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Gift-Splitting Where the Spouse Is a Beneficiary

by Bruce D. Steiner, Esq.[*]
Kleinberg, Kaplan, Wolff & Cohen, P.C.
New York, New York

A husband and wife can elect to treat gifts to third parties as if made one-half by each spouse for gift tax purposes.[1] Consent to gift-splitting is signified on the gift tax return.[2]

It is not always clear whether gift-splitting is available for gifts to trusts where the spouse is a discretionary beneficiary of the trust.[3] In this regard, the regulations provide that "if one spouse transferred property in part to his spouse and in part to third parties, the consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to his spouse."[4] However, it is not always easy to determine whether the interest of the beneficiaries other than the spouse is ascertainable and severable from the spouse's interest. Even if the interests are ascertainable and severable, they may be difficult to ascertain.

SITUATIONS WHERE THIS ARISES

This issue arises in several contexts.

Insurance Trusts

A donor creates an insurance trust for the benefit of his or her spouse and issue, and makes gifts to pay the premiums. For gifts in trust to qualify for the gift tax annual exclusion, the beneficiaries must have a present interest. The most common way to accomplish this is to give some combination of the spouse and issue the right to withdraw some or all of the contributions to the trust. This is called a *Crummey* power, named for the taxpayer who was the subject of the case allowing the annual exclusion for such withdrawal powers.[5] The Tax Court subsequently allowed

[*] Copyright © 2012. Mr. Steiner, a member of the New York, New Jersey, and Florida Bars, can be reached at (212) 986-6000 or bsteiner@kkwc.com. The author would like to thank Nicholas C. Guerra, Esq., of the Morris Law Group in Boca Raton, Florida, David A. Handler, Esq., of Kirkland & Ellis LLP in Chicago, and Gideon Rothschild, Esq., of Moses & Singer LLP in New York for their helpful suggestions.

[1] §2513(a). All statutory references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] For a detailed explanation of the rules and procedures governing gift-splitting, see Zeydel, "Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 *J. Tax'n* 334 (June 2007); Pratt, "Gift-Splitting: The Intricacies of §2513 of the Code," 78 *Fla. Bar J.* 11 (2004); Irizarry-Díaz, "Effective Use of the Election to Split Gifts," 26 *Tax Mgmt. Est., Gifts & Tr. J.* 247 (Nov./Dec. 2001).

[3] Steiner, "Gift-Splitting to a Trust Where the Spouse is a Discretionary Beneficiary," *Leimberg's Estate Planning Newsletter* #1476 (2009).

[4] Regs. §25.2513-1(b)(4).

[5] *Crummey v. Comr.*, 397 F.2d 82 (9th Cir. 1968).

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the annual exclusion for withdrawal powers given to grandchildren who were contingent beneficiaries.[6]

If the premiums (and the value of the policies transferred, if existing policies are transferred to the trust) are less than the gift tax annual exclusion amount ($13,000 for gifts made in 2012 and $14,000 for gifts made in 2013)[7] multiplied by the number of beneficiaries other than the spouse having *Crummey* withdrawal powers, plus $5,000 if the spouse has a *Crummey* withdrawal power, there is generally no need to consider gift-splitting.[8] However, if the gifts are more than this amount, gift-splitting must be considered.

Family Trusts

If a donor creates a family trust for the benefit of his or her spouse and issue, this is essentially the same as an insurance trust, except that the assets are other than life insurance. Here, too, if the gifts are less than the donor's available gift tax annual exclusions with respect to the beneficiaries of the trust, there is generally no need to consider gift-splitting. However, if the gifts are more than the available annual exclusions, gift-splitting must be considered.

Large Gifts in Trust

A donor wants to give $10.24 million to a trust for the benefit of his or her spouse and issue to take advantage of the $5.12 million gift tax exemption amount available to him or her and to the spouse for gifts made in 2012.[9] The donor does not anticipate that his or her spouse will ever need distributions from the trust. Moreover, distributions to the spouse from a trust that is already out of the donor's estate are counterproductive from a transfer tax standpoint. However, the donor may want to include his or her spouse as a permissible beneficiary in case the spouse ever needs distributions because of unforeseen circumstances.

