

IRREVOCABLE TRUSTS AND IN TERROREM CLAUSES

The use of “Crummey” trusts and withdrawal powers to qualify a contribution to the trust as a gift of a present interest is approaching its 50 year anniversary. The most recent question involving the use of Crummey powers is: If a trust contains a withdrawal provision (a “Crummey” right) and an *in terrorem* or “no contest” clause, will a transfer to the trust by the Grantor qualify for the annual exclusion under Internal Revenue Code Section 2503?

According to CCA 201208026, issued in 2012, “[t]o be a present interest, a withdrawal right must be legally enforceable. For example, if a trust provides for withdrawal rights, and the trustee refuses to comply with a beneficiary's withdrawal demand, the beneficiary must be able to go before a state court to enforce it.”

The presence of the *in terrorem* clause in the trust caused the Service grave concern.

Under the terms of the Trust in this case, a beneficiary cannot enforce his withdrawal right in a State court. He may only press his demand before an Other Forum and be subject to the Other Forum's Rules. Notwithstanding any provisions in the Trust to the contrary, the Other Forum will not recognize State or federal law. If the beneficiary proceeds to a State court, his existing right to income and/or principal for his health, education, maintenance and support will immediately terminate. He will not receive any income or principal for his marriage, to buy a home or business, to enter a trade, or for any other purpose. He will not have withdrawal rights in the future, and his contingent inheritance rights will be extinguished. Thus, a beneficiary faces dire consequences if he seeks legal redress. As a practical matter, a beneficiary is foreclosed from enforcing his withdrawal right in a State court of law or equity.

Withdrawal rights such as these are not the legally enforceable rights necessary to constitute a present interest. Because the threat of severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory. Consequently, no annual exclusion under § 2503(b) is allowable for any of the withdrawal rights.

However, the Service's position was rejected in the case of *Mikel v. Commissioner*, T.C. Memo 2015-64. There the Grantor's created an irrevocable trust with Crummey withdrawal powers for 60 beneficiaries. (The use of the annual exclusion at \$12,000 over the 60 Crummey beneficiaries reduced the Grantor's overall gift to under the then lifetime gift tax exclusion of \$1,000,000). The Trust contained an arbitration provision that provided that an issue of interpretation of the trust would be submitted to a panel of three persons of the Orthodox Jewish faith to enforce the provisions of the trust and give any party the rights under New York law.

The trust also contained an *in terrorem* clause that was designed to discourage any beneficiary from challenging the discretionary decisions of the trustees to make distributions of the trust corpus or income.

To the Service, the presence of the *in terrorem* clause in the trust suggested that the Crummey beneficiaries had an “illusory withdrawal power”, unenforceable in a court of law because, (1) the arbitration clause denied the beneficiaries of their right to go before a state court to enforce the withdrawal right and (2) the *in terrorem* clause was a deterrent to a beneficiary seeking legal redress as their beneficial interest under the trust would cease.

The Service’s arguments were not persuasive to the Court. The beneficiaries possessed a present interest in the trust because they had “ an unconditional right to withdraw property from the trust and their withdrawal demands could not be ‘legally resisted’ by the trustees.”

Mikel offers guidance to the proper drafting of an *in terrorem* clause in a Crummey trust. The restrictions on contesting the trust or the actions of the trustee must not prohibit the enforcement of the beneficiary’s rights to withdraw funds under applicable Crummey powers granted in the trust. The language of the *in terrorem* clause in any Crummey trust should be carefully reviewed to insure that the enforcement of a Crummey right of withdrawal will not trigger a loss of benefits and therefore render the power to withdraw as “illusory”.

Challenging the validity of the trust can be prohibited. Challenging the exercise of a trustee’s discretion in making distributions of the trust estate can be prohibited. But if you want a contribution to the trust to qualify for the gift tax annual exclusion, no prohibition should be contained in the trust that would stifle the exercise of the withdrawal right. *Mikel* offers practitioners excellent guidance in drafting for these issues.
