Selecting Trustees and Structuring Trustee Powers: Guidance for Estate Planners on Tax and Non-Tax Consequences

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Today’s faculty features:

Sasha A. Klein, JD, LLM, Senior Vice President, Director of Trusts & Wealth Services, Sabadell Bank & Trust, Palm Beach, Fla.

Mark R. Parthemer, Managing Director and Senior Fiduciary Counsel, Southeast Region, Bessmer Trust, Palm Beach, Fla.

Jordan D. Veurink, Attorney, Lindquist & Vennum, Sioux Falls, S.D.

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The Trustee Selection Minefield - Tax Traps and Other Trustee Selection Considerations

(or Twenty Things You Need to Know About Selecting a Trustee and Structuring Trustee Powers)

Steve R. Akers       Mark R. Parthemer
Managing Director   Bessemer Trust  Managing Director
akers@bessemer.com  parthemer@bessemer.com

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IV. SAVINGS CLAUSES TO AVOID ADVERSE TAX EFFECTS FOR
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   A. Significance of Savings Clauses Regarding Tax Effects For Grantors,
This outline addresses tax and non-tax factors that should be considered in selection of a trustee or co-trustees and structuring the powers of trustees for various types of trusts. Clients typically like to keep as much control as possible, and often want to place as much control in their trust beneficiaries as possible. This desire must be balanced against management, tax, and creditor issues that may result in significant advantages in placing restrictions on the control of the donor or trust beneficiaries. This outline addresses trustee selection against the backdrop of a client’s desire to retain as many “strings” over the transfer as possible without causing the donor or beneficiaries to be “strung-up” by those other countervailing factors. As one court has expressed the issue, “the cost of holding onto the strings may prove to be a rope burn.” Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st Cir. 1970).

I. NON-TAX FACTORS

A. Legal Capacity.

1. General Statutory Requirements. A trustee must have legal capacity, and if the trustee is a corporation, it must have the power to act as a trustee. E.g., TEXAS TRUST CODE § 112.008(a). A beneficiary or settlor may generally serve as trustee.

2. Requirements for Corporate Trustee. Most states have limitations on corporations that have the authority to serve as trustee. For example, Section 3 of the Texas Probate Code defines a “corporate fiduciary” as a financial institution as defined by Section 201.101 of the Texas Finance Code, having trust powers, existing or doing business in Texas or another state, and being authorized by law to act under the order of any court of record without giving bond, as trustee, executor, or administrator. Under Section 201.101 of the Texas Finance Code, a financial institution includes a bank or trust company chartered under laws of the United States or any state. For a list of activities that does not require obtaining a charter to engage in trust business, see Section 182.021 of the Texas Finance Code. In Texas, corporations generally do not have serving as a fiduciary within the scope of their permissible purposes; provided that a non-profit corporation may serve as trustee of trusts of which the non-exempt corporation is named as a beneficiary. TEXAS BUS. ORGANIZATIONS CODE § 2.001 & 2.106 (2003); See TEX. FIN. CODE § 181.001 et. seq.

3. Requirements for a Foreign Corporate Fiduciary. Most states limit the ability of out-of-state entities serving as trustee. For example, a foreign corporation or other entity chartered or domiciled in another jurisdiction as a trust company or depository institution with trust powers may act as a trustee in Texas only as provided by Section 105A of the Texas Probate Code. (As discussed below, this provision apparently is
overridden by the Supremacy Clause as to financial institutions that are organized as National Associations.)

a. **Reciprocity Requirement.** Many states have statutes that adopt a reciprocal approach. For example, a Texas court can appoint a corporate fiduciary from another state (a “foreign corporate fiduciary”) as a fiduciary in Texas only if a Texas financial institution can be appointed under the laws of the state of the foreign fiduciary “to serve in like fiduciary capacity.” TEX. PROB. CODE § 105A(a).

b. **Filing Requirement.** A foreign corporate fiduciary shall file with the Secretary of State of Texas (1) a copy of its charter, (2) an appointment of the Secretary of State as its resident agent for service of process, and (3) a designation of the agent who shall receive notices from the Secretary of State. TEX. PROB. CODE § 105A(b).

c. **Not Doing Business.** A foreign fiduciary who satisfies the requirements of Section 105A is not deemed to be doing business in Texas for purposes of Section 8.01 of the Texas Business Corporation Act.

d. **National Associations.** The Office of the Comptroller of the Currency takes the position that under the Supremacy Clause of the U.S. Constitution a national association can serve in any state without meeting any state requirements, including the modest filing requirements. See e.g., OCC Interp. Ltr. No. 872 (Dec. 1999) and OCC Interp. Ltr. No. 866 (Oct. 1999).

4. **Charitable Corporation.** A charitable corporation may serve as the trustee of a trust (1) of which the charity is a beneficiary, or (2) benefiting another charitable organization. TEX. BUS. ORGANIZATIONS CODE § 2.106 (2003)(a). A charity meeting those requirements has immunity from any suit alleging that the corporation’s role as trustee constitutes engaging in the trust business in a manner requiring a state charter. TEX. BUS. ORGANIZATIONS CODE § 2.106 (2003)(b).

B. **Personal Attributes of Trustee.** The personal attributes of the trustee should be of paramount importance in the selection process. All too often, the tax factors predominate, but the planner must not lose sight of the personal attribute factors. The fact that the trust works for tax purposes will be of little benefit if a poorly selected trustee dissipates the trust assets through poor administration of the trust.

> “Serving as an executor or trustee is neither an honor, nor a game for beginners to play. Acting as an executor or trustee requires technical skills, experience, and an ability to deal with the family members involved. Nevertheless, clients often choose an executor and the trustee without fairly evaluating the needs of the estate or trust against the named fiduciary’s abilities to meet those needs.” Schlesinger, Edward, Fifty-Two Questions to Ask Before Choosing Your Executor and Trustee, Successful Estate Planning Ideas and Method Service (1986).

Various personal attributes to be considered in selecting the trustee include sound judgment, impartiality (or desired partiality toward decedent’s preferred beneficiaries),
financial ability and responsibility, integrity and honesty, locality, permanence and continuity (particularly important for long-lived trusts), loyalty, trustworthiness, and experience as a trustee. Some of these attributes are explored in more detail.

1. **Judgment; Experience.** Attorneys are all too familiar with situations where trust assets have been dissipated due to the inexperience of the trustee. A good trustee can provide sound business judgment to the beneficiaries.

2. **Impartiality; Objectivity; Lack of Conflict of Interest.** The objectivity and lack of conflict of interest factor is very important in many family situations. Selecting an appropriate trustee can avoid conflict situations that may result in family tensions (or outright hostilities) that can never be repaired.

   a. **Beneficiaries Having Conflicting Interests.** In situations where the beneficiaries have conflicting interests (the classic case being a split-family situation, where the settlor’s spouse and children by a prior marriage are both involved as current or contingent beneficiaries.) One commentator suggests using an independent trustee in these types of situations:

   “On our facts, the first thing that the estate planner should do is to convince the client to use the services of a truly independent trustee. In this respect, even though [certain approaches may] lessen the possibility of conflict between the client’s children and their stepmother, to a certain extent the objective will be undermined by having a child act as trustee. Because opinions will differ, there still will be circumstances in which the son-trustee does not accede to the stepmother’s requests, creating the possibility of a confrontation. This also might be the case if someone like a brother-in-law or other disinterested relative is appointed as trustee.

   The use of an independent fiduciary—perhaps a corporate fiduciary such as a bank—removes the opinions, the underlying distrust, the misunderstandings, and most of all the personalities from the decision-making process. Consequently, there is a better chance of achieving the desired cooperation between the family members.” Tiernan, *Creating an Amicable Estate Plan for the Decedent’s Children and the Second Spouse*, 94 J. TAX'N (Feb. 2001).

   b. **Avoiding Family Tension.** Stephen Leimberg has summarized the various interpersonal relationships that can be affected by using a family member as trustee:

   “How will the trustee react when faced with a choice that favors him at the expense of other beneficiaries—or favors others at this expense? What are the intra-family implications of those choices? For instance, will he alienate one family member by (even properly) denying a distribution, or ingratiate himself to another by being liberal in his policy of making distributions? Can he say no to one child and yes to another without causing a never-ending family feud? A trustee who is also a family member may be forced by conscience or by duty to make choices injurious to the harmony of family relationships.
Will the trustee (such as the grantor’s spouse) be subject to the influence of one or more children (or a second spouse or lover) to make distributions that may not be in the best interest of other beneficiaries? Is the family member-trustee easily persuaded or likely to show favoritism? The remarriage of a spouse or child who is named as trustee may result in less than impartial decisions—especially where the trustee has been given discretionary powers over trust income or principal—even if the new spouse is not included in the class of possible recipients.

A child/trustee may take on the role of a parent to his or her remaining parent or siblings. This may be positive, but it also may result in an attempt to control the lives of family members through the family finances as if that person were a parent rather than a child.

An independent professional trustee is not subject to such problems. Since the choice between no and yes may be one of the most important duties of a trustee, this ability of a professional trustee to be objective and impartial should be given high preference in the decision-making process.” S. Leimberg, THE TOOLS AND TECHNIQUES OF ESTATE PLANNING 480 (11th ed. 1998).

3. Investment Sophistication; Track Record; Prudent Investor Act. The investment sophistication of the trustee is important with respect to the investment growth of the trust. The trustee’s experience in various types of investments should be considered. For example, does the trustee have experience in the increasingly important area of alternative investments (private equity, venture capital, and hedge funds) to increase returns while reducing overall portfolio volatility?

Under the Uniform Prudent Investor Act, which is being passed by many of the state legislatures, the trustee must evaluate the investments in the context of the entire trust and the risk and return objectives of the trust. In addition, the trustee has a duty to diversify the trust assets. Some commentators observe that the Prudent Investor Rule may increase the level of sophistication required of trustees. See Heisler & Butler, TRUST ADMINISTRATION ch. 5 (Ill. Inst. For Continuing Legal Educ. 1999).

4. Permanence and Availability. Especially for long-term trusts, the long-term existence and availability of the trustee is important. Corporate trustees have the advantage of perpetual existence. The client should inquire, however, into the rate of turnover of the professional staff of the corporate trustee. Having someone available who can develop a long-term helpful relationship with the beneficiaries may be very important in many situations. “It is no big stretch to say that a warm, cooperative, known voice on the other end of the telephone line is probably more important to an elderly surviving spouse than an extra three percent of total return.” Karisch, Protecting the Surviving Spouse, 38TH ANNUAL SW LEGAL FDN. WILLS & PROB INST. 18 (May 1999).

Geographic availability of the trustee may also be important. Some individuals who are being considered as a possible trustee might be expected—over a long period of time—to move locations. Furthermore, beneficiaries may move to new locales, and the ability of the trustee to respond to geographic moves of the beneficiary should be considered.
5. **Sensitivity to Individual Beneficiaries’ Needs.** One of the important duties of a trustee is to make appropriate distributions to the trust beneficiaries, often within some degree of discretion. Being able to understand the beneficiaries and their circumstances is important. Some clients choose to use co-trustees, one of whom has experience in providing the myriad of fiduciary services, and one of whom has a personal relationship with the beneficiaries. In that situation, the co-trustees could be given exclusive responsibility for the administration vs. distribution responsibilities. However, even in that case, the client may want to have the trustee consent to distributions (with the obvious input of the related co-trustee), to get the benefits of having an objective voice who can “shield” the related individual from unreasonable requests for distributions.

6. **Accounting; Tax Planning; Record-Keeping.**

“Corporate fiduciaries have a definite advantage over nonprofessional individual trustees when considering the myriad accounting procedures, tax compliance, and tax planning opportunities that must be handled by a trustee. The level of sophistication, expertise, and experience that should be applied over the lifetime of any trust is one that few nonprofessionals can provide. This means that most family members will simply be incapable of fully understanding all of the problems that must be avoided and the availability and implications of the tax and property law elections that must be weighed. Even knowledgeable attorneys and accountants do not have the requisite practical day-to-day experience unless they practice solely in this field.

It is possible and in many cases appropriate for a trustee to hire agents for advice and assistance. Most trustees will communicate regularly with outside attorneys and accountants. But planning policy and decisions must be made by the trustee; these are among the duties that cannot be delegated. . . . Will an untrained trustee know whom to call or if the advice received is both legally correct and practical? Will a nonprofessional understand the interplay between tax, trust, and property law well enough to interpret provisions in the trust and adequately inform beneficiaries about the tax and other legal effects of various choices?” S. Leimberg, *THE TOOLS AND TECHNIQUES OF ESTATE PLANNING* 483 (11th ed. 1998).

The trust must maintain detailed records and reports typically are given to beneficiaries and the appropriate taxing authorities on a periodic basis. “This requires regular statements of the receipts, disbursements, and assets of the trust in an intelligible form, and careful long-term record storage.” *Id.* at 484.

7. **Fees.** Fees that will be charged by the trustee are a factor. However, the client should not be “penny-wise and pound-foolish.”

“Relatives, beneficiaries, business associates, and close friends will often serve as trustee without charging a fee. The grantor should be careful to determine whether the individual will properly carry out his duties and give sufficient attention to the administration of the trust. One is easily lured away from his responsibilities by more lucrative endeavors. ‘You get what you pay for.’” Malouf, *Choosing a Trustee: Old Problems, New Problems, A Few Solutions*, at 5, Presentation to Dallas Estate Planning Council (January 1991).
Fees are often the primary reason that a client elects to use family members or friends as trustees rather than a professional fiduciary. There are certainly many situations in which it is appropriate to use carefully selected individuals as trustees. However, the clients should consider the long-term effects on the trust and balance all of the personal attribute factors in weighing whether to use a corporate fiduciary despite the fee differences.

“Where the trust is likely to be of substantial size, administration of the trust may require special confidence and expertise beyond the ability of any individual, whether a relative, friend or business colleague. For this and other reasons a corporate trustee is often selected. The use of a corporate fiduciary as an ‘independent trustee’ may be necessary to avoid adverse federal income or estate tax consequences. A corporate fiduciary presumably would bring special skills and competence to investment, tax and other matters of trust administration that would amply justify its commissions. Continuity is assured since the trusteeship would be unaffected by disability, death or other contingency by reasons of the corporate fiduciary’s perpetual existence. Although an individual named as trustee might be willing to serve without compensation, this savings might be offset by the need to retain and compensate attorneys, accountants, investment advisors and other agents.” G.G. Bogert, G.T. Bogert & A. Hess, BOGERT’S TRUSTS AND TRUSTEES § 121 (2001).

C. Likelihood of Self-Dealing Transactions. In many situations, the overall plan will call for a trustee to purchase assets from related parties or affiliates. This brings into play the independence and lack of conflict personal attributes discussed in section I.B.2. above. In addition, legal restrictions on the ability of the trustee to enter into certain self-dealing transactions may be imposed if the trustee is also personally involved in the transaction.

Many state statutes have restrictions on self-dealing transactions, but many of those restrictions may be waived in the trust instrument. For example, the Texas Trust Code prohibits a loan of trust funds to a trustee, affiliate or relative of a trustee (§ 113.052), a purchase or sale of trust property by or to a trustee, affiliate or relative of the trustee (§ 113.053), a sale of property from one trust to another trust having the same trustee (§ 113.054), and a purchase of the trustee’s securities (§ 113.055). The term “relative” includes a spouse, ancestor, descendant, brother or sister, or spouse of any of them. TEX. PROP. CODE § 111.004(13).

In many situations, the settlor may want to relieve the trustee of self-dealing prohibitions if permitted by local law. In Texas, the trust instrument may alter self-dealing prohibitions that would otherwise apply under the Code. Previously, a corporate trustee could not be relieved from the self-dealing provisions in Section 113.052 (loan of funds to trustee or specified related parties) or Section 113.053 (purchase or sale of property from or to trustee or specified related parties), but amendments in 2007 allow the settlor to waive those prohibitions even for corporate trustees. TEX. PROP. CODE §§ 111.0035(b)(2), 114.005(a); TEX. FINANCE CODE § 197.005(b). The Texas Trust Code also addresses a corporate trustee making a temporary or permanent deposit of funds with itself. TEX. PROP. CODE § 113.007 (temporary deposit pending reinvestment) & 113.057 (permanent investments). The Texas Trust Code specifically authorizes a corporate trustee to employ an
affiliate to provide brokerage, investment, or other account services for the trust and to permit the affiliate to charge a commission for its services. The statute requires that the amount charged by the affiliated be disclosed and not exceed the customary amount that is charged by the affiliate for comparable services to others. TEX. PROP. CODE § 113.053(f).

In addition, restrictions are imposed on banks by the OCC, but Section 9.12 of Regulation 9 relieves a trustee from many self-dealing restrictions when the proposed action is authorized by applicable law.

Despite the statutory provisions allowing waiver of self-dealing prohibitions on the trustee, there are some suggestions in cases that there may be public policy concerns that would limit the ability of the settlor to relieve a trustee of liability for future self-dealing transactions. See Langford v. Shamburger, 417 S.W.2d 438, 444 & 447 (Tex. Civ. App.—Ft. Worth 1967, writ ref'd n.r.e.) (dictum that “it would be contrary to the public policy of this state to permit the language of a trust instrument to authorize self-dealing by a trustee”; on rehearing, the court stated that the language of a trust instrument specifically authorizing self-dealing “could present a serious question of public policy”). See also Interfirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882 (Tex. Civ. App.—Texarkana 1987, no writ). However, the Texas Supreme Court has upheld an exculpatory clause, relying primarily on section 113.059 of the Texas Trust Code, which allows a settlor to relieve the trustee from a duty, liability or restriction contained in the Code, except that a corporate trustee may not allow lending or sales transactions with itself. Texas Commerce Bank, N.A. v. Grizzle, 96 S.W.3d 240 (Tex. 2002). The opinion does not address public policy concerns placing limits on the ability of a settlor to allow self-dealing transactions. The Texas legislature responded by amending section 113.059 to incorporate the provisions of the Restatement (Second) of Trusts § 222, which prohibit the enforcement of an exculpatory clause that would relieve a trustee of liability for a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of the beneficiary. In addition, the amendment makes clear that an exculpatory clause may not relieve the trustee for liability for any profit derived by the trustee from a breach of trust.

Cases generally recognize that no matter how broad the trust instrument’s provisions are, the trustee will remain liable for a breach of trust committed in bad faith or with reckless indifference to the interest of the beneficiary. Restatement (Second) of Trusts § 170 Comment t.

D. Situs Selection Issues. The situs of the trust may affect various important legal issues, including asset protection, state income taxation, and the application of the rule against perpetuities to the trust.

If the client wishes to create a “Dynasty Asset Protection Trust” (i.e., a trust that is not subject to the rule against perpetuities and that is generally not subject to creditors claims against the settlor of the trust), it may be necessary to require that at all times there be sufficient trustees resident in the state whose law is being used. At least fourteen states have adopted varying approaches regarding “self-settled spendthrift trusts”: Alaska, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. (In addition, Oklahoma law provides that the a settlor's creditors cannot reach the assets of a revocable trust up to $1 million established for the settlor's spouse, descendants or charities, but this does not
recognize “self-settled trusts” because the settlor cannot be a beneficiary of that trust. Also see COLO. REV. STAT. §38-10-111.) Laws in these states provide generally that trust assets are generally not subject to creditors claims of the settlor merely because the settlor is a discretionary beneficiary of the trust. These various states have differing provisions regarding trustee selection in order to take advantage of the state’s laws. For example, Rhode Island requires that all trustees be a resident or authorized to do business in that state. R.I. GEN. LAWS § 18-9.2-2(8)(I) (1999). Alaska and Delaware require that one trustee be a resident in their states. Some of the jurisdictions require that at least some of the trust assets be located in or administered in the host jurisdiction. See Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, at 56 (March/April 2002).

