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News Analysis -- Clinton Defense Fund II: What Was the Bill From the Tax Lawyers?

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====== HIGHLIGHT ======

In a news analysis, contributing editor Lee A. Sheppard examines whether President Clinton has a tax problem with his new legal defense fund. The new trust, of which former Arkansas Senator David Pryor functions as the grantor, will actively solicit contributions from everyone except lobbyists, PACs, and government employees, and will accept as much as $10,000 per donor per year.

Sheppard says that what the Clintons have here is called a Crummey trust after Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). And Sheppard notes that the administration, in its latest budget proposal, would eliminate the Crummey rule.

====== FULL TEXT ======

In addition to his other problems, the president may have a tax problem with his new legal defense fund, the last one having failed to dent his legal bills, which are $3.2 million and climbing. (For discussion, see Tax Notes, July 4, 1994, p. 12.) This new trust, of which former Arkansas Senator David Pryor functions as the grantor, will actively solicit contributions from everyone except lobbyists, PACs, and government employees, and will accept as much as $10,000 per donor per year. (This amount is based on Senate rules for legal defense funds.) The new trust, called The Clinton Legal Expense Trust, was drafted at Arnold & Porter.

The Clintons will send their legal bills to the trust, which will not be permitted to know precisely what they are for. The trust will pay the Clintons' legal bills either directly or by reimbursing the Clintons for payments made by them. Ideally, the Clintons will merely acknowledge the accuracy of legal bills that they send to the trust, without having to make a payment and wait for reimbursement. The trust will terminate when Paula Jones goes away, or when the Clintons' legal fees have all been paid, whichever comes later.

The trustees will periodically notify the Clintons when funds have been contributed to the trust, and the Clintons will have a lapsing power to withdraw those funds within 30 days of contribution. The Clintons have provided a letter to the trustees stating that they will not exercise their power to withdraw funds from the trust. According to a lawyer for the trust, this was not necessary to make the trust kosher under federal statutes proscribing acceptance of gifts by the executive. It seems that the Clintons merely wanted to reassure donors publicly that the trust donations would not be used for any purpose other than payment of legal fees.

The Clintons' letter to the trustee, the date of which is roughly coterminous with the creation of the trust, states:

> We have been advised that the trust instrument affords us the unrestricted right to withdraw all contributions accepted by the trust. We will not exercise our right to withdraw any contributions accepted by the trust. We believe that contributions accepted by the trust should be used solely for the purposes that we understand are stated in the trust instrument -- to pay the trust's expenses and to pay legal fees and expenses permitted by the trust that we have or will incur.

A Crummey Rule

What the Clintons have here is called a Crummey trust after Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). In Crummey, the Ninth Circuit held that a gift of property in trust for a minor child is a gift of a present interest in property when the minor has a legally unrestricted present right to demand that the trustee distribute the property to him free and clear. Crummey and subsequent cases have established that a trust beneficiary who has a limited withdrawal power has a present interest in additions to a trust established for his benefit, even if the beneficiary never exercises the power or has no practical capacity to do so.

That is, the courts are willing to pretend that a minor who is a trust beneficiary has a real withdrawal power, making additions to a Crummey trust eligible for the gift tax exclusion. The gist of the Crummey rule is a finding that the trustee could not legally resist a withdrawal demand made by a beneficiary, not the likelihood that the beneficiary would ever make such a demand. The Ninth Circuit in Crummey specifically rejected likelihood of withdrawal as a test for whether a present interest had been transferred. The court noted that some of the trust's minor beneficiaries probably did not know of the existence of their withdrawal powers, and that a guardian would have to be appointed for them to exercise those powers. (392 F.2d at 88.)

So when donations are made to their trust, the Clintons will have a present interest in those amounts because the trust instrument permits them to withdraw the money within 30 days of the donation, as in the Crummey case. But the Clintons have agreed in writing not to exercise their withdrawal powers. This could mean, under Crummey, that gifts to the trust would not be gifts of a present interest, so that the gifts would be ineligible for the section 2503(c) gift tax exclusion, and the donors would incur gift tax, San Antonio accountant Steven **Bankler** suggested.

