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THE ANNUAL EXCLUSION AND FUTURE INTERESTS

— by Neil E. Harl*

As is widely known, gifts of \$10,000 or less per year per donee are eligible for the federal gift tax annual exclusion.¹ Moreover, gifts of \$10,000 or less do not require the filing of a federal gift tax return.² What is less widely known is that only *present interests* qualify for the annual exclusion.³ Gifts of future interests are not eligible.⁴ And gifts of future interests require the filing of a federal gift tax return regardless of amount.⁵

Many seemingly ordinary transactions can give rise to gifts of future interests. Besides requiring the filing of a federal gift tax return regardless of amount, the major concern is that the gift uses up the federal estate and gift tax unified credit.⁶

Transfers involving new or existing entities

For transfers of property to new or existing corporations, the outcome may be a gift of a future interest to the corporate shareholders to the extent the transferor does not receive equivalent value in the form of stock or debt securities.⁷ Gifts of stock in a closely held corporation with a history of non-payment of dividends may be considered a gift of unascertainable value and thus a gift of a future interest.⁸ For that reason, it is generally prudent to declare a small amount of dividends occasionally on stock if it is planned for the stock to be transferred by gift.

However, gifts to partners' capital accounts in a partnership have been held eligible for the federal gift tax annual exclusion where each partner was entitled to be paid the partner's capital account on demand.⁹

Transfers of property to a land trust with the transferor retaining control over the land are transfers of future interests as to family members who receive no present benefit.¹⁰ Similarly, transfers of non-income producing real property to an irrevocable inter vivos trust may be gifts of future interests where the trust authorized the trustee to hold unproductive property and barred the trustee from selling the property.¹¹ The same result has been reached where the trustee had complete discretion to accumulate or distribute trust income.¹²

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Crummey powers

A discretionary power in a trustee as to payment of trust income may render the taxpayer ineligible for the federal gift tax annual exclusion¹³ unless the beneficiaries are given a power to demand trust income.¹⁴ Such powers are referred to as *Crummey* powers, named after *Crummey v. Commissioner* which established present-interest status for transfers if the donee has a right to make withdrawals from the trust.¹⁵

To be effective, the right to withdraw from the trust must meet several conditions —

- Beneficiaries must have knowledge of the power and a reasonable opportunity to exercise the power.¹⁶
- If some of the beneficiaries are minors, notice given should be sufficient for appointment of a fiduciary and reasonable time for the fiduciary to act.¹⁷

Even unexercised demand rights of remote contingent beneficiaries may support a federal gift tax annual exclusion.¹⁸

- The right of immediate distribution given to minor beneficiaries may create a present interest even though the language of the trust does not specifically provide for withdrawal by a guardian.¹⁹
- If trust beneficiaries do not receive a present interest in trust income, a transfer of property to the trust may create a future interest if rights to trust distribution are not fixed until a later time.²⁰
- A trustee who fails to advise beneficiaries of the existence of the trust and the powers of withdrawal may have breached their duty to holders of the power.²¹

Transfers for minors

Transfers for the benefit of minors must satisfy the requirements of I.R.C. § 2503(c).²² Trustee discretion does not bar the exclusion unless there are no "substantial restrictions" under the terms of the trust instrument of the exercise of such discretion.²³

FOOTNOTES

- ¹ I.R.C. § 2503. See generally 6 Harl, *Agricultural Law* § 46.04[1] (1993); Harl, *Agricultural Law Manual* § 6.01 (1993).
- ² Treas. Reg. §§ 25.6019-1, 25.6075-1.
- ³ I.R.C. § 2503(b).
- ⁴ *Id.*
- ⁵ See n. 2 *supra*.
- ⁶ See I.R.C. §§ 2503, 2505.
- ⁷ Rev. Rul. 71-443, 1971-2 C.B. 337. See Ltr. Rul. 7935115, May 31, 1979 (transfer of corporate stock to issuing corporation); Ltr. Rul. 8422015, Feb. 15, 1984 (same).
- ⁸ See *Stark v. U.S.*, 345 F. Supp. 1263 (W.D. Mo. 1972), *aff'd*, 477 F.2d 131 (8th Cir. 1973).
- ⁹ *Wooley v. U.S.*, 90-1 U.S.T.C. ¶ 60,013 (S.D. Ind. 1990).
- ¹⁰ *McClure v. U.S.*, 79-2 U.S.T.C. ¶ 13,319 (Ct. Cl. 1979).
- ¹¹ *Maryland Nat'l Bank v. U.S.*, 609 F.2d 1078 (4th Cir. 1979).
- ¹² *McManus v. Comm'r*, T.C. Memo. 1980-296, *aff'd*, 82-1 U.S.T.C. ¶ 13,456 (6th Cir. 1982).
- ¹³ See Rev. Rul. 75-415, 1975-2 C.B. 374.
- ¹⁴ *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
- ¹⁵ *Id.*
- ¹⁶ Ltr. Rul. 8006048, Nov. 16, 1979.
- ¹⁷ Ltr. Rul. 8022048, March 4, 1980 (trust contribution two days before the end of calendar year; annual exclusion allowed because donor was natural guardian of minor and local law permitted natural guardians to exercise withdrawal rights); Ltr. Rul. 8308033, Nov. 23, 1982 (each beneficiary had unrestricted right for 30 days to withdraw; annual exclusion available if notice given and no impediment to appointment

of guardian under local law). See Rev. Rul. 73-405, 1973-2 C.B. 321 (gift tax annual exclusion allowed even though no fiduciary appointed; no impediment in trust or local law to appointment).