E. Power to Allocate Gains to Income Under Section 104. Section 104 of the new Uniform Principal and Income Act, which was approved by the National Conference of Commissioners on Uniform State Laws in July 1997, and approved by the American Bar Association in January of 1998, is in the process of being adopted in many states. It was adopted (with modifications) by the Texas legislature in 2003. If a trust provides for the mandatory distribution of all income, and if a trustee makes the decision under section 104 to allocate some or all capital gains to income for a particular year, the decision directly impacts the amount to be distributed to the income beneficiary. Accordingly, section 104 of the Uniform Act and most of the states adopting the provision stipulate that the discretion may only be exercised by an independent trustee. See Wolf, Total Return Trusts—Meeting Human Needs and Investment Goals Through Modern Trust Design, at 23, ACTEC 2002 ANNUAL MEETING. The Texas statute does not permit a beneficiary who is serving as a trustee to allocate gains to income under the statute.

F. Ability of Beneficiary to Force Distributions. In some situations, a donor creates a trust to provide long-term management for the benefit of a spendthrift beneficiary. The donor should be aware that if standards for distributions are listed in the trust agreement, the beneficiary may go to court to force a trustee to make distributions within the prescribed standards. If a trust gives the trustee wide discretion in deciding to make distributions, without specified standards for exercising that discretion, the beneficiary will have a much more difficult time convincing a court to force the trustee to exercise its discretion in a particular manner. See Porter, Exercising Discretion in Discretionary Trusts Great Expectations: Charles Dickens Diminished Expectations: Trust Beneficiary Managed Expectations: Trustee, Thirty-Seventh Annual Heckerling Inst. On Est. Pl. ¶ 1400 (2003). However, for tax reasons, wide discretion over distributions is usually only allowed for an independent trustee. If a major goal of the donor in a particular situation is to provide long-term management for spendthrift beneficiaries, using an independent trustee with wide discretion over distributions may be preferable.

G. Trust Protectors and Bifurcated Co-Trustee Powers. Trustee duties may be divided among various fiduciaries. State laws typically allow trustees to delegate certain trust duties and powers to agents. (The agent owes a duty of reasonable care, and the trustee must act prudently in making the delegation and monitor the agent’s performance.) UNIF. TRUST CODE §807; TEX. PROP. CODE §117.011; RESTATEMENT (THIRD) OF TRUSTS §9; UNIF. PRUDENT INVESTOR ACT §9; see also, John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 MO. L. REV. 105 (1994). The authority of co-trustees to delegate responsibilities among themselves is much more limited. See UNIF. TRUST CODE
§703(e) (delegation to a co-trustee of function the settlor reasonably expected the trustees to perform jointly not permitted).

A settlor may provide for divided powers either by (i) providing a director to direct particular trustee actions, and (ii) having co-trustees with a bifurcation of their respective powers. A settlor may also appoint a “trust protector” with designated “grantor-like” powers that can be very broad powers to make changes regarding the trust.

Trustee duties are being divided for various reasons. For trust directors or co-trustees with bifurcated responsibilities, reasons include specialization of skill sets or specialized assets. (There is significant jurisdictional competition for directed trusts or trusts with bifurcated co-trustees because state laws vary significantly to the extent that these provisions are respected.) For trust protectors, reasons include tax considerations, a desire to impose checks and balances, and the perceived need to adapt to change.

A Uniform Law Commission project is addressing divided trusteeships. The project will likely result in a uniform act revision dealing with divided responsibilities among co-trustees or trust advisors.

1. Directed Trusts. A number of states have directed trust provisions, recognizing the authority of a third person to direct certain actions of the trustee. This may desirable, for example, if the settlor wants to designate someone with specialized knowledge about a particular asset (such as a closely held business) to direct actions with respect to the trust’s interest in that asset, and relieve the other co-trustee from responsibility for that asset. (A settlor might want a corporate trustee to be responsible for “investable assets” without being responsible for (or charging fees for) detailed oversight of a closely held business in which the trust owns an interest.) The state statutes vary to the extent to which the trustee may rely on that direction without liability. E.g., UNIF. TRUST CODE §808(b) (trustee may act in accordance with the direction “unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust”); TEX. PROP. CODE §114.003(b); FLA. STAT. §736.0808(2). A third person may also be given the power to direct the modification or termination of the trust. E.g., UNIF. TRUST CODE §808(c); TEX. PROP. CODE §114.003(a). These statutes typically provide that the third person holding the direction power is “presumptively a fiduciary.” E.g., UNIF. TRUST CODE §808(d); TEX. PROP. CODE §114.003(c). Some state statutes provide broader authority for the trustee to act in reliance on directions from the advisor without liability. E.g., ALASKA STAT. §13.36.375(c) (a “trustee ... required to follow the directions of the advisor is not liable, individually or as a fiduciary, to a beneficiary for a consequence of the trustee’s compliance with the advisor’s directions, regardless of the information available to the trustee, and the trustee does not have an obligation to review, inquire, investigate, or make recommendations or evaluations with respect to the exercise of a power of the trustee if the exercise of the power complies with the directions given to the trustee”); 12 DEL. C. §3313 (“then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act”); 760 ILL. COMP. STAT. §16.3(f)(1) (willful misconduct); R. S. MO. §456.8-808(8) (bad faith or reckless indifference). For a detailed listing of directed trust statutes, see Richard W. Nenno, State Directed Trust
Can these limitations on the ability to relieve the directed trustee of liability be overridden in the trust instrument? The comments to §808 of the Uniform Trust Code indicate that a settlor could relax those standards in the trust instrument:

The provisions of this section may be altered in the terms of the trust. See Section 105. A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary.

Section 105 of the Uniform Trust Code, referenced in that comment, is the section listing what duties cannot be altered in the trust agreement. The comment suggests that §105 would not prohibit a trust instrument from overriding the manifestly contrary to terms of trust/serious breach of trust liability default standard of §808(b).

2. Bifurcated Co-Trustee Powers. Co-trustees have limited authority to split their duties and responsibilities. See UNIF. TRUST CODE §703(e) (delegation to a co-trustee of function the settlor reasonably expected the trustees to perform jointly not permitted). A comment to §703(e) explains that

trustees should be encouraged to delegate functions they are not competent to perform. Subsection (e) is premised on the assumption that the settlor selected cotrustees for a specific reason and that this reason ought to control the scope of a permitted delegation to a cotrustee. ... The exact extent to which a trustee may delegate functions to another trustee in a particular case will vary depending on the reasons the settlor decided to appoint cotrustees. The better practice is to address the division of functions in the terms of the trust, as allowed by Section 105.

Absent an effective delegation of duties among co-trustees or a division of responsibilities in the trust agreement, all co-trustees generally have an obligation to participate in all elements of the trust administration. UNIF. TRUST CODE §703(e). Trustees generally take action by majority vote, but if a co-trustee disagrees with the decision made by the majority, that co-trustee may refuse to join in the action and avoid liability for the action except that each co-trustee must exercise reasonable care to prevent a co-trustee from committing a serious breach of trust and to compel a co-trustee to redress a serious breach of trust. UNIF. TRUST CODE §703(f)-(g); TEX. PROP. CODE §114.006(a)-(b). The co-trustee who disagrees with an action may nevertheless join in the action but dissent and avoid liability for the action unless it constitutes a “serious breach of trust.” UNIF. TRUST CODE §703(h); TEX. PROP. CODE §114.006(c).

The trust agreement, however, may divide the responsibilities among co-trustees. For example, there may be an investment/administrative co-trustee and a distribution co-trustee; the sole authority and responsibility of the distribution co-trustee would be to make distribution decisions. The Uniform Trust Code provides that the terms of a trust
generally control and can change the rules that would otherwise apply, as long as the
trustee must act in good faith in accordance with the terms of the trust for the interests
of its beneficiaries and as long as the trust terms are for the benefit of its beneficiaries
and have a lawful purpose that is not contrary to public policy. UNIF. TRUST CODE
§105(b). Section 105(b) lists other specific provisions that may not be modified, but
dividing responsibilities among co-trustees is not listed as one of the prohibited
modifications.

A few states have adopted statutes that specifically address the ability of a settlor to
divide the duties of co-trustees. The Alaska statute relieves the “excluded trustee” from
any duty whatsoever with respect to responsibilities allocated to a co-trustee:

> Notwithstanding the other provisions of this section, if the terms of a trust
> instrument provide for the appointment of more than one trustee but confer on
> one or more of the trustees, to the exclusion of other trustees, the power to
direct or prevent specified actions of other trustees, the excluded trustees shall
> act in accordance with the exercise of the power. An excluded trustee under this
> subsection is not liable, individually or as a fiduciary, for a consequence that
> results from complying with the exercise of the power, regardless of the
> information available to the excluded trustee. An excluded trustee does not
> have an obligation to review, inquire, investigate, or make recommendations or
evaluations with respect to the exercise of the power. A trustee having the
> power is liable to the beneficiaries as a fiduciary with respect to the exercise of
> the power as if the excluded trustees were not in office and has the exclusive
> obligation to account to and to defend an action brought by the beneficiaries
> with respect to the exercise or the power. In this subsection, “power” means the
> power to direct or prevent specified actions by other trustees. ALASKA STAT.
> §13.36.072 (amended in 2013, applicable to pre-existing or subsequent trusts).

Other states have not been as expansive in relieving a co-trustee for all responsibility
with respect to duties allocated to another co-trustee. For example, the Florida statute
is similar to the Alaska statute, but provides that the excluded trustee is has no liability
for actions allocated to another co-trustee “except in cases of willful misconduct on the
part of the excluded trustee.” FLA. STAT. §736.0703.

3. **Trust Protectors.** A “trust protector” may be given “grantor-like” powers that can be
very limited or very broad to make changes regarding the trust such as the power to
modify or amend the trust agreement, change beneficial interests, veto or direct
distributions, modify powers of appointment, change the trust situs, change trustees or
advisors, terminate the trust, or appoint successors. Offshore trusts have historically
used trust protectors, leading to growing use in the U.S. In one respect, many trusts
have “trust protectors” to the extent that they authorize specified persons to remove and
replace trustees, among other possible actions. A variety of the state directed trust
statutes have language broad enough to apply to trust protectors as well. E.g., 12 DEL.
C. §3313(f) (“For purposes of this section, the term “advisor’ shall include a “protector’;
a non-exclusive list of example powers includes removing and appointing fiduciaries,
modifying or amending the instrument for tax or other efficiency reasons, or modifying
powers of appointment). A few states have enacted statutes addressing the powers of
trust protectors specifically including Alaska, Delaware, Idaho, Illinois, Nevada, New
Hampshire, South Dakota, and Wyoming) that list example powers that trust protectors could hold. *E.g.*, 760 ILL. COMP. STAT. §16.3(d) (non-exclusive list of 10 example powers that trust protectors could hold); NEV. REV. STAT. §163.5553 (non-exclusive list of 12 example powers that trust protectors could hold).


A potential concern with giving extremely broad “grantor-like” powers to trust protectors is that abuse of the power by continued grantor “control” may result in adverse treatment:

> [“T"]he IRS may attempt to attack a trust protector arrangement where is believes the appointment has been used to allow a settlor to retain power over trust property that would otherwise subject the assets to estate tax inclusion under IRC § 2036 or IRC § 2038. For this reason, it is important that a trust protector remain an independent actor and not subject to the control of a settlor. While flagrant actions may, as always, open the door to attack as a sham, the appointment of a trust protector by itself should not subject trust property to inclusion. Jonathan C. Lurie & William R. Burford, Drafting Flexible Irrevocable Trusts, 33 ACTEC L.J. 86, 91-92 (Summer 2007).

As an example, *SEC v. Wyly*, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) was a securities law violation case in which the court determined that the amount of disgorgement would be based in part on the income taxes that the defendants avoided by an offshore trust structure. Trust protectors had the power to remove and replace independent trustees located in the Isle of Man. The court determined that the settlors controlled all decisions for the trust, by expressing their “recommendations” to trust protectors who relayed those recommendations to the trustee, who *always* did as instructed. The court determined that the independent trustee exception to the grantor trust rules under §674(c) did not apply because the settlors in fact controlled all decisions.

H. Summary Personal Attributes Issues. One commentator has observed that the “most disrespected decision in estate planning” is the selection of who will serve as trustee and as successor trustees. Charles A. Redd, *The Most Disrespected Decision in Estate Planning*, Trusts & Estates 13-14 (July 2014). Mr. Redd suggests various characteristics that should be considered.

> “Does the individual under consideration as trustee possess sufficient expertise and the necessary experience to do the job? …

> Is the proposed trustee independent, or does the proposed trustee have an inherent conflict of interest? …

> Does the trustee have an appropriate fiduciary demeanor? Trustees often must make difficult choices...”\

A conclusion may please one or more beneficiaries while causing
distress to others. To be successful, a trustee must possess the judgment to make prudent assessments and have the resolve to make and defend decisions in the face of possibly aggressive opposition.

**Will the trustee being considered be around long enough to see the job through?** ...

**Where’s the proposed trustee located?** ...

**Will the trustee expect to be paid?** The cost of trust administration is an important factor. However, trust administration is never free. ...

**Is the trustee accountable?** ... If a corporate fiduciary is serving or if an individual trustee is bonded (which is exceedingly difficult to accomplish), the answer is ‘yes.’ Otherwise, depending on the amounts of the losses, the answer could easily be ‘no.’

**Critical Element.** Designating initial and successor trustees is among the most critical elements of the estate-planning process. It’s often not treated as such but should be. The best estate planners understand this reality and skillfully guide their clients through a thoughtful and deliberate trustee selection process.” *Id.*

II. DONOR TAX ISSUES

A. Gift Tax Issues.

1. **Incomplete Gift—Structure Planning Based on Donor’s Intent.** The transfer to a trust may or may not be a completed gift, based on the terms of the trust and the identity of the trustee. The trust terms and trustee selection must be planned after taking into consideration whether the donor wishes to make a complete gift for gift tax purposes.

   If there is a completed gift initially, there could be immediate gift tax due, based on the size of the gift. However, if the gift is not complete initially, the assets—including subsequent appreciation—will still be included in the donor’s estate under Sections 2036-2038 of the Code of 1986 (hereafter, references to “Sections” will be to sections of the Internal Revenue Code of 1986, as amended) for estate tax purposes until the gift has been completed. If the gift is “completed” sometime after the initial transfer, the gift tax will be calculated based on the value of the assets when the gift is subsequently completed.

   Section 2511 of the Code applies the gift tax to “direct or indirect” gifts of all kinds of property whether in trust or otherwise. The regulations add that a gift may be complete even if, at the time it is made, “the identity of the donee may not ... be known or ascertainable.” Treas. Reg. § 25.2511-2(a). The regulations provide that various retained interests or powers by the donor will result in a transfer being an incomplete gift until the retained interest or power is relinquished. As a result, certain powers retained by the donor as a trustee, or in some situations as a co-trustee, will result in a transfer not being treated as a completed gift for gift tax purposes.

2. **Retained Right to Receive Distributions.**

   a. **Overview.** A transfer is a completed gift only to the extent that the donor “has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another.” Treas. Reg. § 25.2511-2(b). Regulation § 25.2511-2(c) states that a gift is incomplete to the extent that the donor reserves the power to revest the property in himself. This
power can be indirect, such as through the power to force a trustee to make distributions to the donor under a trustee’s power to make distributions that is limited by a fixed or ascertainable standard, which is enforceable by or on behalf of the donor. (The regulation refers to Regulation § 25.2511-1(g)(2) to determine what are “fixed or ascertainable standards.”) Such a transfer “is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.” Treas. Reg. § 25.2511-2(b).

One case that considered the ascertainable standard exception for this purpose is Gramm v. Comm’r, 17 T.C. 1063 (1951). The court held that the discretion to make principal distributions to the settlor for “comfort, education, maintenance or support” did not constitute an ascertainable standard; so there was no completed gift. The court held that the transfer was not a completed gift because “there was no limitation as to the amount which could be withdrawn by the corporate trustee for the comfort, etc. of the decedent.” (This analysis may seem contrary to the Regulation, which would suggest that there is a completed gift if there is not an ascertainable standard that the donor can enforce.)

If a trustee who is not the donor has absolute discretion over distributions to the donor and if the donor’s creditors cannot reach the transferred property, the gift is complete. Holz Estate v. Comm’r, 38 T.C. 37, 42 (1962), acq. 1962-2 C.B. 4; Rev. Rul. 76-103, 1976-1 C.B. 293 (gift not complete where trust permitted discretionary distributions to grantor and, under the controlling state law, the grantor’s creditors could reach the entire trust property; gift would become complete if trustee moved situs of the trust to a state where the grantor’s creditors cannot reach the trust assets). Several cases have specifically addressed that an incomplete gift results if creditors of the settlor/beneficiary can reach the trust assets. Outwin v. Comm’r, 76 T.C. 153 (1981); Hambleton v. Comm’r, 60 T.C. 558 (1973); Paolozzi v. Comm’r, 23 T.C. 182 (1954), acq. 1962-1 C.B. 4; but see Herzog v. Comm’r, 116 F.2d 591 (2d Cir. 1941) (gift complete despite creditor’s ability to reach trust assets).

The IRS has ruled privately that a gift to an “Alaska Trust” (which could not be reached by the donor’s creditors) was a completed gift even though the trustee could in its discretion make distributions to the donor. Ltr. Rul. 9837007. Letter Ruling 200944002, which also apparently involved an Alaska trust, recognized that transfers to the trust are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re vest beneficial title or change the beneficiaries.

If a person transfers assets to a “self-settled” trust in a jurisdiction that does not allow creditors to reach the trust assets merely because the settlor is a discretionary beneficiary, the person may wish to create a pool of assets as a protected nest egg in the remote event of a severe financial reversal, but the person may not want to make a completed gift subject to gift taxes. A classic strategy that has been used by some planners in that situation is to provide that the settlor has a testamentary limited power of appointment to shift assets among a listed group of appointees. (However, that strategy by itself will likely no longer be used after the issuance of ILM 201208026, discussed in Section II.A.3.a of this outline, until there is further clarification of the incomplete gift issue.)
A private letter ruling has addressed a transfer under which the donor’s spouse had a testamentary power of appointment to appoint the trust property back to the donor. The ruling held that a transfer to an irrevocable trust for the donor’s spouse was a completed gift even though the spouse had a special testamentary power of appointment to appoint the assets to a trust for the benefit of the donor, and even though the IRS found that an implied agreement existed between the spouses that the donee spouse would in fact execute a codicil to her will appointing the trust assets to a trust for the benefit of the donor. Ltr. Rul. 9141027. (To be more conservative, the planner should avoid having any express or implied agreement regarding the exercise of the power of appointment in such circumstances to avoid incomplete gift treatment.)

b. **Summary of Selection of Trustee Issues as to Donor Retained Rights to Income In Order To Avoid Having Transfer Treated as Incomplete Gift.** If any distributions may be made to or for the donor’s benefit, there must be an independent trustee making the distribution decision, and there cannot be an ascertainable standard that allows the donor to compel a distribution. Furthermore, the donor cannot be a co-trustee participating in such decisions unless the other co-trustee has a substantial adverse interest in the disposition of the transferred property. Treas. Reg. § 25.2511-2(c). Even if there is an independent trustee or a co-trustee with an adverse interest, the trust should be located in a jurisdiction that recognizes spendthrift protection for self-settled trusts to assure that the retained discretionary interest does not cause the transfer to be treated as an incomplete gift because of the ability of the donor’s creditors to reach the trust assets. (In addition, as discussed below, the donor can have no power to shift benefits from one beneficiary to another.)