Maybe. The Clinton Legal Expense Trust is intended to satisfy a legal obligation of the Clintons -- their legal bills arising largely out of the alleged, but strongly denied by the president, modern interpretation of what Europeans politely call the king's pleasures. Whenever the trust pays a legal bill for the Clintons, there has been a constructive distribution of trust funds to them. The trust will pay bills that the Clintons have acknowledged as their valid debts. The Clintons' acknowledgment of their bills and the trust's payment of them can be thought of as a withdrawal request and the satisfaction of that request. And certainly when the trust reimburses the Clintons for a legal bill they have paid, they have made a withdrawal.

Seen in this light, the Clintons' letter could have been more artfully worded. It should have said:

> We have been advised that the trust instrument affords us the unrestricted right to withdraw all contributions accepted by the trust. We will not exercise our right to withdraw any contributions accepted by the trust, except for the purpose of payment of legal fees and expenses permitted by the trust that we have or will incur.

There is still a question whether the Clintons waived any of their withdrawal rights by their letter to the trustee. The gift tax result would also depend on whether the Clintons' blanket waiver of their withdrawal rights is legally effective. A lawyer for the trust argued that the letter is not legally binding on the Clintons, because there is no enforcement mechanism, so that the letter would not prevent them from exercising their withdrawal rights. That is, under Crummey, the trustee could not legally resist a withdrawal demand from the Clintons, regardless of what the letter says. So the Clintons would have to expressly waive their right to withdraw each contribution or let the right lapse after having been given notice of a contribution.

The progeny of the Crummey decision have gone far to give credence to the legal fiction of withdrawal rights despite numerous practical obstacles to their exercise. The leading case in this regard is Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), a reviewed decision.

In Cristofani, the IRS basically re-litigated Crummey unsuccessfully, since the decision expanded the Crummey rule to donees having remote interests in the trust property. The grantor had given withdrawal powers to her own children, who were the direct beneficiaries of the trust, as well as to her minor grandchildren, who were the contingent remaindermen. The clear motive for giving withdrawal powers to the contingent remaindermen was to take advantage of the gift tax exclusion. The IRS argued that gifts to the grandchildren were not gifts of a present interest since they were contingent remaindermen. (The IRS made the same argument in technical advice memorandum 9731004.)

The Tax Court flatly refused to distinguish Crummey on that basis. "We do not believe, however, that Crummey requires that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the section 2503(b) exclusion," Judge Ruwe wrote for the unanimous court. The remoteness of the grandchildren's interest in the trust property, the court explained, goes to the likelihood that they would exercise their Crummey powers, and likelihood of exercise is irrelevant under the Crummey rule. The court added that there was no agreement that the grandchildren would not exercise their powers, though they in fact did not exercise them. (See also Estate of Kohlsaat v. Commissioner, 73 T.C.M. 2732 (1997).)

In technical advice memorandum 9532001, the IRS sticks by its position that a Crummey power that a beneficiary never intends to exercise does not confer a present interest in property eligible for the gift tax exclusion. At the time the Crummey trust discussed in the ruling was created, the beneficiaries signed statements waiving their right to be notified of contributions, reserving the right to revoke their waivers. As a practical matter, this meant that they waived their right to make withdrawals, since withdrawals would have to be made within a limited time after the contribution. The IRS ruled that there was no gift of a present interest. (Regulation section 25.2503-3(c), Examples 1 and 3.) Relying on Fondren v. Commissioner, 324 U.S. 18 (1945), the

IRS argued that "a donee must have current notice of any gift in order for that gift to be a transfer of a present interest."

The Tax Court disagreed in Estate of Holland v. Commissioner, T.C. Memo. 1997-302. In that case, the trustees, who were the parents of the trust beneficiaries, failed to notify the minor beneficiaries of their right to withdraw contributions to the trust. The court found the failure to give notice irrelevant. Relying on Crummey and Cristofani, Judge Parr stated "The sufficiency of the notice given the beneficiaries is a factor in the likelihood that the right of withdrawal will be exercised; it is not a factor in the legal right to demand payment from the trustee."

In Holland, the IRS further argued that the decision of the parties to pool the numerous gifts to the trust to obtain better investment returns constituted evidence of a tacit agreement that the beneficiaries would not exercise their withdrawal rights. The court agreed with the inquiry -- that if the beneficiaries, trustees, and donor had an understanding that limited the legal ability of the beneficiaries to exercise their right to withdraw trust corpus, then the beneficiaries may not have received gifts of a present interest. But the court found that the facts were otherwise, and that the decision to pool the gifts was just sound investing that did not limit the beneficiaries' legal ability to make withdrawals.

