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# **Impact of Arbitration or “In Terrorem” Provisions in Crummey Trusts—Mikel v. Commissioner, T.C. Memo. 2015-64. (April 6, 2015)**

*Non-Binding Arbitration Provision and In Terrorem Provision Triggered by a Beneficiary Who  
Contests Trust Distributions Do Not Disqualify Trust Transfers for Gift Tax Annual Exclusion*

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## BRIEF SYNOPSIS

The IRS created somewhat of a stir in 2012 among estate planners when it issued CCA 201208026, suggesting that the gift tax annual exclusion would not be available for gifts to Crummey trusts that have arbitration or “in terrorem” (*i.e.*, “no contest”) provisions. That CCA apparently was issued in relation to *Mikel v. Commissioner*, decided April 6, 2015, which rejects the IRS’s position in that CCA regarding arbitration and in terrorem provisions in Crummey trusts.

Spouses in 2007 each gave \$1,631,000 to a Crummey trust with 60 beneficiaries having withdrawal rights. If those transfers qualified for the \$12,000 gift tax annual exclusion for 60 beneficiaries, the resulting \$720,000 of annual exclusion reduced the taxable gift by each spouse to \$911,000, which would have been sheltered by each spouse’s \$1 million gift exemption amount.

The trust agreement provided that if any dispute arises regarding the proper interpretation of the agreement, the dispute “shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith.” The panel is directed to “give any party the rights he is entitled to under New York law.” The trust agreement also had an in terrorem provision stating that a beneficiary would cease to be a beneficiary if the beneficiary institutes or participates in any proceeding to oppose or challenge a trust distribution or “files any action in a court of law.”

In a summary judgment proceeding before the Tax Court, the IRS took the position that the beneficiaries did not receive a present interest in property because the rights were not legally enforceable, which the IRS maintains requires that a beneficiary can “go before a state court to enforce that right” and that the arbitration provision would not meet that requirement. Furthermore, even though a beneficiary is not bound by the arbitration decision and can bring a state court action to contest the arbitration decision under local (New York) law, the judicial enforcement remedy is “illusory” because of the in terrorem provision.

The court rejected the IRS position and granted summary judgment for the donors that the transfers constituted present interests that qualified for the annual exclusion. The court reasoned that “it is not obvious the beneficiary must be able to ‘go before a state court to enforce that right.’ ... A beneficiary would suffer no adverse consequences from submitting his claim to [the arbitration panel], and respondent has not explained why this is not enforcement enough.” The in terrorem provision in this case does not apply to a contest regarding a beneficiary’s withdrawal right because it only applies to an action to oppose or challenge a trust distribution. *Mikel v. Commissioner*, T.C. Memo. 2015-64 (April 6, 2015, Judge Lauber).

## BASIC FACTS

1. **Transfer to Trust.** Spouses jointly transferred real properties and a condominium with an asserted value of \$3,262,000, or \$1,631,000 by each, to a Crummey trust with withdrawal powers allegedly for 60 beneficiaries. If those transfers qualified for the \$12,000 gift tax annual exclusion for 60 beneficiaries, the resulting \$720,000 of annual exclusion reduced the taxable gift by each spouse to \$911,000, which would have been sheltered by each spouse’s \$1 million gift exemption amount.
2. **Crummey Provision and Withdrawal Notices.** The beneficiaries had withdrawal powers limited to the gift tax exclusion amount under §2503(b). The trustees were required to notify all beneficiaries (and the guardians for minor beneficiaries) of trust contributions

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within a reasonable time after the contribution of property to the trust. A beneficiary's withdrawal power lapsed if not exercised within 30 days of receiving the notice. A savings clause stated that the withdrawal provision will be construed to effect the grantor's intention that the transfers to the trust qualify for the gift tax annual exclusion. The gift to the trust was made on June 15, 2007, and the trustees gave notice to the beneficiaries of the contribution on October 9, 2007.

3. **Distribution Provisions.** The trust authorizes the trustees in their discretion to make distributions under a specific standard to any of the trust beneficiaries.
4. **Arbitration Provision.** If a dispute arises concerning the proper interpretation of the trust, the trust agreement requires that the dispute "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith." Such a panel in Hebrew is called a "*beth din*." The panel is directed to "enforce the provisions of this Declaration ... and give any party the rights he is entitled to under New York law." The trust said that the intention was "to effectuate the intent of the parties ... that they have performed all the necessary requirements for this Declaration to be valid under Jewish law." The opinion states in Footnote 4 that any decision by the arbitration panel will not be binding on a beneficiary:

According to respondent, beneficiaries of a trust will not be deemed by a New York court to have consented to an arbitration provision, and a New York court will not enforce an arbitral award against a nonconsenting party. Given respondent's concession on this point, we need not address the correctness of these State law propositions.