3. **Powers to Change Beneficial Interests.**

   a. **Powers to Change Beneficial Enjoyment That Cause Incomplete Gift.** A transfer is generally incomplete to the extent that the donor retains the power to change the interests of the beneficiaries among themselves. Treas. Reg. § 25.2511-2(c); Sanford Estate v. Comm’r, 308 U.S. 239 (1939). The following are examples of retained powers, which if held by the donor alone or in conjunction with another trustee who does not have a substantial adverse interest, will cause a transfer to be incomplete (unless the ascertainable exception applies, as described immediately below):

   - The power to shift benefits from one beneficiary to another, such as through a “sprinkling” power;
   - The power to add one or more beneficiaries of the trust;
   - The power to remove one or more beneficiaries of the trust;
   - The power to distribute or accumulate income, thus affecting the amount passing to another person who is the remainder beneficiary. Treas Reg. § 25.2511-2(c)
   - A provision that is often used to avoid having a completed gift is for the donor to retain a testamentary limited power of appointment to appoint the assets among a designated group of potential appointees. However, using retained
testamentary limited powers of appointment is not an absolute way to avoid having a transfer to a trust treated as a completed gift if the grantor is not the sole beneficiary of the trust. In ILM 201208026 (issued by the IRS general counsel office) individuals made a gift to a trust, 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 grantor’s 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 ILM concluded that the entire transfer was a completed gift despite the grantor’s retained testamentary limited power of appointment. The ILM stated that the retained testamentary powers of appointment do cause the remainder interest to be an incomplete gift, but reasoned that the testamentary powers of appointment relate only to the remainder interest. During the grantors’ lifetimes, they had no ability to keep the trustee from making distributions among the potential trust beneficiaries—which might potentially include all of the trust assets. Therefore, the ILM reasoned that the gift was complete as to the “beneficial term interest” that existed before the grantors’ deaths—but was an incomplete gift as to the remainder interest. Furthermore, the ILM reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to “applicable family members”) was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest was the full value transferred to the trust.

If the trustee has any of these powers either alone or in conjunction with a non-adverse party (and if the ascertainable standard exception does not apply), the trustee must be someone other than the donor, and the donor must not have the power to have himself or herself appointed as trustee.

b. **Ascertainable Standard Exception.** The regulations clarify that a power to change beneficial interests will not cause a transfer to be incomplete for gift tax purposes if the power is held in a fiduciary capacity and is subject to a “fixed and ascertainable standard.” Treas. Reg. § 25.2511-2(c) & 25.2511-2(g). If there is a fixed and ascertainable standard, the beneficiaries would have legal rights to force distributions according to the standard, thus divesting the donor of dominion and control over the transferred property. The regulations cited above do not give examples of what constitutes an ascertainable standard, but an analogous regulation (addressing powers by a trustee who has a beneficial interest in trust property) does provide details, including the requirement that the standard be such that the trustee is “legally accountable” for exercise of the power. The analogous regulation states that a power to distribute for the “education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard.” Treas. Reg. § 25.2511-1(g)(2).

There have been only a few cases addressing the ascertainable standard exception in connection with whether retained powers to change beneficial interests preclude treating a transfer as a completed gift. See McHugh v. U.S., 142 F. Supp. 927, 929 (Ct. Cl. 1956) (“to provide properly for the essential needs—such as food clothing,
shelter and illness expenses” constituted ascertainable standard; transfer subject to such standard was a completed gift; Pyle v. U.S., 766 F.2d 1141 (7th Cir. 1985), rev’g 581 F. Supp. 252 (“necessary for her health, support, comfort and maintenance requirements” constituted ascertainable standard, based on an Illinois Supreme Court case holding that the word “comfort” created an ascertainable standard; transfer subject to such standard was a completed gift).

In light of the ascertainable standard exception, purely administrative powers retained by the donor should have no gift tax effect. See Dodge, 50-5th T.M., Transfers With Retained Interests and Powers 93 (2002); cf. Byrum v. Comm’r, 408 U.S. 125 (1972) (no estate tax effects under Section 2038 of administrative powers held in a fiduciary capacity). (The Byrum case is discussed in detail in section II.B.4.c. of this outline.)

c. **Power to Affect Time or Manner of Enjoyment, But Not to Shift Among Beneficiaries.** A gift is not considered incomplete merely because the donor reserves the power to change the manner or time of enjoyment, but not to shift benefits among beneficiaries. Treas. Reg. § 25.2511-2(d). Therefore, a retained power by the donor as trustee to distribute or accumulate income will not preclude a completed gift as long as there is only one beneficiary of the trust and all assets must eventually be distributed to the beneficiary or his estate.

d. **Power Exercisable In Conjunction With Others.** If the donor has the power to change beneficial interests only in conjunction with another person who has a “substantial adverse interest in the disposition of the transferred property or the income therefrom,” the transfer will still be treated as a completed gift. Treas. Reg. § 25.2511-2(e). The regulations do not define a substantial adverse interest, but presumably the doctrines related to adverse parties for income tax purposes (I.R.C. § 672(a)) and powers of appointment (I.R.C. § 2041(b)(1)(C) & 2514(c)(3)) will apply. The interest of a beneficiary who is adversely affected by the decision to distribute or accumulate income must be substantial in relation to the whole. See Paxton v. Comm’r, 57 T.C. 627 (1972), aff’d, 520 F.2d 923 (9th Cir. 1975) (3.8% interest not substantial); Paxton v. Comm’r, T.C. Memo. 1982-464 (1982) (9.9% interest not substantial); Comm’r v. Prouty, 115 F.2d 331 (1st Cir. 1940) (discretion to distribute or accumulate income for beneficiary for life, with remainder passing to the beneficiary’s issue as appointed by beneficiary’s will; beneficiary not hold a substantial adverse interest). The consent of a person who would otherwise have a substantial adverse interest will not be sufficient to preclude completed gift treatment if there is an agreement in advance regarding the person’s consent to exercise of the power by the donor. Camp v. Comm’r, 195 F.2d 999 (1st Cir. 1952); Schwarzenbach v. Comm’r, 4 T.C. 179 (1945).

e. **Contingent Powers.** A donor is not deemed to retain a power that arises only upon a future contingency, even if the likelihood of the contingency can be calculated actuarially. Lasker v. Comm’r, 1 T.C. 208 (1942); TAM 8546001; PLR 8727031. For example, the mere possibility that the donor may become a trustee in the future (but outside the control of the donor) will not result in the donor being treated as holding the powers of the trustee for purposes of determining whether the transfer is a completed gift. Goldstein v. Comm’r, 37 T.C. 897 (1962), acq., 1964-1 C.B.
(Part 1) 4; Rev. Rul. 54-537, 1954-2 C.B. 316 (contingency in donor’s control, by removing the trustee and appointing himself as successor).

f. Summary of Selection of Trustee Issues as to Retained Power to Change Beneficial Interests In Order To Avoid Having Transfer Treated as Incomplete Gift. This paragraph summarizes powers that the donor can have (or not have) and still make a completed gift. If the donor is the trustee, the trustee cannot have the discretion to shift benefits among beneficiaries, unless the discretion is limited by a “fixed or ascertainable standard.” If the donor is a co-trustee or must consent to discretionary distributions that may shift benefits among beneficiaries, the other person must have a substantial adverse interest with respect to the discretion over the disposition of the transferred property. In that circumstance, the third party cannot have an express or implicit agreement regarding consent to the donor’s exercise of the discretionary power. The donor may be a possible future trustee, as long as the donor cannot control his substitution as trustee (such as through a power to remove and appoint himself as successor trustee.) The donor may serve as trustee if the trustee’s only discretion is to accelerate or delay distributions to a single beneficiary, with no ability to shift benefits in any way to any other persons.

B. Estate Tax Issues.

1. Who is the “Grantor”?

Sections 2036 and 2038 may estate inclusion where certain interests or powers are retained by the grantor of a trust. Therefore, determining who is the “grantor” for this purpose is important. Generally, the person who makes an actual transfer, for state law purposes, to the trust is considered a grantor for this purpose. Heasty v. U.S., 239 F. Supp. 345 (D. Kan. 1965), aff’d, 370 F.2d 525 (10th Cir. 1966). There are several exceptions, in which transfers made by others will be attributed to a grantor. See generally Stephens, Maxfield, Lind & Calfree, Federal Estate & Gift Tax’n ¶ 4.08[7] (2001); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M., at 112-138 (2002).

a. Reciprocal Trust Doctrine. If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are “interrelated”, the trusts will be “uncrossed,” and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court reasoned:

“Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.” (emphasis added) Id.
If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *Estate of Levy v. Comm’r*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; IRS conceded that if the special lifetime power of appointment was valid under local New Jersey law the reciprocal trust doctrine could not apply; see detailed discussion of case based on conversations with counsel in the case by Mark Merric, *The Doctrine of Reciprocal Trusts*, LSI Archive #1282, April 24, 2008); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son’s death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries); but see *Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting)(identity of beneficiaries is not a prerequisite to application of reciprocal trust doctrine; retained mutual powers to control timing of distributions should be sufficient to invoke the doctrine).

If trusts of unequal value are reciprocal, the values to be included in either grantor’s estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm’r*, 140 F.2d 636 (8th Cir. 1944).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in Grace)
- Fund the trusts with different assets and different values (observe that Grace holds that just having different assets is not sufficient to avoid the doctrine, but it applies only to the extent of mutual value, *Estate of Cole v. Comm’r*, 140 F.2d 636 (8th Cir. 1944))
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse’s outside resources and the other would not
- One of the settlors would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event (for example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife’s trust until three years after wife’s death and then only if the husband’s net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a “5 or 5” withdrawal power from husband’s trust after their son’s death)
- One trust includes the “other settlor” as a discretionary beneficiary but the other trust would merely give an independent party (not exercisable as a fiduciary), perhaps after the passage of some specified time, the authority to add the “first settlor” as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like Levy)
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees
or perhaps in one trust the power is exercisable only with the consent of a non-adverse party)

- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

There may be an advantage to making the primary beneficiary the Settlors’ grandchildren, and having the settlors include each other only as secondary beneficiaries.

In any event the differences need to be “real.” Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are administered after they are created may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.


The Grace case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. Estate of Bischoff v. Comm’r, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); Exchange Bank & Trust Co. of Florida v. U.S., 694 F.2d 1261 (Fed. Cir. 1984); Ltr. Rul. 9451059 (where beneficiaries of two trusts can appoint property to each other, unrestricted by an ascertainable standard, the trusts would be uncrossed, and each beneficiary would be considered to have a general power of appointment over the trust of which he is a beneficiary, citing Matter of Spear, Jr., 553 N.Y.S.2d 985 (Sur. Ct. 1990), in which the court adopted the reciprocal trust theory to find that trust beneficiaries had general power of appointments to qualify for the “Gallo exemption” that was available for GST purposes prior to 1990); Ltr. Rul. 9235025 (the settlors’ two daughters had a power to appoint the trust property to any descendant of the settlor other than herself, including the other daughter; while noting the potential application of the reciprocal trust theory, the IRS concluded that the particular factual situation did not justify its application); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each
other as trustee with broad distribution powers); but see Estate of Green v. Comm’r, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

b. **Indirect Transfers.** Various indirect transfers may be attributed to a grantor. For example, if A transfers cash to B, with the understanding that B will transfer property to a trust for A’s benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. Estate of Shafer v. Comm’r, 749 F.2d 1216 (6th Cir. 1984). See Brown v. U.S., 329 F.3d 664 (9th Cir. 2003)(husband made gift to wife; wife made gift to trust; husband died within three years; applied step transaction doctrine to determine that husband was the “real donor” so that §2035 applied to gift tax on transfer within three years of death). As another example, if a husband owes funds to his wife from a prior loan, but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust. Estate of Marshall v. Comm’r, 51 T.C. 696 (1969), nonacq. 1969-2 C.B. xxvi. Cf. Treas. Reg. 25.2511-1(h)(2,3,9) (examples of indirect transfers for gift purposes). See also Estate of Kanter v. Comm’r, 337 F.3d 833 (7th Cir. 2003) (son was treated for income tax purposes as grantor of trusts purportedly established by his mother where son funded trusts).

2. **Retained Beneficial Interest in Donor.**
   a. **Statutory Provision—Section 2036(a)(1).** The gross estate includes the value of all property to the extent the decedent:
      - Has made a transfer other than a bona fide sale for a full and adequate consideration;
      - Under which he has “retained” the possession or enjoyment of, or the right to the income from the property;
      - For his life or for any period not ascertainable without reference to his death (example: income quarterly for life but income in the quarter of his death will not be paid) or for any period which does not in fact end before his death (example: retain income for five years and donor dies within that five year period).
   
   b. **Only Donative Transfers Are Subject to Section 2036.** Transfers for full and adequate consideration are not subject to Section 2036. If one donor creates a trust and another person sells assets to that trust for full and adequate consideration, the person who sold assets to the trust will not be subject to section 2036, regardless who serves as trustee of the trust.

In Pierre v. Commissioner, T.C. Memo 2010-106, the court determined (1) that the step transaction doctrine applies to aggregate the gifts and sales made to each trust on the same day within moments of each other (50% combined interest transferred to each trust) for valuation purposes (although this determination had the negligible effect of merely reducing the lack of control discount from 10% to 8%). A possible risk of this type of reasoning is that the IRS might argue that the entire
transaction of a gift to create a trust and a subsequent sale to that trust should be collapsed into a single transaction for §2036 purposes. If so, the IRS might argue that the combined transfer is treated as a transfer for less than full and adequate consideration with a retained interest (i.e., the note payments), so that the sale portion of the transaction no longer qualifies for the “bona fide sale for full consideration” exceptions to §2035 and §2036. That is a huge step from what the court did in Pierre, and perhaps the IRS will never even make that argument let alone find a court receptive to it. Query whether the risk is reduced if the initial gift is not the same asset that is being sold; it may be harder to collapse those separate transactions involving separate assets (perhaps unless the gift asset is used as downpayment for the sale transaction). However, the downside risk is so great that it makes sense to take steps to avoid the argument, to the extent possible, by delaying the sale transaction for some “appropriate” period of time after the gift.

c. Types of Retained Interests That Cause Estate Inclusion.

(1) Right to Use of Property or Income. A direction that the donor has the right to actual use of trust property or trust income clearly comes within the meaning of the statute, regardless of who is serving as trustee. If there is a retained right to receive only a portion of the income, only that corresponding part of the trust is included in the estate. Treas. Reg. § 2036-1(a)(last paragraph).

(a) Implied Understanding. The statute also applies if there is an implied understanding that the settlor will be allowed to use or receive income from the transferred property. The implied agreement may be “an understanding, express or implied, that the interest or right would later be conferred.” Treas. Reg. § 20.2036-1(c)(1). For example, section 2036 was applied on the basis of an implied agreement where the trustee merely had the discretion to make distributions to the settlor and others, but in fact distributed all of the income to the settlor for his lifetime. Estate of Skinner v. U.S., 316 F.2d 517 (3d Cir. 1973) See Estate of Paxton v. Comm’r, 86 T.C. 785 (1986) (donor transferred almost all assets to trust). The latest battleground for this IRS attack is with family limited partnerships where the donor continues to receive disproportionate distributions whenever the donor (or the donor’s estate) needs cash. E.g., Estate of Liljestrand v. Comm’r, T.C. Memo. 2011-259 (“The existence of an implied agreement is a question of fact that can be inferred from the circumstances surrounding a transfer of property and the subsequent use of the transferred property”); Estate of Strangi v. Comm’r, T.C. Memo. 2003-145 (“Circumstances that have been found probative of an implicitly retained interest under section 2036(a)(1) include transfer of the majority of the decedent’s assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement”), aff’d, 96 AFTR2d 2005-5230 (5th Cir. 2005); Kimbell v. U.S., 91 AFTR 2d 2003-585 (N.D. Tex. 2003) (“the circumstances surrounding the establishment of the partnerships show that, at the time of the transfer, there was an implied agreement or understanding that decedent would retain the enjoyment and economic benefit of the property he had transferred”), rev’d 371 F.3d 257
The IRS has made the implied understanding argument in a multitude of cases, with varying results. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 160-169 (2002); Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001).

(b) Continued Use of Residence. Estate inclusion under Section 2036 has been argued in many cases involving continued use of a transferred residence by the donor. The cases have generally tended to require more than just continued possession of a residence in order to find that an agreement existed at the time of the transfer. See Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001). In fact, the IRS concedes that continued co-occupancy for interspousal transfers will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 78-409, 1978-2 C.B. 234; Ltr. Rul. 200240020. However, the IRS is not as lenient where the residence is given to family members other than the spouse. E.g., Estate of Trotter v. Comm’r, T.C. Memo. 2001-250.

Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. Estate of Wineman v. Comm’r, T.C. Memo. 2000-193 (2000). Co-tenants are each entitled to nonexclusive possession rights, so can the donor continue to live in the residence because of his or her retained undivided co-tenancy interest? Stewart v. Comm’r, 617 F.3d 148 (2d Cir. 2010) involved a situation where mother and son both co-occupied a residence. Mother made transfers of an undivided interest in the residence to the son and they both continued living there. The court (over a strong dissent) stated that “co-occupancy of residential premises by the related donor and donee is highly probative of the absence of an implied agreement.” The court suggested a test for residential premises, providing that if there is both “continued exclusive possession by the donor and the withholding of possession from the donee,” §2036(a)(1) will apply. The court suggested strongly that §2036(a)(1) would not apply if there is continued occupancy by both owners.

In Estate of Tehan, T.C. Memo 2005-128, the IRS included the value of the decedent’s condominium ($275,000) in his gross estate under §2036 even though he had transferred the condo to his children in a series of three fractional gifts during three years prior to his death. The decedent had an agreement that as long as he owned any interest in the home, he would pay all of the expenses in return for the exclusive rights to use and occupy the property. However, that arrangement was continued for the two months after the decedent had transferred his entire interest up to his death. The
IRS argued that the following facts proved the existence of a retained interest: The decedent retained possession of the condo, paid all expenses (even as the children's percentage ownership increased to 35%, then 72%, then to 100%), did not pay any rent, and at trial it was established that the children would not have evicted him even if he had not paid expenses.

(c) Payment of Rent by Donor. If the donor retains use of the transferred property under a lease agreement that provides for fair rent, it is not clear whether Section 2036 applies. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 162-163 (2002); Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor's estate. However, the trend of the cases is not to apply section 2036 where adequate rental is paid for the use of the property. E.g., Estate of Barlow v. Comm'r, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); Estate of Giselman v. Comm'r, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. E.g., Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. See Tech. Adv. Memo. 9146002 (Barlow distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. E.g., Estate of Du Pont v. Comm'r, 63 T.C. 746 (1975).

The Tax Court rejected the Barlow approach in a case where the decedent did not pay fair rental value. In Disbrow v. Comm'r, T.C. Memo 2006-34, the decedent transferred her residence to a partnership comprised of herself and family members for no consideration. (She subsequently gave her 28% interest in the partnership to the other partners.) There was an agreement that decedent would continue to live in the residence, and there was a formal lease agreement. However, the court determined that the decedent did not pay fair rental value to the partnership for the residence.

"While the presence of a lease may sometimes lead to a finding of a lack of retention for purposes of section 2036(a)(1), see, e.g., Estate of Barlow v. Commissioner, 55 T.C. 666 (1971) (possession and enjoyment of real property pursuant to a lease was not a retention of the possession or enjoyment of the property for purposes of section 2036(a) where the tenant paid FRV), such is not true where, as here, the tenant pays less than FRV as to the lease of the property. Decedent's rights under the lease agreements to the exclusive possession and enjoyment of the
residence triggers the application of section 2036(a)(1) to the residence in that decedent did not pay FRV for that possession and enjoyment.”