The cases show that drafters of Crummey powers can get away with all manner of practical restrictions on withdrawal, so long as there are no legal restrictions and there is no evidence of the wink-and- nod agreement not to exercise. So the Clintons, if nothing else, may make new law in the area of the illusory nature of Crummey powers. Trust advisers are usually very careful to avoid any evidence of an implied understanding that Crummey powers will not be exercised. Here that understanding is express, but probably meaningless in that the beneficiaries will in fact be making constructive withdrawals.

The Clinton Treasury, ironically, has chosen this moment to propose elimination of the Crummey rule as part of the administration's fiscal 1999 budget request. The Treasury regards the Crummey rule as an unproductive legal fiction, because the parties, who are usually related, tacitly agree that the holder of the withdrawal power will never exercise it. In the budget request, Treasury points out that the rule has been expanded to permit gift tax exclusions in cases when the phony withdrawal power was held by someone other than the direct beneficiary of the trust, as in Cristofani. Treasury proposes to amend section 2503(b) to allow a gift tax exclusion only for outright gifts of present interests. The proposed effective date is for gifts completed after December 31, 1998.

The life insurance industry lobby opposes this proposal because whole life insurance, which can grow tax free, is often used to fund Crummey trusts. Excluded gifts take the form of annual premiums on a policy in which the trust beneficiary becomes the income beneficiary on the death of the insured. Here, as in some of the administration's other life insurance proposals, the deferral of tax on inside buildup on whole life insurance is an important aspect of the tax shelter. The insurance industry is fighting vigorously to protect tax deferral for inside buildup, not just because it provides a competitive advantage, but because the market for whole life insurance is not growing. Basically, no one except the most unsophisticated customers buys whole life insurance for any purpose other than as a tax shelter.

And even without the life insurance industry's opposition, the administration proposal has to get past congressional Republicans who have somehow convinced otherwise responsible newspapers to characterize transfer taxes as "death taxes." Transfer taxes are pet peeves of both Senate Majority Leader Trent Lott, R-Miss., and House Ways and Means Committee Chair Bill Archer, R-Texas. Archer, for his part, pronounced all of the administration's revenue-raising proposals to be "dead before arrival" at a recent hearing. (Tax Notes, Mar. 2, 1998, p. 1079.)

The Joint Committee on Taxation staff description of the administration's Crummey proposal, however, hints that a compromise position might be to retain the Crummey rule while eliminating the Cristofani extension to remote beneficiaries. The staff also suggests that existing insurance trusts might be grandfathered. (See H&D, Special Supplement, Feb. 26, 1998, p. 2581.)

Income Taxes

The trust instrument provides for distributions out of trust principal or income to satisfy any income tax liabilities of the Clintons arising out of their status as trust beneficiaries. Lawyers for the trust have concluded that donations to the trust will be gifts to the Clintons, and not income to them. And the trustees do not expect the trust to earn any income, because they anticipate paying contributions over to lawyers as soon as they are received.

Can President Clinton sustain an argument that contributions to a legal defense fund are gifts and not income? Commissioner v. Duberstein, 363 U.S. 278 (1960), stands for the rule differentiating gifts from income. A gift, Justice Brennan wrote, must be made out of the donor's "detached and disinterested generosity," and not with an expectation of an economic benefit in return. In Duberstein, the taxpayer received a new Cadillac from a business associate to whom he had provided successful sales leads. Both parties testified that the sales leads were the justification for the taxpayer getting a new car.

Duberstein requires an objective assessment of the donor's intent, that is, the dominant reason for the donor having made the transfer. The question is factual, the Court stated, given that the drafters of the section 102 exclusion meant "gift" in a colloquial sense. No specific set of factors can be prescribed; whether a transfer is a gift requires the use of all of the fact-finder's practical human experience. The Court saw itself as distilling and applying existing law to the facts at issue, rather than as announcing a new standard.

Why do people give money and time to politicians? They may have any of a variety of motives ranging from the expectation of a financially beneficial political favor to simply sharing the politician's beliefs. In U.S. v. Pisani, 773 F.2d 397 (2d Cir. 1985), the Second Circuit held that when a politician diverts campaign contributions to personal use, it is a question of fact under Duberstein whether the contributors intended to make a gift.

