principal must:

1. Be used only for the benefit of a minor prior to the minor's reaching age 21.
2. Pass to the minor upon reaching age 21 or pass to the minor's estate or pursuant to a general power of appointment exercisable by the minor if the minor dies before age 21.

In addition to Section 2503(c), there are two ways that a gift in trust can qualify for the annual exclusion. First, if a gift is made to a trust in which the beneficiary has a mandatory income right, then, generally, the discounted present value of that income interest is a gift of a present interest. That value, however, will be less than the amount contributed; for example, the value of a lifetime right to receive income from $10,000 is less than the $10,000 itself.

Alternatively, if the beneficiary of a trust is given a properly structured withdrawal right, the amount over which the beneficiary has such a right equals a present interest.[1] Therefore, a favored means of structuring gifts in trust is to provide each beneficiary with a withdrawal right so that the gift is one of a present interest and hence qualifies for the gift tax annual exclusion (a *Crummey* power).

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A withdrawal right given to a beneficiary does not have to be unlimited in duration to convert a future interest into a present interest. Generally, all that is required is that the withdrawal right provide the beneficiary with a meaningful opportunity to obtain complete control of the property.[2] Usually, a withdrawal right is meaningful if it is open for 30 or 45 days and then expires if the beneficiary has not exercised that right.[3]

Beneficiary's withdrawal right

The right of withdrawal is a general power of appointment under Regs. 20.2041-1(c)(1) and 25.2514-1(c)(1). The beneficiary's withdrawal right usually expires at the end of a certain period of time. At the expiration of that time, the withdrawal right (*i.e.*, the general power of appointment) is said to lapse as to that portion over which the beneficiary could have, but did not, exercise the withdrawal right. A lapse of a power of appointment is a release of the power to the extent that the property that could have been appointed exceeds the greater of: (1) $5,000, or (2) 5% of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied.[4]

To the extent it is not treated as a release, a lapse is not a transfer for gift tax purposes. Under Section 2514(b), the release of a power of appointment is a transfer for gift tax purposes by the beneficiary releasing the power. The transfer is to the trust, and the beneficiary has made a taxable gift to the trust if the trust terms do not provide the beneficiary with sufficient control and dominion over the trust so as to

render the transfer incomplete for gift tax purposes.[5] Absent unusual trust terms, no gift tax annual exclusion is available to the beneficiary because the transfer is a gift of a future interest.

Using hanging powers

The next question is how to prevent the lapse of a withdrawal right from being a taxable gift by the beneficiary. One solution is to allow the withdrawal power to lapse only as to the amount that Section 2514(e) protects from treatment as a release (*i.e.,* the greater of $5,000 or 5% of the value of the property out of which the withdrawal right could have been satisfied). The withdrawal right over the remaining amount is carried over to future years and lapses only when such lapse will not be a taxable gift.

Example. Donor contributes $20,000 in year 1 to a trust for the benefit of A and B. A and B are given withdrawal rights so that Donor can avail herself of the $10,000 per beneficiary annual exclusion from gift tax. A and B are discretionary income and principal beneficiaries; the balance of the trust is to pass to A and B, in equal shares, at Donor's death, if they are both living, or all to the survivor if one is alive.

If A's and B's withdrawal rights expire at the end of 30 days without being exercised, then each of them has released a general power of appointment and therefore has made a transfer for gift tax purposes equal to $10,000 (the amount they could have each withdrawn) minus the greater of (1) $5,000 or (2) $1,000 (5% of the total amount from which each withdrawal right could have been satisfied). A and B have each arguably made taxable gifts equal to $5,000.

Assume the document uses a hanging power. In this case, A's and B's withdrawal rights will lapse after 30 days as to only $5,000; the withdrawal right over the remaining $5,000 will continue in effect until it can lapse without gift tax consequences. In year 2, assume Donor makes no contributions. A and B each have withdrawal rights remaining as to $5,000. In year 2, each withdrawal right, because it is not more than $5,000, can lapse without any gift tax consequences.

Example. Assume there are five beneficiaries of a trust. The donor makes annual contributions of $20,000 per beneficiary per year for the first five years of the trust. The donor is married, and her husband consents to have the gifts deemed made one-half by him. The trust document gives each beneficiary withdrawal rights which, in effect, hang for as long as necessary to prevent the nonexercise or lapse from being treated as a taxable gift by the beneficiary. The results of this example are shown in Exhibit I below.