The court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons. (1) The partnership was not a business but was a testamentary device whose goal was to remove the residence from the decedent’s estate. (2) The decedent’s relationship to the residence was not treated by either the decedent or the partnership as that of a tenant to leased property (payments were frequently late, the partnership never sent late notices or accelerated payments, rent was set at an amount under fair rental value that was considered necessary to maintain the residence). (3) The residence transfer occurred when decedent was almost 72 years old and in poor health, and after decedent’s death the partnership never sought to rent the residence but sold the residence to a family member for less than full market value. (4) The donees wanted decedent to continue to reside in the residence as long as she wanted. (5) Decedent transferred the residence to the partnership on advice of counsel to minimize estate taxes. The court rejected the estate’s contention that the rent was fair rental value because she shared the residence with others. The court reasoned that there was no credible evidence that anyone other than the decedent could use the residence without her consent.

(2) **Payment of Grantor’s Debts.** The grantor is treated as having retained the “use, possession, right to income, or other enjoyment” of property to the extent that such interest is to directed to be applied toward the discharge of legal obligations of the decedent (regardless who is the trustee). Treas. Reg. § 2036-1(b)(2); *Hooper v. Comm'r*, 41 B.T.A. 114 (1940).

(3) **Support of Dependents.** If the trust directs the trustee to make payments in support of the grantor’s dependents, Section 2036(a)(1) applies. Treas. Reg. § 2036-1(b)(2). However, if the trust merely directs the payment of income to a person whom the donor is obligated to support, Section 2036(a)(1) does not apply if the grantor’s support obligation would continue, because the income distribution in that situation would not benefit the grantor. See *Colonial-American Nat’l Bank v. U.S.*, 243 F.2d 3112 (4th Cir. 1957). For example, the IRS has ruled that a trust requirement that required the trustee to consider the beneficiary’s other resources would avoid Section 2036(a)(1) if the other resources included the support obligation of the grantor. Ltr. Rul 8504011. Similarly, if a trust requires that all income be distributed to a grantor’s dependent, but states that the beneficiary “should” use the income for his maintenance and support, Section 2036(a)(1) is not triggered unless local law provides that receipt of the income by the beneficiary discharges the donor’s legal support obligation. *Wishard v. U.S.*, 143 F.2d 704 (7th Cir. 1944).

Even if a trust provides for distributions in support of the grantor’s dependent, once the grantor no longer has the obligation to support the trust beneficiary (such as when the dependent reaches the age of majority), Section 2036 would cease to apply. The retained right would not have continued for a period that
does not in fact end before the grantor’s death. Estate of Pardee v. Comm’r, 49 T.C. 140 (1967).

d. Settlor as Totally Discretionary Beneficiary. Two different phrases/words in the statute suggest that naming the grantor as a beneficiary in the trustee’s discretion might not trigger Section 2036. First, the statute refers to the grantor keeping a “right to” income. Second, the statute requires that the grantor “retain” the income interest. As to the first argument, the legislative history indicates that the substitution of the phrase “right to the income” in 1932 was meant to broaden, not restrict the reach of Section 2036(a)(1) and to extend it to cases where the grantor had the right to income but did not actually receive it. See Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 56 (2002). The second argument does lend a credible argument that a totally discretionary interest might not be subject to Section 2036(a)(1). Professor Dodge lists four exceptions to the “general rule that discretionary trusts for the settlor are not included under §2036(a)(1):

- Where there was an agreement or understanding that the transferor would receive the income. Such an agreement may sometimes be inferred from the fact that the transferor in fact received (all of) the income. (See section II.B.2.c.(1)(a) of this outline, above.)

- Where, under the law of creditor’s rights, the settlor’s creditors can reach the trust income to pay the transferor’s debt. (See Section II.B.2.d.(1) of this outline, immediately below.)

- Where the settlor is herself trustee of such a discretionary trust. (See Section II.B.2.f. of this outline, below.)

- Where the trustee’s discretion is limited by a standard that can be enforced by the settlor-beneficiary. See Blunt v. Kelly, 131 F.2d 632 (3d. Cir. 1941) (“support, care or benefit”); Estate of John J. Toeller, 165 F.2d 665 (7th Cir.1946) (“misfortune or sickness”); Estate of Boardman v. Comm’r, 20 T.C. 871 (1953), acq. 1954-1 C.B. 3 (trust provided distributions for grantor “as the trustee deems necessary for her comfort, support and/or happiness”; held that these standards—especially “happiness”—gave grantor an enforceable right to demand income distributions and caused inclusion under Section 2036); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 57 (2002).

(1) Includible if Settlor’s Creditors Can Reach Trust Assets. If the donor’s creditors can reach the trust assets, because of the potential discretion to distribute assets to the donor, Section 2036(a)(1) would apply. UNIF. TRUST CODE §505 (2000) (settlor’s creditors can reach whatever “can be distributed to or for the settlor’s benefit”); RESTATEMENT (THIRD) OF TRUSTS § 60, Comment f (if settlor is discretionary beneficiary, creditors can reach maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor”); Rev. Rul. 77-378, 1977-2 C.B. 347 (gift complete, even though trust assets were distributable to settlor in trustee’s complete discretion, where donor’s creditors could not reach trust assets); Rev. Rul. 76-103, 1976-1 C.B. 293 (gift incomplete, where trust assets were
distributable to settlor in trustee’s complete discretion and where donor’s
creditor could reach trust assets; also trust assets included in donor’s estate
under § 2038 because of donor’s control to terminate the trust by relegating the
grantor’s creditors to the entire trust property; Estate of Uhl v. Comm’r, 241
F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive
additional payments in discretion of trustee; only trust assets needed to produce
$100 per month included in estate under §2036(a)(1) and not excess because of
creditor’s lack of rights over other trust assets under Indiana law); Outwin v.
Comm’r, 76 T.C. 153 (1981) (trustee could make distributions to settlor in its
absolute and uncontrolled discretion, but only with consent of settlor’s spouse;
gift incomplete because settlor’s creditors could reach trust assets, and dictum
that grantor’s ability to secure the economic benefit of the trust assets by
borrowing and relegating creditors to those assets for repayment may well
trigger inclusion of the property in the creditor’s gross estate under Sections
2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985)
(denied IRS’s motion for summary judgment, apparently based on §2036(a)(1),
because settlor’s creditors could not reach trust assets where trustee could
distribute assets to grantor in trustee’s uncontrolled discretion, but only with
the consent of the remainder beneficiary of the trust and a committee of
nonbeneficiaries).

(2) “Alaska Trusts”. Some states (Alaska was the first) have amended their trust
and creditor laws to provide that creditors cannot reach trust assets merely
because the trustee may, in its discretion, make distributions to the settlor, if
certain procedural requirements are satisfied. At least thirteen states have
adopted varying approaches regarding “self-settled spendthrift trusts”: Alaska,
Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio (the most recent
state to adopt a self-settled trust statute), Rhode Island, South Dakota,
Tennessee, Utah, Virginia, and Wyoming. (In addition, Oklahoma law
provides that the a settlor’s creditors cannot reach the assets of a
revocable trust up to $1 million established for the settlor’s spouse,
descendants or charities, but this does not recognize “self-settled trusts”
because the settlor cannot be a beneficiary of that trust.) See section I.D. of
this outline. A trust that meets those requirements apparently could include
the donor as a beneficiary without causing estate inclusion, but there is no IRS
ruling acknowledging this result. See Letter Ruling 200944002 (naming settlor
as discretionary beneficiary of Alaska trust did not automatically trigger §2036
but IRS refused to give a ruling that §2036 absolutely did not apply, leaving
open possibility of arguing that there was an implied agreement or
understanding of retained enjoyment and access to the trust assets whenever
desired; IRS has informally indicating that it is no longer issuing even the
limited guidance that was given in this letter ruling). However, it is not clear
that a person living in another state, who creates a trust governed by the laws of
one of those states, would necessarily be exempted from creditors claims in the
state of domicile.

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Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust.

Choosing the laws of a “self-settled trust state” as the governing law for the trust, however, provides no absolute protection if the settlor does not reside in that state or unless the trust otherwise has significant contacts with that state. The settlor’s state of domicile may refuse to recognize the asset protection features of the trust on public policy grounds. The state of the settlor’s residence may assert that public policy prevents using an asset protection trust in another state. See Huber v. Huber, 2013 WL 21454218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor’s or trustee’s domicile, the location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument’s designation of Alaska law is disregarded under the principles of §270 of the Restatement); In re Herbert M. Zukerhorn, BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

(3) Section 2036 Concerns. Creating the trust under the laws of a self-settled trust state can help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor’s spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). See Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor’s worries.

Another possible strategy is for the trust to specify that an independent trust protector could add the grantor as a beneficiary, but only if the grantor’s net worth became less than a specified amount.

Private Letter Ruling 200944002 addressed an Alaska trust and recognized that the “trustee’s authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor’s gross estate under §2036” as long as state laws provide that including the grantor as a discretionary
beneficiary does not cause the trust to be subject to claims of the grantor’s creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor “combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust’s assets in Grantor’s gross estate for federal estate tax purposes under §2036.” For a general discussion of this ruling, see Shaftel, “IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts,” 112 J. TAX’N 213 (April 2010); Rothschild, Blattmachr, Gans & Blattmachr, “IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor’s Estate,” 37 EST. PL. 3 (Jan. 2010). Beginning in late 2011, the IRS has told other parties requesting similar rulings that it is not willing to issue further similar rulings. According to counsel, the Service’s unwillingness to rule is not attributable to family exceptions or other differences under the laws of other states. Rather, the Service appears to be troubled by commentary about the Mortensen Alaska bankruptcy case. Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska “self-settled trust” under the 10-year “clawback” provisions of §548(e) of the Bankruptcy Act. The agents at the Service said that PLR 200944002 probably wouldn’t have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor’s creditors. For further discussion of those cases and §2036 issues surrounding the use of self-settled trusts, see Item 5.l of the author’s December 2012 “Estate Planning Current Developments and Hot Topics” (available from the author).

(4) Potential Incomplete Gift Issue. Some planners have expressed concern that the IRS might take the position that the gift is an incomplete gift, because of the possibility (perhaps, however remote) that creditors might be able to reach the assets. E.g., Outwin v. Comm’r, 76 T.C. 153, 162-65 (1981)(gift to trust incomplete if creditors can reach trust assets); Herzog v. Comm’r, 116 F.2d 591 (2d Cir. 1941)(gift to trust is completed gift if state law provides that settlor-beneficiary’s creditors could not reach the trust corpus or income). The Illinois Supreme Court recently held that a decedent’s creditors could reach assets that had been transferred to a Cook Islands trust. Rush University Medical Center v. Sessions, 2012 Ill. 112906 (2012). That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction’s law should apply under relevant conflict of laws principles, but held that the state’s passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In Rush University, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about
having to enforce the judgment in the Cook Islands. That case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have “self-settled trust” legislation.

(5) **Grantor Trust Under Section 674(a).** Income tax effects of trustee selection are covered in a later section of this outline. However, be aware that if the grantor is a potential beneficiary, the trust will be a grantor trust, unless the consent of an adverse party is required before a distribution may be made to the grantor. I.R.C. §674(a). The mere possibility that income may distributed in satisfaction of the grantor's legal obligation of support does not cause grantor trust treatment—the income is taxed to the grantor only to the extent that income is actually distributed in satisfaction of the grantor’s support obligation (other than to the grantor's spouse.) I.R.C. § 674(b).

e. **Transfer to Spouse With a Potential of Having Spouse Appoint the Assets Back to Grantor.** If the grantor gives property in trust for his spouse (or anyone else), and gives the beneficiary of the trust an inter vivos or testamentary power of appointment to appoint the trust assets to anyone, including the grantor (but not to the beneficiary, his estate, his creditors, or the creditors of his estate), does the grantor have to include the assets in his estate under Section 2036(a)(1) because of the possibility of receiving the assets back from the trust? (The gift effects of this transfer will also be addressed in light of the unique nature of this type of transfer.)

(1) **Completed Gift for Gift Tax Purposes.** Despite the fact that the property may eventually be returned to the donor, the transfer is a completed gift, because the donor has so parted with dominion and control as to leave him in no power to change its disposition whether for his own benefit or for the benefit of another. Reg. § 25.2511-2(b). Also, the donor has retained no power to re vest beneficial title to the property in himself, which also makes a gift incomplete. Reg. § 25.2511-2(c). Letter Ruling 9141027 held that a transfer to an irrevocable trust for the donor's spouse was a completed gift even though the spouse had a special testamentary power of appointment to appoint the assets to a trust for the benefit of the donor, and even though the IRS found that an implied agreement existed between the spouses that the donee spouse would in fact execute a codicil to her will appointing the trust assets to a trust for the benefit of the donor. However, to assure that the initial transfer is treated as a completed gift, there should be no express or implied agreement regarding the exercise of the power of appointment.

Furthermore, if a creditor of the donor could reach the trust assets, the gift would be incomplete. Until the power of appointment is exercised appointing some interest in the property to the creditor, a creditor arguably would have no rights in the trust property. However, if the spouse holds an inter vivos power of appointment and if the donor's creditor is also a creditor of the spouse, underlying state law may afford creditors rights to the property, since the spouse would have the current power to appoint the property in a manner that would satisfy the donor's and spouse's creditors. To avoid this argument, the
spouse should not hold an inter vivos power of appointment, or at least should be restricted from the appointing the property in a manner that would have the effect of satisfying the spouse’s creditors.

(2) **Application of Section 2702.** If the gift is complete, does §2702 apply in valuing the gift? Section 2702 should not apply, because the spouse will not have held an interest in the transferred property, both before and after the transfer. Ltr. Rul. 9141027.

(3) **Inclusion in Spouse’s Estate.** Whether the trust is included in the spouse’s estate depends on whether, under traditional planning principles, the spouse has a power over the trust that is taxable under Section 2041. Two letter rulings in 1991 addressed situations in which the donee-spouse had a power of appointment to appoint the trust property back to the donor. In Letter Ruling 9140068, the transfer was to an inter vivos QTIP trust, and the trust assets were includible in the donee spouse’s estate under Section 2044. In Letter Ruling 9141027, the transfer was to a trust that was not included in the spouse’s estate. Letter Ruling 9128005 involved an outright transfer from husband to wife, where the wife, on the same day as the gift, executed a codicil leaving the property back to a trust for the husband if she predeceased him. The property was obviously included in her gross estate.

(4) **Inclusion in Donor’s Estate.** The main issue is whether the trust assets are included in the donor’s gross estate, (1) if the donor predeceases the spouse, or (2) if the spouse predeceases and in fact appoints the trust property to a trust for the benefit of the donor.

Section 2036(a)(1) includes in a decedent’s gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise, under which the decedent has retained for the decedent’s life or for any period which does not in fact end before the decedent’s death the possession or enjoyment of, or the right to the income from the property. Has the donor retained an interest in the trust, if the spouse must later exercise the power to leave the assets back to the donor? Regulation §20.2036-1(c)(1) provides that an interest or a right is treated as being retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.

The regulations address such a contingency with respect to Sections 2038 and 2036(a)(2), dealing with powers that the donor could regain upon the occurrence of contingencies, but does not address the effect of such a contingency under Section 2036(a)(1), which is the relevant section. Reg. §§20.2036-1(a)(3) & 20.2036-1(b)(3).

This issue is receiving increased attention by planners. The IRS might argue that §2036 could apply in the donor spouse’s estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse
bequeaths the property back into a trust for the benefit of the original donor spouse.

See Estate of Skifter v. Comm’r., 56 T.C. 1190, at 1200 n.5 (1971), aff’d 468 F.2d 699, 703 (2d Cir. 1972)(life insurance policy transferred to wife and bequeathed back to trust for husband with husband as trustee at wife’s death not includible in husband’s estate under §2042, reasoning that §§2036 and 2038 would not have applied if an asset other than a life insurance policy had been the subject of the transfer; Tax Court and circuit court both emphasized that if the transfer and bequest were part of a prearranged plan, estate inclusion would have resulted, noting that the bequest back to the husband was made “long after he had divested himself of all interest in the policies”); Estate of Sinclaire v. Comm’r, 13 T.C. 742 (1949)(predecessor to §2036 and 2038 applied where decedent gave assets to her father, who transferred the assets the following day to a trust providing decedent with a life interest and power to appoint the remainder interests); Rev. Rul. 84-179, 1984-2 C.B. 195 (§2036 did not apply because decedent’s transfer to the donee and the bequest back to the decedent in trust were unrelated and not part of a prearranged plan); Gen. Couns. Mem. 38,751 (June 12, 1981) (indication that step transaction doctrine will be applied if the decedent’s transfer and the donee’s bequest for the benefit of the decedent were part of a prearranged plan, and in particular that cases where the donee’s transfer occurs shortly after the decedent’s initial transfer would invoke the doctrine); see generally Gans, Blatmaehr & Bramwell, Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?, 42 REAL PROP., PROB. & TR. J. 413, 432-33 (2007). To the extent possible, structure the transfer to remove the inferences of such an implied agreement (by allowing the passage of time, not transferring all assets, having the donee-spouse actually exercise a power of appointment rather than just allowing assets to pass back into trust for donor under trust default provisions, etc.).

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse’s estate under §2044.

Summary of Potential Application of §2038. Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, the donee spouse must be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

In addition, realize that if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if there was no implied agreement of how the donee-spouse would exercise the power of appointment at the time of the original transfer. While various
cases that have held that assets in a trust that can be reached by the donor’s creditors are in the donor’s gross estate under §2036 [e.g., Estate of Paxton v. Comm’r, 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. E.g., Outwin v. Comm’r, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor’s spouse; gift incomplete because grantor’s creditors could reach trust assets, and dictum that grantor’s ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor’s gross estate under §§2036(a)(1) or 2038(a)(1)).

Summary of Potential Application of §2036. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. Prof. Jeffrey Pennell’s conclusion: “I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036.” However, the creditors right issue may raise potential inclusion issues under §2036.

Various other possible restrictions would help bolster the argument that the spouse’s power of appointment would not cause an estate inclusion problem for the donor. The actual exercise of the power, or even more conservatively, the manner in which the power of appointment could be exercised in favor of the donor-spouse, could be limited in the following possible ways. The appointment for the donor could be limited to payments for the health, support and maintenance of the donor. (Observe, however, that there are no cases suggesting an ascertainable standard exception for Section 2036(a)(1) like there are for Sections 2036(a)(2) and 2038.) Additionally, the permissible trust could require that distributions could be made to the grantor only after other income and assets of the donor had been exhausted, so that A’s creditors could not reach the property. See Covey, Current Developments, 1992 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 115.8.

If case law subsequently becomes clear that the mere existence of the power causes estate inclusion problems for the original donor, the donee-spouse could release the power of appointment, but the release would have to occur more than 3 years before the donor’s death under section 2035.

Creditor Rights Issue. A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a “self-settled trust” and subject to claims of the donor’s creditors. This would seem to turn on what has been called the “relation back doctrine.” The creditor under the Relation Back Doctrine could argue: (i) the exercise of a special power of appointment constitutes a transfer “from the donor of the power, not from the donee,” Restatement (First) of Property §318 comment (b) (1940)); and (ii) the power of appointment is “conceived to be
merely an authority to the power holder to do an act for the creator of the power,” American Law Institute, Donative Transfers vol. 2 §§ 11.1-24.4, in Restatement (Second) of Property 4 (1986). However, “none of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ....” Barry Nelson, Asset Protection & Estate Planning – Why Not Have Both?, at 15-11 2012 Univ. Miami Heckerling Inst. on Est. Planning ch. 17, ¶ 1701.2[B] (2012). See Alexander Bove, Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined, 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, “Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder’s discretionary exercise of a power of appointment, but it is a risk”). See also Watterson v. Edgerly, 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband’s creditors under the trust spendthrift clause).

At least seven states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, Ohio, Texas and Wyoming. The Arizona, Ohio, and Texas statutes also address the issue for all inter vivos trusts initially created for the donor’s spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. Ariz. Rev. Stat. §14-10505(E-F); Ohio Rev. Code §5805.06(B)(3)(a); Tex. Prop. Code §112.035(d)(2),(g)(effective September 1, 2013).