- ¹⁸ *Est. of Cristofani v. Comm'r*, 97 T.C. 74 (1991), *acq. in result only*, 1992-1 C.B. 1 (right to withdraw limited to 15 days after property contributed to trusts). See AOD 1992-09 (IRS will deny exclusions for powers held by individuals who either have no property interests in trusts except for *Crummey* powers or hold only contingent remainder interests). Compare Ltr. Rul. 9141008, June 24, 1991 (annual exclusion not allowed for grandchildren as remote contingent beneficiaries with limited demand rights).
- ¹⁹ *Naumoff v. Comm'r*, T.C. Memo. 1983-435; Ltr. Rul. 8485004, June 27, 1984 (same). See also Ltr. Rul. 8433024, May 10, 1984 (present interest in trust transferred where beneficiary had power to demand interest and contributions to trust from past year on annual basis).
- ²⁰ *Est. of Kolker v. Comm'r*, 80 T.C. 1082 (1983) (each beneficiary living on donor's birthday to receive distribution from trust).
- ²¹ *Karpf v. Karpf*, 240 Neb. 302, 481 N.W.2d 891 (1992) (no damages, however).
- ²² See *Ross v. Comm'r*, 652 F.2d 1365 (9th Cir. 1981) (provision that interest passed to "heirs at law" rather than to donee's estate made annual exclusion unavailable).
- ²³ Treas. Reg. § 25.2503-4(b)(1). See *Illinois Nat'l Bank of Springfield v. U.S.*, 91-1 U.S.T.C. ¶ 60,063 (C.D. Ill. 1991) (substantial restriction existed because trust limited use of funds to education and disability; annual exclusion not allowed).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

ADMINISTRATIVE EXPENSES. A creditor who had sold cattle feed to the debtor during the bankruptcy case, sought payment as an administrative expense under Section 506(c) for the feed from the proceeds of the sale of the cattle. A creditor with a security interest in the cattle objected, arguing that only a trustee had the authority to seek administrative expense status for expenses used to preserve collateral. The court held that creditors also have standing to seek administrative expense status for property used to preserve collateral. However, the court also held that because the creditor had not filed an adversary proceeding under Bankr. Rule 7001 and no evidence had been presented as to whether the feed was a reasonable and necessary expense which benefitted the secured creditor, the proceeds would be paid to the trustee pending the filing of an adversary proceeding. *In re Blaisure*, 150 B.R. 343 (Bankr. M.D. Pa. 1992).

AVOIDABLE TRANSFERS. In December 1988, the debtor executed an agreement to purchase a one-half interest in a horse owned by a creditor. The purchase agreement granted the seller a security interest in the debtor's interest in the horse to secure the purchase price which was to be paid over six years. The financing statement was not filed until May 1991, less than 90 days before the debtor filed for bankruptcy. The court held that the perfection of the security interest was an avoidable transfer. *In re Calumet Farm, Inc.*, 150 B.R. 403 (Bankr. E.D. Ky. 1992).

DISCHARGE-ALM § 13.06.* The creditor sold produce to a corporation in which the debtor was the president, principal shareholder and bookkeeper. The creditor filed a notice of the claim with the USDA to preserve its rights in the PACA trust and obtained a default judgment against the corporation. The creditor sought to have the claim declared nondischargeable for defalcation while acting in a fiduciary duty. The court held that the debtor was a fiduciary as to the PACA trust as a responsible person in the corporation and the failure to preserve the trust for creditors was defalcation making the debt nondischargeable. *In re Harper*, 150 B.R. 416 (Bankr. E.D. Tenn. 1993).

EXEMPTIONS-ALM § 13.03[4].

AVOIDABLE LIENS. The debtor claimed a homestead exemption and sought to avoid judicial liens against the homestead as impairing the exemption. The Ohio exemption provided an exemption for a homestead only upon a judicial sale of the homestead. The debtor argued that *Owen v. Owen*, 111 S.Ct. 1833 (1991) required that the judicial liens be avoided. The court held that *Owen* did not apply because the debtor had no exemption right until a judicial sale occurred, whereas in *Owen*, the debtor had a right to the exemption as of the bankruptcy filing but the state exemption law attempted to remove the exemption as to judicial liens. *In re Braverman*, 150 B.R. 681 (Bankr. S.D. Ohio 1993).

CONVERSION. Within one month prior to filing for bankruptcy, the debtors sold several non-exempt, non-attached properties and purchased exempt property. A