By including the spouse as a permissible beneficiary, it becomes necessary to consider whether gift-splitting is available. Gift-splitting is relevant not only for gift tax purposes, but also for generation-skipping transfer (GST) tax purposes.

If gift-splitting applies for gift tax purposes, the gift is also treated as if made one-half by each spouse for GST tax purposes.[10] However, for GST tax purposes, the spouse is treated as the transferor of one-half of the entire value of the property transferred, regardless of the interest deemed to be transferred by the spouse for gift tax purposes by reason of gift-splitting.[11] Thus, for example, if the spouse has a *Crummey* withdrawal power, it is taken into account for gift tax purposes, but not for GST tax purposes.[12]

CASES AND RULINGS

There are only a few cases dealing with the availability of gift-splitting where the spouse is a permissible beneficiary of the trust. There are also only a few rulings involving this issue.

In Rev. Rul. 56-439,[13] the trustees had complete discretion as to both income and principal. The IRS ruled that, because the value of the spouse's interest could not be determined, gift-splitting was not available.

In *Robertson v. Comr.*,[14] the donor's wife received all of the income of the trust. In addition, the trustee had discretion to distribute principal to the wife, but only for her maintenance and support. The wife had substantial assets of her own. Given the wife's other assets, and the provisions of the trust agreement limiting the trustee's discretion to invade the trust principal for her maintenance and support, the Tax Court concluded that there was no likelihood of the exercise of the power to distribute principal to the wife. Accordingly, the court allowed gift-splitting for the portion of the gift attributable to the principal.

In *O'Connor v. O'Malley*,[15] the trustees had discretion to distribute the principal to the donor's husband. However, the donor testified that she did not intend for any principal to go to her husband, he disclaimed his interest in the principal, and no principal was distributed to him. The district court allowed gift-splitting as to the principal.

In *Kass v. Comr.*,[16] the Tax Court did not allow gift-splitting where the trustees could invade the trust for the donor's wife's ''general welfare.'' The donor ''failed to prove sufficient facts by which to measure the probability of the exercise of the power.''

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[6] *Cristofani Est. v. Comr.*, 97 T.C. 74 (1991).

[7] *See* Rev. Proc. 2012-41, 2012-45 I.R.B. __, §3.19(1) (2013); Rev. Proc. 2011-52, 2011-45 I.R.B. 701, §3.31(1) (2012).

[8] The spouse's *Crummey* power is generally limited to $5,000. The reason for this is that, under §2642(f), GST exemption generally cannot be allocated to a transfer during the estate tax inclusion period (ETIP) when it would be included in the donor's or the donor's spouse's estate. However, there is an exception for a power of withdrawal held by the spouse that is limited to the greater of $5,000 or 5% of the principal, and that lapses within 60 days after the transfer. Regs. §26.2632-1(c)(2)(ii)(B).

[9] *See* Rev. Proc. 2011-52, §3.29.

[10] §2652(a)(2).

[11] Regs. §26.2652-1(a)(4), (5), *Ex. (9)*.

[12] PLR 200218001. The IRS missed this in PLR 200213013.

[13] 1956-2 C.B. 605.

[14] 26 T.C. 246 (1956).

[15] 57-1 USTC ¶11,690 (D. Neb. 1957).

[16] T.C. Memo 1957-227.

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In *Falk v. Comr.*,[17] the trustees had discretion to distribute the income and principal of the trust to the donor's wife if necessary for her "adequate comfort, support and maintenance." The Tax Court allowed gift-splitting for the principal but not the income, stating that the possibility of invasion of principal was so remote as to be negligible, but that the possibility of invasion of income was not so remote.

In *Wang v. Comr.*,[18] the donor's wife was entitled to all of the income of trust. In addition, the trustees could distribute principal to her "for her proper support, care and health, or for any emergency." The Tax Court said that "emergency" was not an ascertainable standard, so that the wife's interest was not severable. Therefore, the Tax Court did not allow gift-splitting.