Gross Estate Inclusion Because of Creditor Rights? If the donor’s creditors can reach the trust assets, that would cause inclusion in the donor’s estate for estate tax purposes under §2036 if the IRS could establish the existence of an implied agreement that the spouse would exercise the limited power of appointment to appoint the assets into a trust for the donor’s benefit, which creates the creditor’s rights problem. However, at least one case (Outwin v. Comm’r, 76 T.C. 153 (1981)) also states that §2038 could apply if the donor’s creditors can reach the trust assets, and §2038 does not require an implied agreement of a retained interest at the time the gift is originally made, but only looks to conditions that exist at the donor’s death. Accordingly, it may be important to exercise the limited power of appointment to establish a new trust in a “self-settled trust state” or a state that has passed a law similar to the Arizona, Ohio and Texas statutes discussed above. However, even using a “self-settled trust state” for the new trust provides no absolute protection; the donor’s state of domicile may refuse to recognize the asset protection features of the new trust on public policy grounds. The state of the donor’s residence may assert that public policy prevents using an asset protection trust in another state. See Huber v. Huber, 2013 WL 21454218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor’s or trustee’s domicile, the
location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument’s designation of Alaska law is disregarded under the principles of §270 of the Restatement); In re Herbert M. Zukerhorn, BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

(5) **Summary.** Giving the donee-spouse a testamentary power of appointment to appoint the assets back to the donor or to a trust for the benefit of the donor should not create inclusion problems for the donor as long as there is no express or implied agreement that the spouse would exercise the power of appointment for the donor. Do not have the spouse sign a new will exercising the power of appointment for some period of time. Make sure that the spouses understand that there really is no preconceived plan of whether the power of appointment will be exercised, but that it is just included to provide helpful flexibility. Other restrictions, discussed above, that could be added would help bolster a non-inclusion argument, but should not be necessary.

f. **Effect of Trustee Selection on Retained Right to Income.**

(1) **Grantor as Trustee.** If the grantor is the trustee with the power to make distributions of income to the grantor, to make payments in satisfaction of the grantor's obligations, or in satisfaction of the grantor’s support obligations, Section 2036(a)(1) applies. That is the case even if there are no directions to make distributions for the “support” of the grantor’s dependents but merely the discretion to make distributions to dependents. See *Helfrich Estate v. Comm’r*, 143 F.2d 43 (7th Cir. 1944); Ltr. Rul 9122005. The same rule applies if the decedent reserved the power to name himself as the trustee. *Estate of McTighe v. Comm’r*, 36 T.C.M. 1655 (1977) (estate inclusion under Section 2036 where decedent reserved the power to substitute himself as trustee and the trustee retained the right to apply the trust income to satisfy his obligation to support the beneficiary).

What if the grantor can name himself as trustee only if an event outside his control occurs (for example, when a vacancy occurs)? That would clearly still cause inclusion if the issue is a power to control enjoyment of the property under Section 2036(a)(2), but the answer is not totally clear if the issue is whether there is a retained beneficial interest under Section 2036(a)(1). There is a regulation to Section 2036(a)(2) making clear that the contingent power to become trustee is problematic (Treas. Reg. § 20.2036-1(b)(3)), but there is no similar statement in the regulation to Section 2036(a)(1). The primary issue is the retention issue—has the grantor retained the right when he has no control over whether it arises—and that issue should be the same for subsections (a)(1) and (a)(2) of Section 2036. See *Estate of Farrell v. U.S.*, 553 F.2d 637 (Ct. Cl. 1977) (analysis of situation involving Section 2036(a)(2), but analysis repeatedly referred just to Section 2036(a), without making a distinction for (a)(1) and (a)(2)).
(2) **Third Party as Trustee—General Rule.** As discussed above, if the trust directs that income be distributed to the grantor, be applied to discharge the grantor's debts, or to provide for the support of the grantor's dependents, Section 2036(a)(1) is triggered, regardless of who is serving as trustee. However, if the trust instrument gives the trustee discretion in making such distributions, Section 2036(a)(1) may be avoided if there is a third-party trustee.

(3) **Third Party as Trustee—Discretion to Make Payments for Support of Grantor's Dependents.** If the trust instrument directs distributions under standards (such as “comfort” or “welfare”) other than support or maintenance of the dependent, Section 2036(a)(1) is not triggered if there is a third party trustee. Rev. Rul 77-60, 1977-1 C.B. 282. For example, in *Gokey v. Comm'r*, 72 T.C. 721 (1979), a trust for the donor's child's “support, care, welfare, and education” was held to be included in the estate under Section 2036(a)(1), under the reasoning that under local law, the last three terms referred to the child's accustomed standard of living, and merely restated the concept of support. Furthermore, if payments for support are left up to the trustee's discretion, Section 2036(a)(1) should not apply, because no one can compel the distributions and the grantor has therefore not “retained” the right to the distributions. *Commissioner v. Douglas*, 143 F.2d 961 (3d Cir. 1944); *Chrysler Estate v. Comm'r*, 44 T.C. 55 (1965), *acq. in result*, 1970-2 C.B. xix, *rev'd on other issues*, 361 F.2d 508 (2d Cir. 1966). Even a close relative as trustee can have the discretion to make distributions for support of the grantor's dependents without triggering Section 2036(a)(1). *Mitchell Estate v. Comm'r*, 55 T.C. 576 (1970), *acq.*, 1971-1 C.B. 2. However, the trustee’s discretion must extend to whether distributions for support should be made at all, and not merely as to when or how much should be distributed. *See Richards v. Comm'r*, 375 F.2d 997 (10th Cir. 1967) (distributions for settlor’s wife’s support and maintenance “at such times as the trustee in its sole discretion shall determine”; assets includible under Section 2036); Ltr. Rul. 8504011.

(4) **Third Party as Trustee—Discretion to Make Income Distributions to Grantor.** If there are enforceable standards, which the grantor could enforce to require income distributions, Section 2036 applies even if there is an independent trustee. Even if the trustee has total discretion to make distributions to the grantor, the trust assets will still be includible under Section 2036 if the grantor's creditors can reach the trust assets under applicable state law. If the trust is established in a manner that the grantor's creditors cannot reach the trust assets (i.e., it is created in a state that allows self-settled spendthrift trusts, such as Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming AND if the state of the grantor's domicile will recognize such spendthrift protection as to creditors claims arising in the state of domicile), Section 2036(a)(1) probably will not apply to the trust. See Section II.B.2.d.(2-3) of this outline. However, even in that case, the IRS may, in a last ditch effort, argue for estate inclusion in extreme cases where the third party is controlled by the grantor's domination, or where there is an implied agreement or understanding.

(5) **Nature of Relationship of Third Party Trustee to Grantor.**
(a) **Close Relationship of Grantor to Trustee.** A variety of cases have recognized that a grantor did not retain a power held by a trustee, “just because the trustee is the settlor’s wife, young daughter, or golfing companion, or because the trustee tends to follow the settlor’s wishes in exercising discretion.” Dodge, *Transfers with Retained Interests and Powers*, 50-5th T.M. at 159 (2002). An example is *Estate of Beckwith v. Comm’r*, 55 T.C. 242 (1970). In that case, the IRS contended that a variety of factors enabled the grantor to control the flow of income from the trust, including “close business relationships between the settlor and the individual trustees.” The court rejected that position. 55 T.C. at 248-249.

(b) **De Facto Control.** A few cases, in extreme circumstances, have suggested that a grantor is treated as holding powers of a third party trustee where the grantor actually controlled the trustee’s actions. See *Estate of Klauber v. Comm’r*, 34 T.C. 968 (1960) (reviewed)(dictum); see also Tech Adv. Memo. 9043074 (grantor controlled institutional trustee). However, courts have generally been reluctant to attribute powers of a trustee to the grantor. In an early case, the court refused to include assets in the settlor’s estate where the trustee in its discretion could make distributions to the settlor’s minor child, specifically rejecting notion that a court should presume that a trustee would do what the settlor asked of him:

> “The Commissioner's argument that these trustees would be likely to do what he asked of them about assigning income for the support of a minor child departs from the 'practical' and 'realistic' approach we are asked, in the same argument, to take. We have no notion what the trustees would have done had such a request been made. It is apparent, from the terms of the instrument, that the settlor could not direct or control the matter, once the trust settlement had become effective.” *Comm’r v. Douglass Estate*, 143 F.2d 961 (3rd Cir. 1944).

In *Estate of Goodwyn v. Comm’r*, T.C. Memo. 1973-153, the grantor at all times, with the acquiescence of two attorneys serving as trustees, made all decisions regarding the administration of the trust including distributions. Despite that fact scenario, the court concluded that the grantor did not retain the right to designate who could receive distributions to cause estate inclusion under §2036(a)(2). The court in Goodwyn based its reasoning largely on the U.S. Supreme Court case *United States v. Byrum*, 408 U.S. 125, 136-37 (1972), which held that the term “right” as used in §2036(a)(2) refers to “an ascertainable and legally enforceable power.” If the trust allows distributions in the total discretion of the trustee, it will be difficult to show a violation of the trustee’s fiduciary duties. See *McCabe v. U.S.*, 475 F.2d 1142 (Ct. Cl. 1973) (no estate inclusion even though trustee ignored interests of beneficiaries other than settlor). “In sum, the de facto control issue may be essentially dead.” Dodge, *Transfers with Retained Interests and Powers*, 50-5th T.M. at 159 (2002).
A recent federal district court has again resurrected the de facto trustee argument. SEC v. Wyly. 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) was a securities law violation case in which the court determined that the amount of disgorgement would be based in part on the income taxes that the defendants avoided by an offshore trust structure. Trust protectors had the power to remove and replace independent trustees located in the Isle of Man. The court determined that the settlers controlled all decisions for the trust, by expressing their “recommendations” to trust protectors who relayed those recommendations to the trustee, who always did as instructed. The court determined that the independent trustee exception to the grantor trust rules under §674(c) did not apply because the settlers in fact controlled all decisions. The court acknowledged Estate of Goodwyn, T.C. Memo 238 (the same fact situation as in the prior Goodwyn case discussed above), which applied the independent trust exception to §674(c), even though the grantors in fact made all decisions, because §674(c) refers to “an ascertainable and legally enforceable right, not merely the persuasive control which [the grantor] may exercise over an independent trustee who is receptive to his wishes.” The court disagreed with that analysis, with strong language that conceivably could be extended broadly to other contexts:

I disagree. “Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that ‘tax law deals in economic realities, not legal abstractions.” [citing PPL Corp. v. C.I.R., 133 S.Ct. 1897, 1905 (2013) (quoting CIR v. Southwest Exploration Co., 350 U.S. 308, 315 (1956))]. As Professor Danforth, the defendants’ own expert, writes in his treatise, “[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person.” The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.

The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities; making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts [with their nominal foreign grantors], the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus “distributing” income for a beneficiary at the direction of the grantors—the Wylys.
(c) **Implied Agreement or Understanding.** See section II.B.2.c.(1)(a) of this outline.

g. **Summary of Trustee Selection Issues With Respect to Retained Beneficial Interests in Donor.** The grantor cannot serve as trustee if there is any possible retained beneficial interest in the donor, or else the trust will be included in the donor’s estate. Similarly, if the donor has any possible beneficial interest, the donor cannot have the power to name himself as successor trustee (even if he could become a successor trustee only if a contingency occurs that is outside his control.)

As to support of dependents, if a third party trustee serves, the trust could authorize distributions to dependents of the donor as long as there is not a standard for distribution tied to support or maintenance of the donor’s dependents. (The more conservative approach is to always prohibit any distributions from a trust that would satisfy the donor’s legal obligation of support, regardless of who is the trustee.)

If there is any possibility for distributing assets to the donor at some point in the future, there must be a third party trustee to have any hope of excluding the trust assets from the donor’s estate. Even then, the trust must give the trustee complete discretion in making distributions to the grantor, the trust must be established in a jurisdiction that allows “self-settled trusts,” and the jurisdiction of the donor’s domicile must recognize the spendthrift protection of the self-settled trust.

A few older cases questioned whether a trustee who has a close relationship to the donor, and who always follows the donor’s directions, can avoid estate inclusion problems under Section 2036(a)(1). However, most cases have refused to apply a “de facto” control analysis. Regardless of who is the trustee, there must be no agreement or understanding with the trustee regarding how the trust assets will be distributed.

3. **Retained Dispositive Powers in Donor.**

   a. **Statutory Provision--Section 2036(a)(2).** The gross estate includes the value of all property to the extent the decedent:

   - Has made a transfer other than a bona fide sale for a full and adequate consideration,

   - Under which he has “retained” the right either alone or in conjunction with any person

   - To designate the persons who shall possess or enjoy the property or the income from the property

   - For his life or for any period ascertainable without reference to his death or for any period which does not in fact end before his death.
b. Statutory Provision—Section 2038. The gross estate includes the value of all property to the extent the decedent:

- Has made a transfer other than a bona fide sale for a full and adequate consideration
- Under which the decedent had at the date of his death (regardless of when or from what source the decedent acquired a power)
- The power (in whatever capacity exercisable), either by the decedent alone or in conjunction with any person
- To alter, amend, revoke, or terminate enjoyment of the property,
- Or where such power is relinquished during the 3-year period ending on the date of his death.

c. Dispositive Powers that Trigger Application.

(1) Sprinkling Power. The power to shift income or trust property among beneficiaries causes inclusion under either Section. *Estate of McManus v. Comm'r*, 172 F.2d 697 (6th Cir. 1949) (predecessor to Section 2036(a)(2)); *Estate of Craft v. Comm'r*, 608 F.2d 240 (5th Cir. 1980) (Section 2038 inclusion where decedent had power to change beneficiaries and change their respective shares). A power to add beneficiaries would cause inclusion. *But see Rev. Rul. 80-255, 1980-2 C.B. 272* (decedent's ability to have more children and add beneficiaries is not a power to change beneficial interests under Section 2038). A power exercisable to change the beneficiaries only in the decedent's will causes inclusion. *Adriance v. Higgins*, 113 F.2d 1013 (2d Cir. 1940) (predecessor to Section 2038); *Marshall v. U.S.*, 338 F. Supp 1321 (D. Md. 1971).

(2) Power to Accumulate. The power to affect only the timing of distributions, and not the beneficiaries who receive distributions, clearly triggers inclusion under Section 2038. *Lober v. U.S.*, 346 U.S. 335 (1953); *Estate of Alexander v. Comm'r*, 81 T.C. 767 (1983) (retained power to accumulate income for distribution every 5 years caused inclusion, even though all income eventually had to be distributed to the income beneficiary). The regulations under Section 2038 state explicitly that “Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected.” Treas. Reg. § 2038-1(a). The regulation illustrates this with an example where grantor has the power to accumulate income or distribute it to A and to distribute corpus to A, even though the remainder is vested in A or his estate. (In the example described in the regulation, it appears that only the value of the remainder interest would be includible under Section 2038, and not the value of the income interest. The grantor would not have the power to change when A receives the income. He would have to wait until the income is earned in any event before he could receive it. *See Dodge, Transfers with Retained Interests and Powers*, 50-5th
A power to accumulate or distribute income causes inclusion under Section 2036(a)(2) where the income beneficiary is different from the remainder beneficiary, because accumulating income may shift the recipient from the income beneficiary to the remainderman. U.S. v. O'Malley, 383 U.S. 627 (1966), rev'g 340 F.2d 930 (7th Cir. 1964). (The briefs in O'Malley indicate that the trust lasted for a term of years. At termination, the trust assets would pass to the income beneficiary if living but if not, to a third party. See R. Stephens, G. Maxfield, S. Lind, & Calfree, Federal Estate and Gift Taxation ¶ 4.08[5][c] n. 54 (6th ed. 1991). If the income beneficiary and the remaindermen are the same (if the assets pass to the income beneficiary's estate or if the income beneficiary holds a general power of appointment), neither the statutory language of Section 2036(a)(2) nor the regulations address whether Section 2036(a)(2) applies. An argument can be made that Section 2036(a)(2) should not apply because a power "to designate the persons who shall possess or enjoy" connotes some ability to choose among multiple "persons." The Tax Court has observed that "while this position is not without a certain superficial appeal, as well as some support from commentators, we conclude that the weight of logic and judicial precedent is to the contrary." Estate of Alexander, 81 T.C. 757 (1983), aff'd in unpub. Op. (4th Cir. 1985). The case cited the following commentators as supporting the opposite result. R. Stephens, G. Maxfield, & S. Lind, Federal Estate and Gift Taxation ¶4.08[5][c] (5th ed. 1983); C. Lowndes, R. Kramer & J. McCord, Federal Estate and Gift Taxes, § 9.20 (3d ed. 1974). Cases have held that Section 2036(a)(2) applies even in the single vested beneficiary situation. Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955) (sole income beneficiary was remainder beneficiary at trust termination; trust contained no provision as to disposition if beneficiary predeceased trust termination; court determined that under state law the beneficiary's interest was vested and that the trust assets would pass to the beneficiary or to the beneficiary's devisees; predecessor to §2036(a)(2) applied); Ritter v. U.S., 297 F. Supp. 1259 (S.D. W. Va. 1968) (single income beneficiary/remainderman; trust assets pass to beneficiary at age 21 or if die before age 21, "to persons appointed by the beneficiary in his will or if there was no will, to the legal representative of the estate of the beneficiary;" held that § 2036(a)(2) applies, relying primarily on O'Malley, which said that the power to deny beneficiaries the "privilege of immediate enjoyment and conditioning their eventual enjoyment upon termination of the trust" is sufficient to invoke § 2036(a)(2)); Estate of Alexander, 81 T.C. 757 (1983), aff'd in unpub. Op. (4th Cir. 1985)(§2036(a)(2) applied where grantor as trustee could accumulate income for sole beneficiary where the beneficiary or her estate was the sole remainder beneficiary); Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970) (child was sole beneficiary and remainderman was child or child's estate; §2036(a)(2) applied to power to accumulate funds). Cf. Joy v. U.S., 404 F.2d 419 (6th Cir. 1968) aff'g 272 F. Supp. 544 (E.D. Mich. 1967) (trust instrument includes contingent remainder if income beneficiary predeceases trust termination). Despite these cases, some commentators continue to believe that Section 2036(a)(2) should not apply to a mere power to accumulate without a power to shift benefits from one person to another. E.g., R. Stephens, G. Maxfield, S. Lind & Calfree, Federal Estate and Gift Taxation ¶4.08[5][c] (6th ed. 1991).
(3) **Power to Invade Corpus.** A power to invade corpus is a power to alter enjoyment under Section 2038. *Estate of Yawkey v. Comm'r*, 12 T.C. 1164 (1949). The power to terminate a trust by acceleration of the corpus distribution causes inclusion under Section 2038. *Lober v. U.S.*, 346 U.S. 335 (1953); *Estate of O'Connor v. Comm'r*, 54 T.C. 969 (1970). Similarly, under Section 2036(a)(2), an unlimited power to invade corpus for the income beneficiary or other beneficiary is subject to Section 2036(a)(2). *See Commissioner v. Holmes*, 326 U.S. 480 (1946).

(4) **Power to Revoke.** Unlike most states, Texas law provides that every trust is revocable unless it explicitly states that it is irrevocable. TEX. PROP. CODE §112.051. Accordingly, a trust established under Texas law must explicitly state that it is irrevocable, or else the trust assets will be included in the estate under Section 2038. *Estate of Hill v. Comm'r*, 64 T.C. 867 (1975), acq. 1976-2 C.B. 2; Tech Adv. Memo. 9032002.

d. **Similarities In Application of Sections 2036(a)(2) and 2038.**

(1) **Triggering Powers.** As discussed in the preceding section, the powers that trigger the two sections are very similar, with a great deal of overlap.