5. **In Terrorem Provision.** The trust contains an in terrorem provision designed to discourage beneficiaries from challenging discretionary decisions of the trustees to make distributions. A beneficiary's interest in the trust ends "[i]n the event a beneficiary of the Trust shall directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner...."
6. **Gift Tax Returns.** The donors did not file timely gift tax returns reporting the 2007 gifts. For some reason [not discussed in the opinion], the IRS became aware of the large 2007 gifts and contacted the donors about the transfers. Subsequently, the donors in late 2011 filed gift tax returns, each reporting gifts of several residences and a condominium to the trust of \$1,631,000, but reporting that no gift tax was due (presumably claiming \$720,000 of annual exclusion on each return and reducing the taxable gift below the donor's remaining gift exemption).

## HOLDING

The court grants the donors' motions for summary judgment to treat transfers to the trust as gifts of present interests in property that qualify for the gift tax annual exclusion. (Open questions still remain in the case, including issues regarding the underlying value of the gift properties and the proper number of trust beneficiaries (see footnote 2 of the opinion) and therefore the number of annual exclusions.)

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## ANALYSIS

1. **Background.** The gift tax annual exclusion is available for gifts of present interests in property, §2503(b)(1), and a beneficiary that has a right to demand immediate distributions of a contribution to the trust is deemed to receive a present interest. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). This case is appealable to the Second Circuit Court of Appeals, and a 63-year old Second Circuit case held that whether a beneficiary receives a present interest is based on whether a beneficiary is “likely” to receive present enjoyment of trust property. *Stifle v. Commissioner*, 197 F.2d 107 (2d Cir. 1952). The Tax Court rejected that approach in *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991) (focus is not “the likelihood that the minor beneficiaries would actually receive present enjoyment of the property,” but “the legal right of the minor beneficiaries to demand payment from the trustee”). The “likely to receive present enjoyment” principle is not applied by the court even though this case is appealable to the Second Circuit, however, because the IRS has issued several rulings accepting the *Crummey* approach (Rev. Ruls. 85-24, 81-7, 73-405), and because the IRS did not rely on *Stifle* in this case.

Other requirements discussed in prior cases are that the trustee cannot “legally resist a beneficiary’s demand for payment,” *Estate of Cristofani*, 97 T.C. 74, at 83 (1991), and that there is no “prearranged understanding” that the withdrawal right would not be exercised, *Estate of Kohlsaat v. Commissioner*, T.C. Memo. 1997-212. In its acquiescence in *Estate of Cristofani*, the IRS also indicated that it would challenge annual exclusions if exercising a withdrawal right “would result in adverse consequences to its holder (e.g., losing other rights or gifts under the instant trust instrument or other beneficial arrangement).” AOD 1992-9.

2. **IRS General Position.** The IRS did not contest that the trust beneficiaries (including the minor beneficiaries) received timely notice of their withdrawal rights, that the trustees had no power to legally resist a withdrawal demand, or the absence of a prearranged understanding that withdrawal rights would not be exercised. Instead, the IRS argued that the withdrawal right was “illusory” and that any attempt to seek legal enforcement of that right “would result in adverse consequences to its holder.”
3. **Arbitration Provision; Legally Enforceable Before State Court.** The IRS position is that the withdrawal rights were not “legally enforceable” in practical terms unless the “beneficiary can ‘go before a state court to enforce that right.’” The IRS hypothesizes that if the trustees refuse a withdrawal demand, the beneficiary would be required to submit the dispute to a *beth din*. The IRS acknowledged that if the *beth din* rules adversely, the beneficiary “could seek redress in a New York court,” reasoning that under New York law trust beneficiaries will not be deemed to have consented to an arbitration provision and the New York court will not enforce an arbitration award against the nonconsenting party. (See footnote 4 of the opinion.)

The Tax Court stated that even if it accepted the IRS’s contention that a withdrawal power must be “legally enforceable” in an extrinsic sense, it did not know why that had to be in a state court and why submission of the claim to a *beth din* is not sufficient:

First, if we adopt his premise that a withdrawal right must not only be “legally irresistible” under the trust instrument, but also be “legally enforceable” in an extrinsic sense, it is not obvious why the beneficiary must be able to “go before a state court to enforce that right.” Here, if the trustees were to breach their fiduciary duties by refusing a timely withdrawal demand, the beneficiary could seek justice from a *beth din*, which is directed to “enforce the

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provisions of this Declaration ... and give any party the rights he is entitled to under New York law.” A beneficiary would suffer no adverse consequences from submitting his claim to a [beth din](#), and respondent has not explained why this is not enforcement enough.