In PLR 200345038, the donor created three trusts, each for his wife and one of his children. The trustee could distribute income and principal to or for the benefit of the wife or the respective child, but only for his or her health, maintenance, support, and education. The Service ruled that, because the standard for invasion was ascertainable, the wife's right to receive income or principal was susceptible of determination. Therefore, the gift to the wife was severable from the gifts to the other beneficiaries. Accordingly, the gifts were eligible for gift-splitting to the extent not attributable to the wife's ascertainable and severable interest.

The IRS also explained that, notwithstanding the gift tax treatment, as a result of the gift-splitting election, each spouse was treated as the transferor of one-half of the property for GST tax purposes.[19]

In PLR 200422051, the donor's wife was entitled to all of the income of the trust. In addition, the trustee could distribute principal for her "reasonable support and medical care." The Service ruled that the wife's right to receive income and principal was susceptible of determination and allowed gift-splitting for the remaining portion of the gift.

In PLR 200616022, the taxpayer was the one arguing against gift-splitting. In this ruling, the husband created a trust for the benefit of his wife and issue and made contributions to the trust both in the year he created the trust and in a subsequent year. During the husband's lifetime, the trustees had discretion to distribute income and principal, but only to the issue. After the husband's death, the wife became a beneficiary, so that the trustees could distribute income and principal to the wife and issue. The couple elected gift-splitting for the first gift on their gift tax returns for the interests of the issue.[20] However, they neglected to allocate GST exemption to the transfer.

The failure to allocate GST exemption to the transfers was discovered shortly before the husband's death. After his death, the husband's estate and the wife requested a ruling that the husband was the transferor of all of the first gift for GST tax purposes (in other words, that none of the gift qualified for gift-splitting), and the husband's estate requested an extension of time to allocate GST exemption to both transfers.[21] Presumably, the husband had unused GST exemption that the taxpayers wanted to use, so as to preserve the wife's GST exemption.

The Service ruled that, because distributions to the issue during the husband's lifetime were discretionary, this lifetime interest was not susceptible of determination and severable. Thus, the Service ruled that this interest was not eligible for gift-splitting for gift tax purposes and that the husband was the transferor of the entire amount for GST tax purposes. The Service then granted the husband's estate an extension of time to allocate GST exemption to both transfers, effective as of the date of the respective transfers.

In PLR 200616022, the wife would receive all of the income of the trust if the husband died within three years from the creation of the trust.[22] The Service ruled that the value of the wife's interest in the trust was susceptible of determination and severable, so that gift-splitting was available for the remaining portion of the trust.

While the authority is sparse, it is possible to draw several conclusions from the cases and rulings. If the donor can establish that the likelihood of distributions to the spouse is negligible, the spouse's interest can be disregarded, so that gift-splitting will be available. If the donor cannot establish that the likelihood of distributions to the spouse is negligible, the gift will not be considered as made to a third party, so that gift-splitting will not be available. If there are different provisions for income and principal, they will be treated as separate interests and will be tested separately in determining whether gift-splitting is available. Finally, if there is an ascertainable standard for distributions, it may be possible to quantify the value of the spouse's interest, so that gift-splitting will be available for the remaining portion of the gift.

[17] T.C. Memo 1965-22.

[18] T.C. Memo 1972-143.

[19] *See* Regs. §26.2652-1(a)(4).

[20] It is not clear from the ruling how the taxpayers determined the value of the issue's interest in the trust.

[21] A taxpayer can request an extension of time to allocate GST exemption. §2642(g); Regs. §§301.9100-1, -2; Notice 2001-50, 2001-34 I.R.B. 189. Beginning in 2001, GST exemption was automatically allocated to certain GST transfers. §2632(c).

[22] In view of this provision, the trust was probably an insurance trust.

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SOLUTIONS

There are several possible solutions to this problem.