(2) **Joint Powers.** Even though the decedent holds the power jointly with another person, inclusion results under both sections. Unlike the treatment of powers of beneficiaries under Section 2041, or the gift tax treatment of powers held by grantors, whether the person who holds the joint power has an adverse interest is irrelevant under Sections 2036(a)(2) and 2038. *E.g.*, Treas Reg. §20.2036-1(b)(3) (“whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest”).

(3) **Joint Power Holder Can Override Grantor’s Decision.** Even if the joint power holders can override the grantor’s decision (such as where a majority vote controls), both Sections still apply. *See Estate of Yawkey v. Comm'r*, 12 T.C. 1164 (1949).

(4) **Veto Power.** Whether the grantor can act with the consent of another, or whether another person can act with the consent of the grantor makes no difference. Even if the grantor is not the trustee, but merely holds a veto power over actions of the trustee, both Sections would apply if the veto power affects a decision that triggers the Sections. *See Rev. Rul. 70-513, 1970-2 C.B. 194* (only the value of the remainder interest is includible in decedent’s gross estate where the enjoyment of the son’s life estate was not subject to change through exercise of decedent’s reserved power to consent to or veto the trustees’ power to terminate the trust); *Rev. Rul. 55-683, 1955-2 C.B. 603* (predecessor to Section 2038 applied where grantor’s wife could modify or revoke the trust only with the consent of the grantor). The court in *Estate of Carrie Grossman v. Commissioner*, 27 T.C. 707 (1957), noted that “it is irrelevant whether the decedent’s participation initiates the termination, or, as here, is in the nature of a consent after others have set the machinery in motion, it being sufficient under the statute merely that she act ‘in conjunction' with the others * * *,”

(5) Disability of Grantor Disregarded. Under both sections, the inability of the grantor to exercise the problematic powers because of incompetency or other disability is disregarded. Tech. Adv. Memo. 8623004. This is similar to the rule under Section 2041 as to powers held by disabled beneficiaries. E.g., Pennsylvania Bank & Trust Co. v. U.S., 597 F.2d 382 (3d Cir. 1979); Fish v. U.S., 432 F.2d 1278 (9th Cir. 1970).

(6) Capacity in Which Power Is Held Is Irrelevant. Under both sections, estate inclusion results whether the power is held in an individual or a fiduciary capacity. As an example, if the grantor makes a transfer to a private foundation, and has the ability to control disposition of the donated funds as a director of the foundation, estate inclusion results. Rifkind v. U.S., 84-2 U.S.T.C. 13,377, 5 Ct. Cl. 362 (1984) (inclusion under Section 2036(a)(2)); Rev. Rul. 72-552, 1972-2 C.B. 525 (value of inter vivos transfers to a charitable corporation is includible in the estate of the donor who, as president of the corporation, retained power over the disposition of its funds; the value is also includible in determining the marital deduction allowable and qualifies as a charitable deduction.)

(7) Full Consideration Transaction Excluded. Both sections apply only to the extent that the grantor has made a transfer other than a “bona fide sale for an adequate and full consideration.”

e. Differences Between Section 2036(a)(2) and 2038. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 97-98 (2002).

(1) Retention of Power Over Income Only: Amount of Inclusion. A retention of power over distributing or accumulating income alone is enough to cause inclusion of the entire trust property under Section 2036(a)(2). However, under Section 2038, only the actual property over which a power is held is included in the estate. Therefore, a power over only income would require inclusion of only the income interest under Section 2038. Similarly, a power over only the remainder interest would require inclusion of just the remainder interest and not the income interest under Section 2038. Rev. Rul. 70-513, 1970-2 C.B. 194.

(2) Retained Power vs. Power Held At Death For Whatever Reason. Under Section 2036(a)(2), only powers “retained” by the decedent cause inclusion. Under Section 2038, it is sufficient that the decedent holds the power at death, regardless of “at what time or from what source the decedent acquired his power.” Treas. Reg. § 20.2038-1(a). For example, if a decedent did not retain the power to control distributions, but acquired the power only through
appointment as trustee by another person, Section 2038 would apply, but Section 2036 would not.

(3) **Contingent Power.** Under Section 2036(a)(2), “whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime)” is irrelevant. Treas. Reg. § 20.2036-1(b)(3). In Revenue Ruling 73-21, the decedent reserved the power to name a successor trustee (which, under state law, included himself) upon the death, resignation or removal of the trustee. The Ruling concludes that Section 2036(a)(2) applied even though a vacancy had not occurred by the time of the decedent's death. Rev. Rul. 73-21, 1973-1 C.B. 405. At least one case has disagreed with the government's position, holding that a contingent power to determine who enjoys property or the income from property is not subject to Section 2036(a)(2), based on an interpretation of the predecessor statute in the 1939 Code. Estate of Kasch v. Comm'r, 30 T.C. 102 (1958). However, most cases have supported the IRS's position regarding contingent powers under Section 2036(a)(2). E.g., Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977).

In contrast, under Section 2038, the power must actually be possessed at death. “Section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent’s control which did not occur before his death (e.g., the death of another person during the decedent’s life).” Treas. Reg. §20.2038-1(b).

The contingency rule under Section 2036(a)(2) creates a trap—estate inclusion can result if there is the possibility that the grantor might at some point be appointed as the successor trustee if a vacancy occurs, even if the grantor does not hold the power to fire a trustee and appoint himself. Estate of Gilchrist v. Comm'r, 630 F.2d 340 (5th Cir. 1980) (power of grantor to appoint himself as trustee if vacancy occurs).

f. **Exception for Powers Held By Third Party Trustee.** Powers held by a third party rather than by the grantor will not cause estate inclusion. As discussed in section II.B.2.f.(5)(a) of this outline, the IRS’s “de facto” control argument has not been well received by the courts. However, the grantor must be careful not to have an express agreement or understanding regarding the trustee's decisions. Also, the reciprocal trust doctrine might apply to uncross powers held by trustees of “interrelated trusts.” See section II.B.1.a. of this outline.

g. **Ascertainable Standard Exception.** If the distribution powers held by the grantor are limited by a determinable external standard, enforceable in a court of equity, the grantor arguably does not have any power to alter the distributions from the terms of the trust, because the standard sufficiently limits the grantor's discretion. However, there is no explicit ascertainable standard exception in the statutory provisions or regulations to Sections 2036 and 2038. (Regulations under various other sections give guidance on what standards would constitute an ascertainable standard or a definite external standard. Treas. Reg. §§ 20.2041-1(c)(2), 25.2511-1(g)(2), and 1.674(b)-1(b)(5)(i).)
The seminal case establishing the ascertainable standard exception for a donor controlled power over disposition is *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947). In that case, the grantor retained the power as trustee to make distributions to enable the beneficiary to keep himself and his family in comfort “in accordance with the station in life to which he belongs.” The court held that power would not cause inclusion under the predecessor to Section 2038. Since that time, many courts have ruled on whether particular standards are sufficient to avoid inclusion under Section 2036 and 2038. Standards relating to “health education, support and maintenance” are invariably held to avoid estate inclusion, by analogy to the standards exception in Section 2041. E.g., *Estate of Weir v. Comm’r*, 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4 (“the education, maintenance and support” and “in the manner appropriate to her station in life”).

The IRS has recognized that assets will not be included in a settlor’s estate under §2038 if the settlor was empowered to invade corpus only for the beneficiary’s support and education. Rev. Rul. 73-143, 1973-1 C.B. 407. The ruling reasoned as follows:

“Nondiscretionary powers to vary the beneficial interests of a trust held by a settlor-trustee do not render the value of the property subject to the trust includible in his gross estate under section 2038 of the Code. Nondiscretionary powers are those limited by an ascertainable standard. *Estate of Walter E. Frew*, 8 T.C. 1240 (1947), acquiescence, 1947-2 C.B. 2. A power to alter or amend, the exercise of which is not limited by definite external standards and which is, therefore, discretionary in nature renders the value of the property subject to the power includible in the decedent-settlor-trustee’s gross estate. *Charlotte H. Hurd v. Commissioner*, 160 F.2d 610 (1947).”

... The power to distribute corpus for support and education is an ascertainable standard which can be objectively applied.”

The courts have been lenient in recognizing standards as being ascertainable for purposes of Section 2036 and 2038, as long as some definite standard (other than amorphous terms such as “pleasure,” “well-being,” or “happiness”) are used. Darin Digby, of San Antonio, Texas, has provided the following outstanding compilation of cases that have recognized standards as being ascertainable. Digby, Drafting Donor-Trustee Irrevocable Trusts Without Adverse Income, Gift or Estate Tax Consequences to the Donor and Drafting Defective Grantor Trusts, STATE BAR OF TEXAS 6th ANN. ADV. DRAFTING: ESTATE PL. & PROB. COURSE, at H-5 (1995). Blunt v. Kelly, 131 F.2d 632 (3d. Cir. 1941) (“support, care or benefit”); *Estate of John J. Toeller*, 165 F.2d 665 (7th Cir.1946) (“misfortune or sickness”); *Industrial Trust Co v. Comm’r*, 165 F.2d 142 (1st Cir 1947), *aff’g in part and rev’g in part*, 7 T.C. 756 (1946) (“in case of sickness or other emergency”); *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947), *rev’g*, 63 F. Supp 834 (income—“benefit, support, maintenance or education”; corpus—“suffer prolonged illness or be overtaken by financial misfortune which trustees deemed extraordinary”); *Estate of Wilson v. Comm’r*, 187 F.2d 145 (3d Cir 1951), *aff’g*, 13 T.C. 869 (“in case of need for educational purposes or because of illness or for any other good reason”); State

The following, including a compilation of cases by Mr. Digby, summarizes cases where the stated standard was too broad, and where estate inclusion resulted under Section 2036 or 2038. Old Colony Trust Co. v. U.S., 423 F.2d 601 (1st Cir. 1970) (“changed circumstances” standard was acceptable, but “for his best interests” standard was not); Hurd v. Comm’r, 160 F.2d 610 (1st Cir. 1947) (“the circumstances so require”); Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960) (“a special emergency”); Estate of Yawkey v. Comm’r, 12 T.C. 1164 (1949) (“best interests”); Estate of O’Connor v. Comm’r, 54 T.C. 969 (1970) (“for the benefit of”); Estate of Bell v. Comm’r, 66 T.C. 729 (1976) (“for purposes of providing [beneficiary] with funds for a home, business ... or for any other purpose believed by the Trustee to be for [beneficiary’s] benefit ...”); Estate of Carpenter v. U.S., 80-1 U.S.T.C. ¶13,339 (Wis.) (“trustees are authorized but not required” “in the sole discretion of the Trustees”). Cf. Merchants Nat’l Bank v. Comm’r, 320 U.S. 256, 64 S. Ct 108 (1943) (“happiness” not an ascertainable standard for purposes of allowing charitable deduction); Industrial Trust Co. v. Comm’r, 151 F.2d 592 (1st Cir. 1945), cert. denied, 327 U.S. 788 (“pleasure” not an ascertainable standard for purposes of charitable deduction).

The analysis must extend beyond just looking to see if “magic” unacceptable words are used in the description of standards. An excellent discussion of this principle is provided by a Tax Court case that was affirmed by the Second Circuit Court of Appeals. Estate of Ford v. Comm’r, 53 T.C. 114 (1969), nonacq. 1978-2 C.B. 3, aff’d per curiam, 450 F.2d 878 (2d Cir. 1971). In that case, the instrument included the following clause regarding distributions:

“If any time or from time to time it shall appear to the satisfaction of the Trustee that the said [beneficiary] shall be in need of funds in excess of the income which may then be available for his benefit from the trust estate and from any other source or sources of which the Trustee has knowledge, for the purpose of defraying expenses occasioned by illness, infirmity or disability, either mental or physical, or for his support, maintenance, education, welfare and happiness, then the Trustee may relieve or contribute toward the relief of
any such need by paying to him or using and applying for his benefit such sum or sums out of the principal of the trust estate as the Trustee deems to be reasonable and proper under the circumstances. The Trustee, in considering at any time whether or not to make any disbursements of principal under the terms hereof, shall consider primarily the welfare of the said [beneficiary], and shall not unduly conserve the principal for later distribution to him or to others having contingent remainder interests.” 53 T.C. 114, at 120-21 (emphasis added).

The court acknowledged that “the word 'happiness' standing alone, or in conjunction with language exhorting the trustee to administer the trust liberally for the benefit of one beneficiary over another, does not provide an ascertainable standard enforceable in a court of equity.” 53 T.C. at 125. However, the court observed that the invasion provision contains a clause advising the trustee that he should “consider primarily the welfare” of the beneficiary. In addition, the invasion power is prefaced with the clause that it applies when the trustee is satisfied that the income beneficiary is “in need” of funds in excess of the income which may then be available, and that invasion is permitted to “relieve or contribute toward the relief of any such need.” The instrument placed a fiduciary responsibility on the trustee to determine “need” before he could invade principal for any of the prescribed reasons.

In response to the IRS's argument that the term “happiness” afforded unbridled discretion to the grantor-trustee, the court responded:

“To the contrary, we do not accord this single word such as talismanic effect. A word, such as 'happiness,' must be construed in the context in which it appears 'because its meaning may be affected by the words it accompanies.' Estate of Marvin L. Pardoe, 49 T.C. 140, 144 (1967). Viewing the invasion provision in its entirety, we conclude that its emphasis on 'need' delimits 'happiness' as well as the other enumerated terms, and provides an external, objective standard enforceable against the grantor-trustee in a court of equity. United States v. Powell, 307 F.2d 821, 826-828 (C.A. 10, 1962). It is well settled that where the trust instrument contains such a standard, the grantor-trustee is not deemed to have retained sufficient dispositive discretion to activate the operative provisions of either section 2036 or section 2038. Jennings v. Smith, 161 F.2d 74, 77-78 (C.A. 2, 1947). Estate of C. Dudley Wilson, 13 T.C. 869, 872-873 (1949), affirmed per curiam 187 F.2d 145 (C.A. 3, 1951); and Delancey v. United States, 264 F.Supp. 904, 907 (W.D. Ark. 1967). Moreover, an examination of the applicable State law reveals that an aggrieved beneficiary could indeed enforce his rights against an imprudent or wrongdoing trustee. ...

Thus, although we deem the question to be a close one, we conclude that the grantor-trustee herein did not have untrammeled discretion to invade corpus at his own whim or that of the income beneficiary. Consequently, the presence of the invasion power in the trust indenture does not in our view operate to trigger the provisions of sections 2036(a)(2) and/or 2038(a)(1).” 53 T.C. at 126-27.
This extended discussion of the Ford decision is included to emphasize that the ascertainable standard issue will be resolved in the context of the overall provisions for distributions in the trust instrument.

The cases cited above have not been overruled. However, be sensitive to the body of case law that has developed with respect to family limited partnerships suggesting that §§ 2036(a)(2) might apply to partnerships for which the owner has made gifts of limited partnership interests if the owner has "excessive" control as general partner (even if "in conjunction with" others). E.g., Strangi v. Commissioner, T.C. Memo. 2003-145, aff'd, 417 F.3d 468 n.7 (5th Cir. 2005) (Fifth Circuit's affirmance of "Strangi 3" did not address § 2036(a)(2), merely concluding that §2036(a)(1) applied); Kimbell v. Commissioner, 91 A.F.T.R.2d 2003-585 (N.D. Tex. 2003), rev'd, 371 F.3d 257 (5th Cir. 2004 (district court concluded that §2036(a)(1) and §2036(a)(2) applied; reversal based on full consideration exception to § 2036; no specific discussion of § 2036(a)(2) issue as to an FLP; as an LLC, the Fifth Circuit concluded "Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property."); Turner v. Commissioner, T.C. Memo 2011-209 (court pointed to several powers of the decedent as general partner, without indicating how important each was in its conclusion that §2036(a)(2) applied: (i) the sole and absolute discretion to make distributions of partnership income, (ii) the ability to make distributions in kind, and (iii) the ability to amend the partnership without the consent of limited partners). As a practical matter, the IRS does not generally seem to be pressing hard on §2036(a)(2) claims. For example, in Mirowski v. Commissioner, T.C. Memo. 2008-74, the IRS did not even argue that the decedent's serving as the sole manager of the LLC by itself triggered §2036(a)(2). These cases are discussed more fully in Section II.B.4.c of this outline.

Reliance on the older cases should be appropriate, particularly in light of the IRS's published ruling (Rev. Rul 73-143), but the IRS's approach in these few FLP cases suggests that the IRS could at some point take an opposing viewpoint. Whether a court would agree seems suspect, but the issue could arise.

h. Summary of Planning for Ascertainable Standard Exception. To be conservative in the planning process, if the trust instrument reserves for the grantor any dispositive powers, the instrument should apply a strict “health, education, support and maintenance” standard. Using any other words is taking a risk that the IRS might question whether Sections 2036 or 2038 should apply. E.g., Rev. Rul. 73-143, 1973-1 C.B. 407 (power to make payments early “in case of need for education purposes or because of illness or for any other good reason” is not an ascertainable standard). Even though the courts have generally recognized other reasonable standards as being ascertainable, why place yourself in the position of having to argue with the IRS and possibly face an adverse court decision?

i. Effect of Adding That Trustee Makes Decision “In His Sole Discretion”. Various cases have held that adding that a trustee may decide in his sole or uncontrolled discretion whether the stated standards have been satisfied does not change the
result. *E.g.*, *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947) (“in their absolute discretion”); *State Street Trust Co. v. U.S.*, 160 F. Supp 877 (D. Mass 1958) (power to invade capital for the “comfortable maintenance and/or support” of each beneficiary, in the trustee's “sole and uncontrolled discretion”), aff'd, 263 F.2d (1st Cir. 1959); *Estate of Budd v. Comm'r*, 49 T.C. 468 (1968) (“suitable support, education and maintenance of any such beneficiary, the Trustee may, in his uncontrolled discretion, apply ...”). In *Estate of Budd*, the IRS argued that adding the modifier “in his uncontrolled discretion” rendered the standard as not being ascertainable. The Tax Court disagreed, under the reasoning that even though “a court of equity ordinarily will not substitute its discretion for that of the trustee, nevertheless, even where the power is granted in terms of the ‘sole’ or ‘uncontrolled’ discretion of the trustee, it will review his action to determine whether in light of the standards fixed by the trust instrument, such discretion has been honestly exercised.” Cf Treas. Reg. § 25.2511-1(g)(2)(“the fact that the governing instrument is phrased in discretionary terms is not itself an indication that no such standard exists”). However, some commentators have pointed out that adding such a modifier, where the grantor has retained a power over distributions, is dangerous and generally should be avoided. See Kasner, *Why One Should Never Rely on A Private Letter Ruling*, TAX NOTES, 742 (August 5, 1996) (commenting on Letter Ruling 9625031 in which the IRS held that trusts were not included under Section 2036 and 2038 where the trustees—including the grantor—had the right to pay the beneficiary “in their discretions” for his health, support, maintenance, and education). Indeed, the IRS did raise the argument, albeit unsuccessfully, in *Estate of Budd*.

j. **Summary of Trustee Selection Issues With Respect to Grantor Powers Over Dispositive Provisions.** If the grantor has the power, either as trustee or otherwise, to add beneficiaries, change the disposition among beneficiaries, accumulate or distribute income, invade corpus, or revoke the trust, Sections 2036 and/or 2038 will apply. (Under Section 2038, it is not necessary that the grantor “retain” the power; Section 2038 applies if the grantor holds the power at his death, regardless of how the grantor acquired the power.) Estate inclusion also occurs if the grantor has the right to appoint himself as trustee, either currently or (under Section 2036, but not Section 2038) upon the occurrence of a future contingency even if the contingency is out of the grantor’s control (such as a vacancy in the office of trustee.) The Sections apply whether the grantor serves alone or as a co-trustee, or if the grantor just has a veto power, or may act only subject to another person’s veto power. The Sections apply if the grantor keeps the dispositive power in any capacity (for example, as director of a private foundation that receives a gift from the grantor), not just as trustee.