The Service's position

TAM 8901004 illustrates the Service's position towards the hanging power. There, the grantor had cre-

Exhibit I: Illustration of hanging power

Year	*Amount contributed to trust*	*Beneficiary's pro rata share of contribution*	*Amount of contribution which lapses (per beneficiary)*	*Amount of hanging amount which lapses (per beneficiary)*	*Total hanging amount over which each beneficiary's withdrawal right continues*
1	$100,000	$20,000	$ 5,000	$-0-	$15,000
2	100,000	20,000	10,000 (5% × 200,000)	-0-	25,000
3	100,000	20,000	15,000 (5% × 300,000)	-0-	30,000
4	100,000	20,000	20,000 (5% × 400,000)	-0-	30,000
5	100,000	20,000	20,000	5,000 (5% × 500,000= 25,000)	25,000
6	-0-	-0-	-0-	25,000 (5% × 500,000)	-0-
7	-0-	-0-	-0-	-0-	-0-

ated an irrevocable trust which allowed for discretionary payments of income to the grantor's descendants during his lifetime. At the grantor's death, the trust property was divided into two separate trusts—one for the benefit of the grantor's son's family and one for the benefit of the grantor's daughter's family. Descendants (and their spouses) were given a 30-day, pro rata withdrawal right over property added to the trust.

If a beneficiary failed to exercise his or her withdrawal right, the document provided: "Notwithstanding the above, if upon the termination of any power of withdrawal, the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes, then such power of withdrawal will not lapse, but will continue to exist with respect to the amount that would have been a taxable gift and will terminate as soon as such termination will not result in a taxable gift."

Relying on *Procter,*[6] the Service held the above-quoted provision was invalid. It stated: "Accordingly, the provision is a condition subsequent and is deemed not valid as tending to discourage enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective."

In *Procter,* the trust clause held invalid provided as follows: "However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property. . . shall automatically be deemed not to be included in the conveyance in trust hereunder."

The happening of the condition—a judicial finding that the previous transfer was a taxable gift—rendered the previous transfer voidable (*i.e.,* it undid the prior gift). In a real sense, the *Procter* condition rendered ineffective any attempt by the Service to challenge the taxable gift nature of the transaction. And the *Procter* court held that this was contrary to public policy for three reasons:

1. It discouraged the collection of tax since the only effect of a valid attempt to enforce the tax would be to defeat the gift.
2. It obstructed the administration of the judicial system by making courts pass on moot points.
3. It impermissibly resulted in Federal courts rendering declaratory judgments on whether transfers are gifts for gift tax purposes.

In contrast, the use of a properly drafted hanging power should not be caught by the *Procter* analysis. The *Procter* elements include (1) a transfer which (2) becomes voidable (3) if future action by a court (and, extending the court's reasoning, by the Service) determines that the transfer was a taxable gift. Assuming that the lapse of the withdrawal right is the transfer (Element 1), this lapse becomes voidable (*i.e.,* it "hangs" and does not lapse) (Element 2), depending on (a) the year of the lapse (*e.g.,* have other lapses by that beneficiary occurred in that year?) and (b) the amount in the trust out of which the withdrawal power could be satisfied. This amount is the permissible Section 2514(e) amount which can lapse each year without being a release.

Whether the lapse becomes voidable, or hanging, *is not contingent on action by the Service or courts,* so Element 3 of the *Procter* reasoning is not present. This fact alone legitimately distinguishes a properly drafted hanging power from the condition subsequent found to be void in *Procter.* (The foregoing analysis renders the theoretical hairsplitting as to whether a hanging power is a condition subsequent or condition precedent unnecessary. Even if a hanging power is a condition subsequent, it is not the type of condition which should be contrary to public policy under the *Procter* analysis.)

The Service found that the hanging power in TAM 8901004 "discourage[d] enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective." With a properly drafted hanging power, however, enforcement of Federal gift tax provisions will not affect the existence of the gift (*i.e.,* whether the withdrawal right lapses). Rather, the lapse of the withdrawal right will be tied to Section 2514(e) as it relates to the current status of the trust. A condition that is tied to a statutory provision is not contrary to public policy and should not be rendered invalid under a *Procter*-type analysis.

Can a properly drafted hanging power be distinguished from the hanging power in TAM 8901004? There, the trust language provided that the withdrawal power given to a beneficiary would not lapse "if upon the termination of any power of withdrawal, the person holding the power *will be deemed* to have made a taxable gift for federal gift tax purposes" (emphasis added).

Arguably, the Service's position, which is not totally clear in TAM 8901004, is that the language could be interpreted as followed: "[I]f upon the termination of any power of withdrawal, the person holding the power will be deemed *by the Internal Revenue Service or a court* to have made a taxable gift for federal gift tax purposes. . . " (emphasized words not in original text).