Take the Position That Gift-Splitting Is Available

This may be acceptable for smaller gifts, such as insurance trusts or family trusts where the gifts in any one year are not that large. The donor has to file a gift tax return to elect gift-splitting, and the spouse may also have to file a gift tax return. If there is adequate disclosure on the gift tax return, that will begin the running of the statute of limitations.[23]

A donor who takes the position that gift-splitting is available should maintain detailed information evidencing the spouse's financial situation, so that he or she can establish that, based upon the spouse's financial resources, it is highly unlikely that the trustee would actually make distributions to the spouse.[24]

A donor who is taking the position that gift-splitting is available can allocate GST exemption, or not elect out of the default allocation of GST exemption, as the case may be. Allocating GST exemption, or accepting the default allocation of GST exemption, suggests that the donor contemplates that the trust assets are intended for the grandchildren or younger generations. If the trust assets are intended for the grandchildren or younger generations, presumably distributions to the spouse are not contemplated, because that would waste the allocation of GST exemption. That will help to establish that the possibility of distributions to the spouse is negligible, as in *Robertson* and *Falk*, so that the gifts can qualify for gift-splitting.

Limit Distributions to the Spouse to an Ascertainable Standard, Such as Health, Maintenance, and Support

As in *Robertson*, *Falk*, and PLRs 200345038, 200422051, and 200616022, by limiting distributions to an ascertainable standard, it is possible, at least theoretically, to quantify the value of the spouse's interest in the trust. However, limiting distributions to the spouse makes the trust less flexible. Each time the spouse requests a distribution, the trustees must determine whether it falls within the specified standard. However, if the spouse is included as a beneficiary only as a protection against unforeseen circumstances, the likelihood of a needed distribution falling outside the specified standard may be small.

Another disadvantage of an ascertainable standard is that it may make the trust more difficult to decant (i.e., transfer the trust assets to another trust having more desirable terms), and may give the spouse, or the spouse's creditors, an opportunity to argue that the trustees should be required to make distributions to the spouse.

In this regard, at least 16 states have decanting statutes: Alaska,[25] Arizona,[26] Delaware,[27] Florida,[28] Illinois,[29] Indiana,[30] Kentucky,[31] Missouri,[32] Nevada,[33] New Hampshire,[34] New York,[35] North Carolina,[36] Ohio,[37] South Dakota,[38] Tennessee,[39] and Virginia.[40] Florida,[41] Iowa,[42] and perhaps New Jersey[43] permit decanting by case law.

Have the Richer Spouse Create a Trust for the Other Spouse and Issue and the Poorer Spouse Create a Trust for the Issue

In this way, gift-splitting is not necessary. However, under this approach, the trust for the benefit of the issue will not be available to either spouse. This approach will work well in those cases where the richer spouse has sufficient assets that he or she will not need access to either trust, and the poorer spouse has or will have sufficient assets so that access to one trust will be sufficient. If the poorer spouse does not have sufficient assets, and the richer spouse makes a gift to the poorer spouse, care must be taken to avoid the step transaction doctrine. In this regard, in *Murphy*

[23] §6501(c)(9).

[24] Swindle, "Qualifying Trust Transfers for Split-Gift Treatment," 81 *Fla. Bar J.* 72 (2007).

[25] Alaska Stat. §13.36.157.

[26] Ariz. Rev. Stat. Ann. §14-10819.

[27] Del. Code Ann. tit. 12, §3528.

[28] Fla. Stat. §736.04117.

[29] 760 ILCS 5/16.4 (effective Jan. 1, 2013).

[30] Ind. Code Ann. §30-4-3-36.

[31] Ky. Rev. Stat. Ann. §386.175.

[32] Mo. Rev. Stat. §456.4-419.

[33] Nev. Rev. Stat. §163.556.

[34] N.H. Rev. Stat. Ann. §564-B:4-418.

[35] N.Y. Est. Powers & Trusts Law §10-6.6.

[36] N.C. Gen. Stat. §36C-8-816.1.

[37] Ohio Rev. Code Ann. §5808.18.

[38] S.D. Codified Laws Ann. §55-2-15.

[39] Tenn. Code Ann. §35-15-816(b)(27).

[40] Va. Code Ann. §55-548.16-1.

[41] *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782, 196 So. 299 (1940).

[42] *Matter of Spencer*, 232 N.W.2d 491 (Iowa 1975).

[43] *Matter of Wold*, 310 N.J. Super. 382 (Ch. Div. 1998); *Nat'l State Bank of Newark v. Morrison*, 9 N.J. Super. 552 (Ch. Div. 1950); *Guild v. Mayor*, 87 N.J. Eq. 38 (1916).