4. **In Terrorem Provision Does Not Apply to Claims to Enforce Withdrawal Right.** The IRS’s second argument is that even if judicial enforcement is available, the remedy is “‘illusory’ because the in terrorem provision would deter beneficiaries from pursuing it.” The court interpreted the in terrorem provision to apply only to claims challenging any distribution from the trust, and that would not impact a beneficiary who is challenging the refusal of a trustee to honor a beneficiary’s withdrawal right.

The exact language of the in terrorem provision was to cause a beneficiary to forfeit his rights under the trust if he “directly or indirectly institute[s] ... any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner.” The court had little trouble concluding that the restriction on an action to oppose a distribution or challenging any distribution would not be triggered by an action to enforce a beneficiary’s withdrawal right. The court interpreted the “files any action in a court of law” clause “in pari materia with the two clauses that surround it, observing that the clause could not apply literally or it would force a forfeiture if beneficiaries “filed suit to recover for mischievous behavior by their neighbor’s dog.”

5. **Summary of Analysis.** The court concisely summarized its holding and reasoning as follows:

In sum, we conclude that the beneficiaries of the trust possessed a “present interest in property” because they had, during 2007, an unconditional right to withdraw property from the trust and their withdrawal demands could not be “legally resisted” by the trustees. [Crummey](#), 397 F.2d at 88; [Estate of Cristofani](#), 97 T.C. at 84. Assuming arguendo that the beneficiaries’ withdrawal rights must be enforceable in State court, we conclude that this remedy, which respondent concedes was literally available, was also practically available because the in terrorem provision, properly construed, would not deter beneficiaries from pursuing judicial relief.

## OBSERVATIONS

1. **CCA 201208026.** CCA 201208026 was released February 24, 2012 from the IRS Chief Counsel office. In CCA 201208026 individuals made a gift to a trust, which included Crummey withdrawal rights for beneficiaries and which provided that the trustee (the grantor’s son) could make distributions to a variety of beneficiaries (including a charity) for “health, education, maintenance, support ... or for any other purposes.” The trust lasts for the grantors’ lives (unless the trust is sooner terminated by reason of distributions of all of its assets). The grantors retained testamentary limited powers of appointment.

The trust provides that the construction, validity and administration of the trust will be determined by state law “but provision is made for Other Forum Rules”. In addition, a beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust (sometimes referred to as an “in terrorem” or “no contest” clause). The CCA concludes that the withdrawal rights are “illusory” because of these two provisions and the withdrawal rights do not create present interests that qualify for the annual exclusion.

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CCA 201208026 also addressed whether retained testamentary powers of appointment for the grantors kept the transfer to the trust from being an incomplete gift. That issue was not addressed in the summary judgment proceeding in the *Mikel* case. (The CCA concluded that the entire transfer was a completed gift despite the grantor's retained testamentary limited power of appointment. It reasoned that the retained testamentary powers of appointment *do* cause the *remainder interest* to be an incomplete gift, but not the term interest prior to the grantor's deaths. The IRS reasoned that the remainder interest had to be valued at zero under §2702, so the completed gift of the term interest was the full value transferred to the trust.)

2. **Holding Does Not Address A Binding Arbitration Provision.** The court believed that submitting disputes to an arbitration panel should create as much "legal enforceability" as submitting the dispute to a state court. This statement is really dictum, however, because the parties acknowledge that the beneficiary can ultimately submit any dispute to a state court under the relevant (New York) state law (if the beneficiary gets an adverse arbitration decision). (Most of the cases that have addressed the enforceability of trust arbitration clauses have similarly held that arbitration clauses are not enforceable against trust beneficiaries.) Even if the relevant state law recognized that the arbitration decision would be binding, however, the court believed that the availability of an arbitration proceeding should be just as good as a state court proceeding for purposes of being able to enforce a withdrawal right.
3. **In Terrorem Provision.** The in terrorem provision in this trust agreement was unusual, in that it applied only to a beneficiary who contests a trustee's decision to make a distribution from the trust. Traditional in terrorem clauses address a beneficiary who contests the validity of a trust (which also would not seem to apply to a beneficiary attempting to enforce his or her withdrawal power). Unless a particular in terrorem provision would apply to a beneficiary's attempt to enforce a withdrawal power, the court's reasoning would seem to apply: including traditional in terrorem clauses in Crummey trusts should not disqualify gifts to the trust for the gift tax annual exclusion.