Under that interpretation, the condition subsequent is action by the IRS in enforcing a gift, which, if suc-

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[1] See, *e.g., Crummey,* 397 F.2d 82, 68-2 USTC ¶12,541, 22 AFTR2d 6023 (CA-9, 1968).
[2] *Id. Cf.* TAM 8727003.
[3] See, *e.g., Ltr. Ruls.* 8003033, 8004172; and *Rev. Rul.* 83-108, 1983-2 CB 167.
[4] Section 2514(e).
[5] Reg. 25.2511-2(b) and (c).
[6] 142 F.2d 824, 44-1 USTC ¶10,110, 32 AFTR 750 (CA-4, 1944), *cert. den.*
[7] Section 6019(a); but see Reg. 25.6019-3(a).
[8] *Ltr. Rul.* 8142061.
[9] See also *Ltr. Rul.* 8229097.
[10] See Sections 2041(a)(2) and (b)(2).
[11] See, *e.g.,* Regs. 20.2041-3(d)(3) and -(5).

cessful, would render the gift ineffective (*i.e.*, the withdrawal right will be deemed to have continued in existence), thereby creating the circularity problem properly objected to in *Procter.*

Alternatively, if the hanging power provision expressly ties the lapse of the withdrawal right to the greater of $5,000 or 5% per year, which is the Section 2514(e) protected amount, the condition is not a *Procter*-type condition. It does not, in the words of the TAM, "discourage enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective."

Future use of hanging powers

If a hanging power is found in a current irrevocable trust document, the practitioner should attempt to distinguish that power from the *Procter*-type condition subsequent. A practitioner can legitimately argue that TAM 8901004 did not reach the correct conclusion or, in the alternative, that the hanging power language in that TAM is not analogous to the language in the practitioner's document.

Should new documents be drafted with hanging powers? The Service's probable position will be that the power is not valid. Prudence dictates that practitioners should not ignore TAM 8901004. Considering the question purely from an estate and gift tax perspective, however, the following possibilities exist:

1. The advantage of the continued use of hanging powers is that a donor and spouse may make annual exclusion gifts in trust of $20,000 per year per beneficiary and avoid taxable gift consequences to the beneficiary even if the beneficiary does not exercise the withdrawal right. Furthermore, if the trust is properly structured and if the hanging powers have lapsed, the trust property should not be included in the beneficiary's gross estate if the beneficiary dies prior to the termination of the trust.

2. The disadvantage will occur if the Service effectively argues that the hanging amount is a taxable gift. In that situation, a gift tax return arguably was not required under Section 6019 since it was uncertain whether the beneficiary had made transfers by gift.[7]

What about interest and penalties for not paying the tax should a taxable gift be deemed to have occurred? Because of the unified credit, there probably will be no amount of tax due even if the hanging power is invalidated. Therefore, no interest or penalties should be assessed if the Service is successful. The answer might be different if the beneficiary has already used or plans to use his unified credit for other lifetime transfers.

The most apparent disadvantage is that the unified credit will have to be used against the deemed taxable gift. The use of the unified credit could have been avoided if (1) one of the alternative strategies discussed below were used instead of the hanging power, and (2) the trust terminated prior to the beneficiary's death.

Alternatives to hanging powers

In examining the potential alternatives to the hanging power, it is important to focus on the objectives the client is trying to achieve. If the donor desires merely to prevent the lapse of the withdrawal right from being a taxable gift by the beneficiary, the following strategies will address that concern:

1. Limit the withdrawal right to the greater of $5,000 or 5% of the property out of which the right could be exercised. There will be no release and, thus, no transfer for gift tax purposes unless a lapse is greater than $5,000 or 5% of the property over which the withdrawal right could have been exercised. The disadvantage is that the annual exclusion amount will be available only to the extent of $5,000 (or, if greater, 5% of the property over which the withdrawal right applies).

2. Designate the individual with the withdrawal right as the sole beneficiary of the trust (or of a specific share in the trust) and designate that individual's estate as the contingent beneficiary of the trust (or of a specific share) if the beneficiary dies prior to the termination of the trust. As a result, the lapse of the withdrawal right will not transfer property to other beneficiaries and there will be no taxable transfer.[8]

3. Grant to the primary beneficiary a testamentary general power of appointment. This will prevent the shifting of interest from occurring upon the lapse of a general power of appointment. Regulations 25.2511-2(b) and (c) provide that the retention of a power over property by a donor renders a transfer incomplete for gift tax purposes. If the gift is incomplete, a taxable transfer does not occur.[9]

The problem with the strategies discussed in #2 and #3 above is that if the beneficiary dies prior to the termination of the trust, all of the trust property is included in the beneficiary's gross estate. One way to prevent this is to give to the beneficiary a nongeneral power of appointment over the property which the beneficiary could have withdrawn, such as the power to appoint in favor of descendants only. This should still render the lapse a nontaxable gift since the donor/beneficiary has not parted with complete dominion and control. Further, only a portion of the trust will be included in the beneficiary's estate.[10] Because a fraction of the trust property will still be included in the beneficiary's estate, the nongeneral power of appointment is only a limited solution.[11]

Conclusion

The hanging power, if valid, could achieve the best result from both a gift and estate tax view. ★