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Est. v. Comr.,[44] the Tax Court refused to allow a discount for lack of control in the case of a gift by a terminally ill decedent 18 days before death to bring his interest below 50%, while in *Frank Est. v. Comr.*,[45] a similar gift two days before death was recognized.[46] More recently, in *Holman v. Comr.*,[47] the Tax Court refused to apply the step transaction doctrine where the taxpayer transferred assets to a partnership and six days later made a gift of a partnership interest.

Have Each Spouse Create a Trust in an Asset Protection Jurisdiction, Such as Alaska, Delaware, Nevada, or South Dakota

In this way, each spouse can be a beneficiary of both trusts, and gift-splitting will not be necessary.[48]

In the last example, if the trusts are not created in an asset protection jurisdiction, neither spouse can be a beneficiary of the trust that he or she creates. If each spouse is a beneficiary of the trust that the other spouse creates, care must be taken to avoid the application of the reciprocal trust doctrine.[49] Under that doctrine, if the husband creates a trust for the benefit of his wife and issue, and his wife creates an identical trust for the benefit of her husband and issue, the interests of the spouses will be uncrossed, and each spouse will be treated as having created a trust for his or her own benefit. It may be possible to avoid the reciprocal trust doctrine if the trusts are sufficiently different even if each spouse is a beneficiary of the trust created by the other spouse. However, the risk of the doctrine applying is greater than if one trust is for only the benefit of the issue.

Instead of Including the Spouse as a Beneficiary, Give a Nonadverse Party the Power to Add the Spouse, or a Class of Persons Including the Spouse, as Additional Beneficiaries

This power is sometimes used to obtain grantor trust status.[50] Query whether this power can be a nonfiduciary power, and, if it is a fiduciary power, whether the existence of the power makes the spouse a beneficiary for this purpose.

In an analogous situation, one commentator has suggested that, where the trustees have the power to grant a beneficiary a general power of appointment, the very existence of the power to grant the beneficiary a general power constitutes a general power.[51]

In another context, the IRS conceded that the grantor's payment of the income tax on the income of a grantor trust will not constitute an additional gift, but stated that the trustee's discretion to reimburse the grantor for the income tax combined with an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion may cause the trust's assets to be included in the grantor's estate for federal estate tax purposes.[52] This suggests that the Service might treat the spouse as a beneficiary from the inception of the trust if there were a prearrangement to add the spouse as a beneficiary.

[44] T.C. Memo 1990-472.

[45] T.C. Memo 1995-132.

[46] While not discussed in *Frank*, the two cases may have been decided differently because of the issuance of Rev. Rul. 93-12, 1993-1 C.B. 202, in the interim. In Rev. Rul. 93-12, the Service ruled that, in determining the value of a gift of a minority block of stock in a closely held corporation, the block should be valued for gift tax purposes without regard to the family relationship of the donee to other shareholders.

[47] 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

[48] PLR 200944002; Shaftel, ''IRS Letter Ruling Approves Estate Planning Using Domestic Asset Protection Trusts,'' 112 *J. Tax'n* 213 (2010); *see* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[49] Steiner & Shenkman, ''Beware of the Reciprocal Trust Doctrine,'' 151 *Tr. & Est.* No. 4. 14 (Apr. 2012); Merric, ''The Doctrine of Reciprocal Trusts,'' *Leimberg's Asset Protection Newsletter* #1271, 1275, 1282, 1332, 1339 (2008); Hader, ''Planning to Avoid the Reciprocal Trust Doctrine,'' 26 *Est. Plan.* 358 (Oct. 1999); Nelson, ''Taxing Reciprocal Trusts: Charting a Doctrine's Fall from *Grace*,'' 75 *N.C. L. Rev.* 1781 (1997).

[50] §674.

[51] Cornfeld, ''Question and Answer Session I of the Thirty-Second Annual Institute on Estate Planning,'' 32 *U. Miami Heckerling Inst. on Est. Plan.* ¶215 at 2–26 (1998).

[52] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

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