Rev. Rul. 60-14, 1960-1 C.B. 16, dealt with donative intent regarding a legal defense fund. An organization official's personal legal expenses were being paid by a committee of organization officials who raised funds from organization members for this purpose. The committee had been formed for the express purpose of counteracting the national, negative publicity that the official's personal legal problems had afflicted on the organization. The committee's members were officials of the organization. The committee used the organization's offices for its business, and reported its fund-raising to the organization's board. Over a period of several years, the committee collected a substantial sum from organization members and spent nearly all of it on the official's legal expenses. The funds not spent for the official's legal defense were returned to the organization.

The IRS ruled that the amounts spent by the committee for the official's personal legal defense were gross income to him and not gifts. The IRS made an inquiry into donative intent, similar to that of Duberstein. The committee's express purpose -- to spare the organization from the bad publicity occasioned by an official's problems -- was not indicative of donative intent. The IRS also relied on the rule of Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). Old Colony Trust, in which an employer paid an employee's income taxes, established that the payment of another's obligation is income to the person on whose behalf the payment was made. In Rev. Rul. 60-14 the IRS noted that the source of the funds to pay the official's legal expenses was the same as that of his salary -- the organization members.

Although the ruling does not classify the official's income from legal expenses paid on his behalf as compensatory, that is clear from the official's relationship to the organization and does not appear to be necessary to the holding of the ruling. Otherwise, the Clinton situation is comparable. Although the president's long-term interest is to resolve his legal problems, his short-term interest is to ameliorate the bad publicity and attendant damage to his credibility that these problems cause. The president is legally obligated to pay his lawyers the sums they have billed him for services already rendered, and other people will be paying these bills on his behalf. Old Colony Trust would deem the contributions to the trust to be income to the president.

Business Expenses

As this article is being written, the president is going about his daily routine in an effort to pretend that he has not heard the jokes from late night talk show hosts that he has spent the last five years asking White House interns for sexual favors. He is making a big show of business as usual, despite subjecting the occasional foreign dignitary to a press conference prominently featuring lewd questions. He is giving speeches about drunk driving; blocking traffic in New York City; and hobnobbing with Time magazine editors so they will continue to defend him against accusations of trying to foment a war with Iraq to distract the country from Monica Lewinsky. (The New York Times, Mar. 4, 1997, p. A17.)

The king's pleasures may not be what they used to be, but the personal has definitely become political. Your normal chief executive's legal expenses for defending against sexual harassment claims would not be business expenses, because his moral standing with the public is not seen as part of his job. Indeed, unless he is Frank Perdue, the chief executive is not usually so closely identified with the company that it cannot jettison him and his problems and go on. But the chief executive of the country that the Puritans settled in after they were booted out of England and Holland is different. He is expected to have an exclusive and even romantic relationship with the woman that the public has nonetheless accepted as his business partner.

Under section 162, it could be argued that the Clintons' legal expenses are not deductible because their origin is clearly personal, even though the consequences could affect the president's job, under U.S. v. Gilmore, 372 U.S. 39 (1963). In that case, the taxpayer unsuccessfully argued that legal fees paid in divorce litigation were attributable to the conservation of the taxpayer's income-producing property, that is, to keeping it away from his ex-wife. There, the Court stated:

The origin and character of the claim with respect to which
an expense was incurred, rather than its potential consequences
upon the fortunes of the taxpayer, is the controlling basic test
of whether the expense was 'business' or 'personal' and hence
whether it is deductible or not . . . . (Id. at 49.)

The Gilmore origin of the claim test applies to attempts by politicians to deduct legal fees paid while in office. A politician can deduct the costs of protecting his office. In Rev. Rul. 74-394, 1974-2 C.B. 40, the IRS ruled that a judge could deduct the costs of defending himself against charges of misconduct while in office under Gilmore, because the charges arose out of his conduct in office. Similarly, in Rev. Rul. 71-470, 1971-2 C.B. 121, a public official was permitted to deduct the costs of defending himself against a recall. The IRS differentiated McDonald v. Commissioner, 323 U.S. 57 (1944), in which the Supreme Court denied a deduction for campaign expenses incurred by a sitting judge without ruling that the expenses were personal.

Gilmore does not provide a lot of guidance for Clinton's case. Because the alleged Lewinsky episode supposedly occurred while Clinton is in office, Gilmore might allow deduction of expenses defending against these allegations. Also, if Paula Jones' charges and the independent prosecutor's investigation arise only because he is president, Gilmore may allow deduction of Clinton's fees.

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