Estate inclusion will not occur if the dispositive power is subject to a determinable standard (despite the absence of an ascertainable standard exception in the statues or regulations under Section 2036 and 2038.) A wide variety of standards have been approved by courts, but if the grantor holds (or may in the future hold) any dispositive powers, the conservative course of action would be to use a pure “health, education, support and maintenance” standard, without further embellishment. For example, to be conservative, if the grantor might possibly acquire dispositive powers, do not provide that the trustee may make dispositive decisions under the
standard in the trustee’s sole or uncontrolled discretion. If a third party trustee has powers that would trigger estate inclusion if held by the grantor, the grantor should not have the unlimited power to remove and replace the trustee. (See Section III.B.5.g. & h. of this outline.)


a. Administrative Powers Can Affect Distributions. Certain administrative decisions may have the effect of shifting benefits from one beneficiary to another. For example, the power to allocate receipts and disbursements between income and principal can affect the amounts distributed to income beneficiaries and remainders. Similarly, a trustee’s investment powers to invest in high-growth non-income producing assets may shift benefits from the income beneficiary to the remainders. Courts have long recognized that “standard” administrative powers would not invoke the predecessors of Section 2036 and 2038. E.g., Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). However, the IRS has argued (with some success in early cases) that various broad administrative powers would cause estate inclusion under Sections 2036 and 2038. E.g., State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a “very close” case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply).

b. Key Issue: Is Exercise of Power Subject to Review By Court? As the courts have sifted through these types of cases, the emerging principle is that a grantor’s broad management powers will not invoke Section 2036 or 2038 as long as the grantor’s actions are subject to review by a court of equity (for example, if the exercise of the power is subject to fiduciary standards.) See Dodge, 50-5th T.M., Transfers With Retained Interests and Powers 101 (2002). This is particularly true if the grantor’s actions are subject to a standard that, as a practical matter, can be enforced by a court as opposed to actions taken under a “sole discretion” standard. See Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, Tax Notes 1153, 1157 (Sept. 1, 2003). However, some courts have applied this principal regarding management powers even if the grantor has very broad discretion. The court that ruled in favor of the IRS in the State Street case changed its position in 1970, specifically overruling the result in State Street, and adopting a position under Massachusetts law that no amount of administrative discretion prevents judicial supervision of the trustee. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970). In Old Colony, a provision that the trustees could “do all things in relation to the Trust Fund which the Donor could do if living” did not cause Sections 2036 or 2038 to apply. See also United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (trustee-grantor had power to invest assets as he deemed “most advisable for the benefit of the trust estate”; held that trustee’s acts were subject to review by court of equity and did not invoke the predecessor to Section 2038). Some courts have even held that a grantor’s non-trustee powers were reserved in a fiduciary capacity, thus invoking the general rule that administrative powers subject to court review do not trigger application of Section 2036 or 2038. Estate of King v. Comm’r, 37 T.C. 973 (1962), nonacq. 1963-1 C.B. 5
The absence of a fiduciary duty was the determining factor in finding that a grantor who retained controls over Illinois land trusts was subject to Sections 2036(a)(2) and 2038. *Estate of Bowgren v. Comm'r*, 105 F.3d 1156 (7th Cir. 1997) (decedent had no duty to seek agreement of other beneficiaries to deal with their interests and had no fiduciary duty to the donee who received an assignment of an interest in a land trust).

c. Supreme Court's Pronouncement in Byrum. The Supreme Court held that retained rights to vote the transferred stock of a closely held corporation does not constitute a Section 2036(a)(2) power over the property. *U.S. v. Byrum*, 408 U.S. 125 (1972).

The Court reasoned, first, that management powers generally are not powers subject to Section 2036(a)(2). The very strong language of the Supreme Court is quoted at length:

“At the outset we observe that this Court has never held that trust property must be included in a settlor’s gross estate solely because the settlor retained the power to manage trust assets. On the contrary, since our decision in *Reinecke v. Northern Trust Co.*, 278 U.S. 339, 73 L Ed 410, 49 S. Ct. 123, 66 ALR 397 (1929), it has been recognized that a settlor’s retention of broad powers of management does not necessarily subject an inter vivos trust to the federal estate tax. Although there was no statutory analogue to § 2036(a)(2) when Northern Trust was decided, several lower court decisions decided after the enactment of the predecessor of § 2036(a)(2) have upheld the settlor’s right to exercise managerial powers without incurring estate tax liability. In *Estate of King v. Commissioner*, 37 T.C. 973 (1962), a settlor reserved the power to direct the trustee in the management and investment of trust assets. The Government argued that the settlor was thereby empowered to cause investments to be made in such a manner as to control significantly the flow of income into the trust. The Tax Court rejected this argument, and held for the taxpayer. Although the court recognized that the settlor had reserved “wide latitude in the exercise of his discretion as to the types of investments to be made,” id. at 980, it did not find this control over the flow of income to be equivalent to the power to designate who shall enjoy the income from the transferred property.

Essentially the power retained by Byrum is the same managerial power retained by the settlers in *Northern Trust* and in *King*. Although neither case controls this one – *Northern Trust*, because it was not decided under § 2036(a)(2) or a predecessor; and *King*, because it is a lower court opinion—the existence of such precedents carries weight. The holding of management without adverse estate tax consequences, may have been relied upon in the drafting of hundreds of inter vivos trusts. The modifications of this principle now sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been “controlling” stockholders of a closely held corporation. Courts properly have been reluctant to depart from an interpretation of tax law that has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct that results in tax consequences. When courts readily undertake such tasks, taxpayers may not
rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.” 408 U.S. at 132-35.

Second, the Court held that Mr. Byrum did not have a retained “right” as described in Section 2036(a)(2), because of the fiduciary duty that Mr. Byrum owed to the corporation:

It must be conceded that Byrum reserved no such “right” in the trust instrument or otherwise. The term “right,” certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O'Malley. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to “regulate the flow of dividends” to the trust. That “right” was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation. However great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereof. 408 U.S. at 136-138.

The IRS summarized its understanding of the Byrum holding and reasoning as follows: “The court concluded that because of the fiduciary constraints imposed on corporate directors and controlling shareholders, the decedent ‘did not have an unconstrained de facto power to regulate the flow of dividends, much less the right to designate who was to enjoy the income.’ ” Rev. Rul. 81-15, 1981-1 C.B. 457. This is despite the Supreme Court’s acknowledgement in footnote 25 that its conclusion was not based just on the premise that “the general fiduciary obligations of a director are sufficient to eliminate the power to designate with the meaning of §2036(a)(2).”

An interesting position urged by the IRS in one private ruling is that the fiduciary duty doctrine of the Byrum case only applies if there are minority adverse interests who might question decisions made by the fiduciary. The IRS’s view was that “interests of family members, employees, agents or other related or non-adverse persons do not represent minority interests, since whatever legal rights they may be perceived to have under Byrum are apt not to be exercised. Conversely, the presence of a single truly adverse minority interest would make the Byrum rationale applicable.” Ltr. Rul. 8038014. This factor was also mentioned in Strangi (discussed below).

Several cases involving controls by a decedent over a family limited partnership have provided further discussion of the impact of Byrum on retained powers. The IRS recognized in Technical Advice Memorandum 9131006 and in Letter Ruling 9415007 that a parent may make gifts of interests in a limited partnership, and
retain investment and distribution authority over partnership assets as the general partner without causing the partnership assets to be included in his or her estate as a transfer with the retained power to control beneficial enjoyment. In those rulings, the IRS observed that the donor-general partner “occupied a fiduciary position with respect to the other partners and could not distribute or withhold distributions, or otherwise manage the partnership for purposes unrelated to the conduct of the partnership business.” See also Letter Rulings 9332006, 931039, 9026021, G.C.M. 38,984 (May 6, 1983), G.C.M 38,375 (May 12, 1980). The IRS subsequently retreated from that position in several cases involving a decedent with powers over a limited partnership in his capacity of having an interest as general partner of the partnership.

In Kimbell v. U.S., 91 AFTR 2d 2003-585 (N.D. Tex. 2003), the court found that the decedent retained the rights to possession of the economic benefits of the property (§ 2036(a)(1)) and the right to designate who would benefit from the income of the property (§2036(a)(2)). There is no need in this case to search for an implied agreement, because the decedent had the right under the agreement to remove the general partner at any time and appoint herself as the general partner. As the general partner, she could then control distributions. The estate contended that even if the decedent were the general partner, she still would not have sufficient powers to require inclusion under section 2036 because her powers would be held in a fiduciary capacity. The Kimbell court reasoned that “Byrum ... was expressly overruled by Congressional enactment of § 2036(b).” Furthermore, even if Byrum were applicable, the partnership agreement expressly provides that the general partner will not owe a fiduciary duty to the partnership or to any partner. This last factor makes the Kimbell case clearly distinguishable, and the court’s statement that the Byrum case is overruled by §2036(b) is just wrong. The case was reversed by the Fifth Circuit based on the “bona fide sale for adequate and full consideration” exception in §2036. 371 F.3d 257 (5th Cir. 2004). The court very briefly addressed whether LLC assets should be includible under §2036(a)(1) and (a)(2). The court concluded: “Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property.”

In Strangi v. Comm’r, T.C. Memo 2003-145 (2003), the court had an extended analysis rejecting a broad fiduciary duty exception under Byrum. (The Fifth Circuit affirmed the decision based on §2036(a)(1). 96 AFTR2d 2005-5230 (5th Cir. 2005). Having decided the case under §2036(a)(1), the court expressly declined to address §2036(a)(2).) Judge Cohen’s Tax Court memorandum decision pointed to various distinguishing factual distinctions, in its case involving a family limited partnership in which an agent of the decedent held a 47% interest in a corporation that served as the general partner of the partnership and that gave the general partner the sole discretion to determine distributions. The court’s distinctions include the following.

(1) Independent Trustee. In Byrum, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an
independent trustee who had the sole authority to pay or withhold income. In Strangi, distribution decisions were made by the corporation. The decedent owned 47% of the stock and was the largest shareholder. All decisions were ultimately made by decedent’s attorney-in-fact as the manager of the corporation and partnership.

(2) Economic and Business Realities. The flow of funds in Byrum was dependent on economic and business realities of small operating enterprises that impact the earnings and dividends. “These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets.”

(3) Fiduciary Duties. Fiduciary duties in Byrum were distinguished because there were unrelated minority shareholders who could enforce these duties by suit. “The rights to designate traceable to decedent through [the corporation] cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of [the corporation’s] directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of [the corporation], and his own children held 52 of the remaining 53%. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario.” The fact that there was a 1% shareholder of the corporation was “no more than window dressing.” “A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight.” (OBSERVATION: Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties seems inconsistent with cases that have held that very broad administrative powers retained by a donor as trustee do not invoke section 2036, primarily because of the restriction imposed by the fiduciary duties. Those cases involve trust transactions that do not involve any unrelated parties. E.g. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could “very substantially shift the economic benefits of the trust” did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review). In addition, several earlier Tax Court cases relied on the fiduciary duty exception regarding powers that may affect distributions. Estate of Gilman, 65 T.C. 296 (1975), aff’d per cur. 547 F.2d 32 (2nd Cir. 1976)(no estate inclusion; decedent was co-trustee with power to vote stock; there was active conduct of a business and 40% of voting shares of corporation were held by sisters and there was family disharmony); Estate of Cohen, 79 T.C. 1015 (1982)(§2036(a)(2) did not apply to decedent as co-trustee of Massachusetts real estate trust; because courts hold business trustees to a “fair standard of conduct,” the decedent and his sons [as co-trustees] did not have the power to withhold dividends arbitrarily).) One commentator has observed that interpreting Byrum to apply only if there are unrelated parties involved means that “Byrum would not apply to the vast majority of closely held corporations owned entirely by related parties. It may be questioned whether the Supreme Court intended its decision in Byrum to be so limited in its precedential value.” Mulligan, Courts Err in Applying Section 2036(a) to Limited Partnerships, EST. PL. (Oct. 2003). E.g., Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, Tax Notes 1153, 1157-58 (Sept. 1, 2003) (“It is true that, in Byrum, in the course of discussing the constraining nature of the fiduciary duty imposed on the grantor and the corporate directors he could select,
the Court did allude to the fact that there were minority shareholders unrelated to the decedent. This raises the question whether the presence of these shareholders was critical to the Court's holding. The structure of the decision, as well as the backdrop of a well-accepted exception grounded in fiduciary duty principles, suggests it was not....This reading is consistent with Rev. Rul 73–143, which implicitly adopts the principle that a fiduciary duty owed to a family member can so circumscribe the grantor's retained discretion so as to preclude it from being characterized as a right.... In Rev. 81–15, invoking Byrum's fiduciary–duty analysis, the Service concluded that section 2036(a)(2) did not apply in the case of corporate stock where the decedent had retained voting rights even though the only shareholders were apparently the decedent and a family trust created by the decedent.”) See Hellwig, Estate Tax Exposure of Family Limited Partnerships Under Section 2036, 38 REAL PROP., PROB. & TR. J. 169 (Spring 2003)(view that Byrum does not create a broad fiduciary duty exception); but see Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, TAX NOTES 1153 (Sept. 1, 2003); Korpics, The Practical Implications of Strangi II for FLPs—A Detailed Look, 99 J. TAXN 270 (Nov. 2003).

Strangi's interpretation of the Byrum case is far more restrictive than the IRS's published interpretation of Byrum in Rev. Rul. 81–15, 1981–1 C.B. 457, which suggests a general fiduciary duty analysis as the rationale for the Supreme Court's decision in Byrum. (Interestingly, the court cites the IRS's unpublished rulings interpreting Byrum with respect to partnerships [PLRs 9415007, 9310039, & TAM 9131006] and discounts those rulings as having no precedential force, but does not cite the IRS's published position interpreting the fiduciary duty analysis in Byrum. Under CC–2003–014, Chief Counsel attorneys cannot argue contrary to “final guidance.” Final guidance includes Revenue Rulings. Accordingly, Chief Counsel attorneys cannot argue contrary to positions in Revenue Rulings that have not been modified or withdrawn. The fact that subsequent cases have been more favorable to the government is irrelevant.

Following Strangi, very few family limited partnership cases have addressed §§2036(a)(2) or 2038. Estate of Bongard v. Comm'r, 124 T.C. 95 (2005) applied § 2036(a)(1) under very dubious reasoning, based on the conclusion that the decedent had the ability to cause the FLP to acquire cash. This seems more closely aligned to a “right to designate who can enjoy” under § 2036(a)(2) than a retained right of enjoyment under § 2036(a)(1), particularly in light of the court's acknowledgement that the decedent did not need any of the assets transferred to the FLP to maintain his lifestyle. Perhaps the reason that the court did not apply §2036(a)(2) is that there is no implied agreement concept in §2036(a)(2) like there is under §2036(a)(1). Instead, the decedent must have the legal right to designate who can enjoy the transferred assets (although that legal right may have to be exercised “in conjunction with” others.)

In Estate of Kelley v. Comm'r, T.C. Memo 2005–235, the IRS dropped its §2036 and 2038 arguments about 20 days before trial without explanation. There was an LLC that was the 1% general partner. The Decedent owned 1/3 of the member interests of the LLC. The case seems fairly analogous to the Strangi case where the decedent owned 47% of the S corporation that was the 1% GP. Judge Cohen's
broad “in conjunction with” analysis would seem to apply as much to the Kelley facts as to the Strangi facts.

Another FLP case to address §§2036(a)(2) and 2038 is Mirowski v. Comm’r, T.C. Memo. 2008-74. The decedent was the sole manager of the LLC, but the IRS did not even argue that being the sole manager caused §§2036(a)(2) and 2038 to apply as to interests in the LLC that the decedent gave to her daughters. Instead the IRS argued that the agreement allowed the members to determine the timing and amounts of distributions, and the decedent continued to hold a majority interest. The court responded that the agreement in various places contemplated pro rata distributions and observed that the decedent acted in a fiduciary capacity in her role as manager of the LLC.

In Turner v. Comm’r, T.C. Memo. 2011-209, supplemental opinion in response to motion for reconsideration, 138 T.C. No. 14 (2012), the original opinion addressed §2036(a)(2). The court concluded that the decedent retained the right to designate which person or persons would enjoy the transferred property, which would cause estate inclusion under § 2036(a)(2). After acknowledging that a transferor’s retention of the right to manage transferred assets does not necessarily require inclusion under § 2036(a)(2), the court then listed several reasons for its conclusion that § 2036(a)(2) applied in this case. (i) The decedent effectively was the sole general partner. (In footnote 28, the court acknowledged that the decedent’s wife was an equal co-general partner, but the court concluded that even if it were to treat her as a “coequal” general partner, it would reach the same conclusion because § 2036(a)(2) applies if the power is held “alone or in conjunction with any person.”) (ii) The partnership agreement gave the decedent as general partner “broad authority not only to manage partnership property, but also to amend the partnership agreement at any time without the consent of the limited partners.” (iii) As general partner, the decedent “had the sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay Federal and State tax liabilities) and to make distributions in kind.” (iv) Even after the gifts of limited partnership interests, the decedent and his wife held more than 50% of the limited partnership interests and could make any decision requiring a majority vote of the limited partners. Interestingly, the court did not include in its list of reasons the fact that the partnership gave the general partner the right to terminate and dissolve the FLP without a vote of the limited partners.

d. **Broad Powers to Allocate Between Income and Principal.** Even broad authority to allocate receipts and disbursements between income and principal will not trigger Sections 2036 or 2038. E.g., Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st. Cir. 1970); Estate of Budd v. Comm’r, 49 T.C. 468 (1968); cf. Treas. Reg. § 20.2056-5(f)(4) (“power to determine the allocation or apportionment of receipts and disbursements between income and corpus” will not disqualify spouse’s income interest from qualifying for marital deduction). In Estate of Ford v. Commissioner, the trust authorized trustee “to apportion between principal and income of the trust estate any loss or expenditure in connection with the trust estate, which in his opinion should be apportioned, and in such manner as he may deem advantageous and equitable.” Estate of Ford v. Comm’r, 53 T.C. 114, 120 (1969), nonacq. 1978-2
C.B. 3, aff’d per curiam, 450 F.2d 878 (2d Cir. 1971). The IRS argued that the administrative and management powers gave the fiduciary uncontrolled discretion. It stressed particularly the power to allocate receipts, losses, and expenditures of the trust between income and principal. The court dismissed this argument, observing that this “provision is commonly included in trust instruments 'to give the trustee some discretion so that he would not be required to seek court guidance in making doubtful allocations.' ... The trustee herein is directed to exercise this power in an 'advantageous and equitable' manner. Of course, should he abuse his discretion by classifying an obvious item of principal as income, he would be subject to equity court review.” 53 T.C. at 128.

Nevertheless, if the trust instrument permitted an unrestrained power to allocate capital gains to either to principal or income without the possibility of court review, Sections 2036 and 2038 could apply. Stephens, Maxfield, Lind & Calfree, Federal Est. & Gift Tax’n ¶ 4.10[4][c] (2001).

e. **Broad Investment Authority.** Various cases recognize that authorizing the trustee to invest in investments that would not otherwise be permissible under state law or to sell or exchange trust assets does not invoke Sections 2036 or 2038. E.g., United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Ford v. Comm'r, 53 T.C. 114 (1969), nonacq. 1978-2 C.B. 3, aff’d per curiam, 450 F.2d 878 (2d Cir. 1971) (“the power to invest in 'nonlegals' (i.e., investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust”); Estate of Budd v. Comm'r, 49 T.C. 468, 475 (1968) (authority to retain or invest in securities or property that may not be of a character permitted for trustees’ investment under applicable State law).

f. **“All Powers As I Would Have If Trust Not Executed”**. A rather common catch-all administrative power is to say that the trustee can exercise any powers that the settlor could have exercised over the property if it had not been transferred to the trust. This type of common catch-all provision has been found not to trigger application of Sections 2036 or 2038. Old Colony Trust C. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970) (reasoning that such language does not protect trustees from accountability to the court for exercise of the power).

g. **Substitution Powers.** A power of the grantor to substitute assets of equivalent value does not cause Section 2036 or 2038 to apply where it is held in a fiduciary capacity. State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a “very close” case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply). Despite the State Street decision (where the court barely found the predecessor to Section 2036 to apply when the donor, albeit as a fiduciary, could exchange assets with the trust *without regard to values*), the IRS again argued that a substitution power *for equal value* held by the grantor-trustee constituted a power to alter amend or revoke the instrument in Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975).
The court disagreed, reasoning that any property substituted should be 'of equal value' to property replaced, so the grantor was thereby prohibited from depleting the trust corpus. The court viewed that as being no different than the case where a settlor retains the power to direct investments. The IRS subsequently acquiesced in the case. 1977-2 C.B. 1.

What if the grantor retains a substitution power in a nonfiduciary capacity (to cause the trust to be a grantor trust under Section 675(4)(C))? In Jordahl, the grantor who held the substitution power was a trustee, and held the power in a fiduciary capacity. However, the court’s reasoning suggests that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity: “Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of ‘equal value’ indicates that the power was held in trust.” 65 T.C. at 97.

Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides very helpful guidance, indicating that a grantor nonfiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038. The Ruling cites Jordahl, but says that it did not apply § 2038 because the decedent was bound by fiduciary standards. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, “the trustee has a fiduciary duty to prevent the exercise of the power.” The ruling reasons that (1) the trustee “has a fiduciary obligation to ensure that the assets exchanged are of equivalent value,” and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee’s power to reinvest assets and the trustee’s duty of impartiality regarding the beneficiaries. See section II.C.3.e of this outline for further discussion of Rev. Rul. 2008-22. The rulings states that

“[a] substitution power cannot be exercised in a manner that can shift benefits if:

(a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries ["Observe, state law would generally impose both of these duties unless the trust instrument negates these duties"]; or

(b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.”


h. Management Powers Over Partnership. The principles of Byrum v. U.S., 408 U.S. 125 (1972), should mean that the powers of a transferor-general partner of a limited partnership should not cause transfers of limited partnership interests to be
included in the estate under Section 2036(a)(2). However, a few cases have applied § 2036(a)(2) to an individual's who contributed assets to a partnership and held certain management powers over a partnership. See section II.B.4.c of this outline for an extended discussion of the Byrum case and the FLP cases where the person who made contributions to a partnership held direct management powers over the partnership. Would those cases apply with the same force if the individual held those same powers only as a trustee of a trust that owned an interest in the partnership?

Section 2036(b), enacted in response to the Byrum case, applies only to stock of a controlled corporation. There are no rulings where the IRS has taken the position that Section 2036(b) applies to transfers of partnership interests—since the statute specifically references stock of corporations.

i. Effect of Exculpatory Clause Limiting Trustee’s Personal Liability. As discussed above, the fact that a court of equity has the power to review administrative and management decisions of the trustee is the overriding principle that removes administrative and management powers from the reach of Section 2036(a)(2) or 2038. Does the existence of a broad exculpatory clause in the instrument change that result? It should not, because under state law, it is not possible to give a trustee complete exculpation from liability for its decisions. RESTATEMENT (SECOND) OF TRUSTS § 222 (prohibits enforcement of an exculpatory clause that would relieve a trustee of liability for a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of the beneficiary); E.g., InterFirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882, 888 (Tex. App.—Texarkana 1987, no writ) (exculpatory clause does not protect a trustee who used the trustee position to obtain an advantage by action inconsistent with the trustee’s duties and detrimental to the trust, or who takes actions in bad faith or acts “intentionally adverse or with reckless indifference to the interest of the beneficiary”). Cases interpreting Sections 2036 and 2038 have agreed. E.g., Old Colony Trust Co. v. U.S., 423 F.2d 601, 602 (1st Cir. 1970) (IRS argued that exculpatory clause triggered Sections 2036 and 2038; court disagreed observing that exculpatory clause “has no bearing on the question in this case because it does not affect the meaning, extent or nature of the trustees’ duties and powers”).

j. Effect of Guarantees.

(1) Guaranty By Trustee. If the trustee has the authority to guarantee a personal obligation of the settlor or other individual, could that administrative power cause Section 2036 or 2038 to apply? The general principle regarding administrative powers that are exercisable subject to fiduciary standards for the benefit of the trust should control this situation. Texas courts have emphasized the fiduciary duties of trustees in analyzing whether a trustee even has the authority to issue a guaranty. See Three Bears, Inc. v. Transamerican Leasing Co., 574 S.W.2d 193, 197 (Tex. Civ. App.—El Paso 1978), aff’d in part and rev’d in part on other gr, 586 S.W.2d 472 (Tex. 1979).

(2) Guaranty by Donor. If an individual guaranties a trust indebtedness, the question that arises is whether that individual makes a gift to the trust. In
Letter Ruling 9113009, the IRS suggested that a guaranty by an individual for the benefit of another is a transfer, but the IRS indicated that it was not taking a position as to how the gift should be valued. That ruling came under intense criticism, and was withdrawn by Letter Ruling 9409018. An analogous situation is that an S corporation shareholder receives no basis from the guarantee of a corporate loan since nothing is “paid” by merely giving the guaranty. Another analogy is that an insured’s loan to a trust to pay premiums does not create an incident of ownership, where the policy is not used as security for the loan. Ltr. Rul. 9809032. If the loan is not an incident of ownership, a guarantee of a loan should not be an incident of ownership either. There are no further rulings or cases that have addressed whether guarantees constitute gifts.

k. Administrative Powers That CANNOT Be Retained by Grantor. The prior subsections have addressed various administrative powers that do not cause inclusion under Sections 2036 or 2038. There are two situations where administrative powers cannot be retained by the grantor. (In addition, certain controls over the appointment of trustees, such as removal powers, may have adverse consequences. They are addressed in section II.B.5. of this outline.)

(1) Voting Powers. The IRS argued in the past that retaining voting powers over stock that is transferred to a trust constitutes a power causing inclusion under Section 2036(a)(2). The Supreme Court ultimately rejected this argument in U.S. v. Byrum, 408 U.S. 125 (1972). (The Byrum case is discussed in detail in section II.B.4.c. of this outline.) In response, the IRS (nine years later) withdrew an earlier ruling that stated that a power to control dividends by the right to vote nontransferred stock constituted a Section 2036(a)(2) power. Rev. Rul. 81-15, 1981-1 C.B. 457, rev’g, Rev. Rul. 67-54, 1967-1 C.B. 269.

In 1976, Congress passed the “anti-Byrum” amendment, enacting the predecessor to Section 2036(b). That Section provides that a grantor’s retention of the power to vote shares in a “controlled corporation” is deemed to be the retention of the enjoyment of the property for purposes of Section 2036(a)(1). Interestingly, this legislative response to the issue leaves undisturbed the Byrum holding as to Section 2036(a)(2).

Section 2036(b) imposes two requirements: (1) there must be a controlled corporation, and (2) the decedent must have retained voting rights.

As to the first requirement, a corporation is a “controlled corporation” if at any time after the transfer of stock and during the three year period ending on the date of the decedent’s death, the decedent owned (taking into account the attribution rules of Section 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock. I.R.C. § 2036(b)(2).

As to the second requirement, the grantor must retain the right to vote (directly or indirectly) the stock that is transferred. The right to vote nontransferred stock does not count, and the grantor may give non-voting stock and retain
Proposed regulations (that have been outstanding for years) take the position
that the grantor retains the right to vote, for this purpose, if the power is merely
exercisable in a fiduciary capacity as trustee or co-trustee, or where the grantor
may appoint himself as trustee. Prop. Reg. § 20.2036-2(c). There is a right to
vote “indirectly” if there is any agreement, either express or implied, as to how
the shareholder will or will not vote the stock. Id. However, the mere fact that
persons whose ownership of stock would be attributed to the grantor under
Section 318 have the right to vote stock will not be treated as a retention of
voting power by the grantor. Id.

In addition, the IRS takes the position that if stock of a controlled corporation
is transferred to a partnership of which the grantor is a general partner and has
the right to vote the stock as general partner, Section 2036(b) applies. That is
the case even if the voting rights are subject to the fiduciary duties of a general
partner. Tech. Adv. Memo. 199938005, docketed in the Tax Court as Estate of
Coulter v. Comm'r, Docket No. 17458-99. Some commentators disagree with
the conclusion, because under state law a partner has no direct or indirect rights
with respect to the property of the partnership. Under this argument, the
insured-transferor who is the general partner “has no individual right to vote
that stock. Only the partnership has the right to vote that stock.” Eastland, The
Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The
Use of Partnerships in Estate Planning, ALI-ABA PLANNING TECHNIQUES
FOR LARGE ESTATES, at p.107-10 (Nov. 2003).

Observe that Section 2036(b) has its own three-year rule, rather than just using
the three-year rule in Section 2035. The difference is that the Section 2036(b)
provision applies if the grantor held the power to vote at any time within three
years prior to death, whereas Section 2035 does not apply as long as the
relinquishment of any problematic power occurs automatically under the
agreement without any volition on the part of the grantor. Accordingly, any
right that the grantor has as trustee (or otherwise) to vote stock in a controlled
corporation must be relinquished at least three years before the grantor dies, or
else estate inclusion will result under Section 2036(b). For example, if the
grantor of a GRAT is the trustee during the initial term of the GRAT, the
grantor would have to survive at least three years after relinquishing any voting
power over controlled corporation stock. Therefore, if stock of a controlled
corporation is being contributed to a GRAT, (1) the grantor either should not
serve as trustee at all, (2) the grantor should resign as trustee or in some other
manner give up the right to vote the stock at least three years before the GRAT
terminates, or (3) there must be a co-trustee who would hold all of the voting
power with respect to stock of any controlled corporation and the grantor must
be precluded from ever holding any power to vote such stock.

(2) Incidents of Ownership Over Life Insurance. Section 2042 provides that life
insurance proceeds are included in the insured’s estate if (i) the proceeds are
payable to or for the benefit of the insured’s estate, or (ii) if the insured, at his
death, possessed any incidents of ownership in the policy, exercisable either
alone or in conjunction with any other person. The term “incidents of
ownership” has been interpreted very broadly, and includes just about any power over the policy, including the following powers: to change the beneficiary; to surrender or cancel the policy; to assign the policy; or to pledge the policy for a loan or obtain a loan on the policy from the insurer. Treas. Regs. § 20.2042-1(c)(2). In addition, incidents of ownership include the power to elect a settlement option, In Re Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973), or to veto the owner’s right to assign the policy or designate policy beneficiaries, Rev. Rul. 75-70, 1975-1 C.B. 301. However, the insured’s merely making a loan to a trust to enable it to pay premiums is not an incident of ownership in the policy as long as it is not used as collateral for the loan. Ltr. Rul. 9809032.

Any such powers held by the insured in a fiduciary capacity will be treated as if the insured held the incidents of ownership for purposes of Section 2042. Treas. Reg. § 20.2042-1(c)(4); Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), cert denied, 427 U.S. 977 (1976); Freuhauf v. Comm’r, 427 F.2d 80 (6th Cir. 1970); but see Bloch v. Comm’r, 78 T.C. 850 (1982). Under Revenue Ruling 84-179, an insured who holds powers over a policy in a fiduciary capacity will avoid Section 2042 only if all of the following are satisfied: (i) the powers are held only in a fiduciary capacity, (ii) the powers are not exercisable for the insured's personal benefit, (iii) the insured did not transfer the policy to the trust and did not transfer to the trust from personal assets any of the consideration for purchasing or maintaining the policy by the trust, and (iv) the insured did not obtain his trustee powers through some prearranged plan in which the insured participated. 1984-2 C.B. 195. The last two requirements would not be satisfied where the insured transfers an insurance policy to a trust and serves as the trustee or became trustee through some prearranged plan.

Even if the insured is not the initial trustee, if the insured can appoint himself as trustee, the insured will be treated as holding incidents of ownership in the policy. Furthermore, if the insured just has the power to remove and appoint a replacement trustee, the insured may be treated as holding any incidents of ownership held by the trustee. The general effects of trustee removal powers are addressed in section II.B.5.g. of this outline. The effects of removal powers for purposes of Section 2042 are discussed in section II.B.5.h. of this outline.

1. **Summary of Trustee Selection Issues With Respect to Administrative Powers.** Administrative or management powers of the trustee will generally not cause inclusion under Section 2036 or 2038, even if the grantor is the trustee or has the power to become trustee. The cases have reached this conclusion by relying on the authority of a court to review the trustee’s actions under its fiduciary duty; therefore the trustee does not have unfettered control. Accordingly, if the grantor is or may become the trustee, be wary of including language giving extremely broad management powers that are purportedly to be exercised solely in the trustee’s discretion without any court control. (That type of language is probably not enforceable anyway, but why push the envelope?) Similarly, be wary of using extremely broad exculpatory provisions if the grantor is or may become the trustee.
Two powers that the grantor cannot have without adverse tax consequences are (1) the right to vote stock of a “controlled corporation” that the grantor contributes to the trust, and (2) any incidents of ownership over life insurance policies on the grantor’s life. As an example, if the grantor of a GRAT serves as trustee during the initial term, he should not have the power to vote stock if “controlled corporation” stock is conveyed to the GRAT—because the grantor would have to survive at least three years after ceasing to serve as trustee (with the power to vote) before the assets would be excluded from the grantor’s estate for estate tax purposes.

5. Trustee Removal and Appointment Powers.

a. Power to Appoint Self at Any Time. The grantor will be treated as holding any dispositive or management powers held by the trustee if the grantor can appoint himself as the trustee at any time. Treas. Reg. § 20.2036-1(b)(3) (power to remove trustee and appoint himself); Estate of McTighe v. Comm’r, 36 T.C.M. 1655 (1977) (power to substitute self as trustee and power of trustee to make distributions in satisfaction of grantor’s support obligations).

b. Contingent Power to Appoint Self as Successor Trustee. If the grantor has a contingent power to appoint himself as trustee upon the occurrence of an event that is out of his control (such as a prior trustee ceasing to serve due to his death or resignation), Section 2038 does not apply, but Section 2036(a) does apply. Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977) (trustees, under provisions of irrevocable trust, had right to designate persons who would possess trust property and income; settlor could designate herself as trustee if vacancy occurred in office of trustee during her life, and settlor had opportunity to appoint two successor trustees before her death; held, right of trustee to designate beneficiaries would be attributed to settlor); Estate of Alexander v. Comm’r, 81 T.C. 757 (1983); Rev. Rul. 73-21, 1973-1 C.B. 405; See Treas. Reg. § 20.2036-1(b)(3). (At least one case has disagreed with this position, but most have agreed with it. See section II.B.3.e.(3) of this outline.)

c. Power to Appoint Self as Co-Trustee. Sections 2036 and 2038 apply to powers held jointly with someone else. Therefore, the ability to add one’s self as a co-trustee would be just as damaging as being able to become sole trustee—unless the trust instrument reserved the problematic power just for the co-trustee other than the grantor. See section II.B.3.d.(2) of this outline.

d. Veto Power. A corollary to the co-trustee rule is that a power reserved by the grantor to veto actions of the trustee will cause the grantor to be treated as holding the powers of the trustee over which the veto power may be exercised. See section II.B.3.d.(4) of this outline.

e. Power to Appoint a Series of Successor Trustees. Is the power to appoint a series of trustees in effect a power to “amend” the trust that would be subject to Section 2038? No case has directly addressed that argument, although that type of power has been present in a variety of reported cases that have addressed Section 2036 and 2038. E.g., Estate of Budd v. Comm’r, 49 T.C. 468 (1968) (“power to appoint a successor trustee or trustees by instrument in writing lodged with said successor
trustee or trustees, and specifying the date or event upon which the appointment of such successor trustee or trustees shall take effect”).

f. **Power to Add Co-Trustees (Not Including Self).** If the grantor merely has the power to add co-trustees, the grantor generally should not be treated as holding the powers of the trustees, as long as he cannot appoint himself. *Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, and there was no estate inclusion). Nevertheless, there is concern that if the grantor can keep adding co-trustees indefinitely, the grantor could control the trustees’ decision by just appointing trustees who would agree with his position. Even in that situation, there would still be the argument that the grantor has no real power at all, because anyone he appoints is subject to fiduciary standards and control of the courts, unless an express or implied agreement could be shown. See *Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992) (transfer constituted completed gift; court rejected IRS’s argument that donor “had the power to replace trustees with individuals who would do his bidding”); *Estate of Wall v. Comm'r*, 101 T.C. 300, 312 (1993) (“a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take”) (See section II.B.2.c.(1)(a) of this outline regarding the implied agreement principle.)

g. **Power to Remove and Replace Trustee—Sections 2036 and 2038.** If the grantor could remove the trustee and appoint himself, it has long been clear that the grantor is treated as holding the powers of the trustee for purposes of Sections 2036 and 2038. See section II.B.5.a of this outline, above. There is a long history of disagreement as the tax effect of the grantor’s power to remove the trustee and appoint someone other than the grantor as successor trustee. Since 1995, there is now a very clear objective safe harbor, but a brief review of the history of this issue may help provide perspective (and help to analyze situations where the safe harbor is not met.)

In a 1977 revenue ruling, the IRS ruled on a situation in which the decedent held the power to appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process. The IRS ruled that Section 2036 did not apply because “the decedent’s power to appoint a successor corporate trustee in the event of resignation or removal of the original trustee did not amount to a power to remove the original trustee that, in effect, would have endowed the decedent with the trustee’s discretionary control over trust income.” Rev. Rul. 77-182, 1977-1 C.B. 273.

The IRS followed that with the now infamous Revenue Ruling 79-353, 1979-2 C.B. 325, which takes the position that the right to remove a corporate trustee without cause and appoint a successor corporate trustee caused estate inclusion under Sections 2036 and 2038. The IRS posited that this removal and appointment power was an “extremely potent power,” even though the decedent was forced to appoint a successor corporate trustee. After receiving considerable criticism of the ruling, the IRS relented somewhat in 1981, and agreed that Revenue Ruling 79-353
would apply only to transfers after the date of the 1979 ruling. Rev. Rul. 81-151, 1981-1 C.B. 458.

The first court case to address the IRS’s position in Revenue Ruling 79-353 was *Estate of Vak*, which held that the grantor’s unlimited power to remove the trustee and appoint a successor independent trustee (who was not a related or subordinate party under Section 672(c)) did not prevent the grantor from making a completed gift when the transfer to the trust was made. The case summarily rejected the IRS’s position that ”Mr. Vak had the power to replace the trustees with individuals who would do his bidding.” *Estate of Vak v. Comm’r*, 973 F.2d 1409 (8th Cir. 1992).

The IRS next urged its position under Sections 2036 and 2038 regarding removal powers in *Estate of Wall*. That case presented facts very similar to the facts of Revenue Ruling 79-353. *Estate of Wall v. Comm’r*, 101 T.C. 300 (1993). The IRS's position was “that even a corporate trustee will be compelled to follow the bidding of a settlor who has the power to remove the trustee; otherwise the settlor will be able to find another corporate trustee which will act as the settlor wishes. In other words, says respondent, under these circumstances the settlor has the de facto power to exercise the powers vested in the trustee.” 101 T.C. at 311. The Tax Court rejected this argument, relying primarily on the fiduciary duty of any trustee that might be appointed by the grantor:

“[U]nder established principles of the law governing trusts, a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the settlor, prior to appointment, as to how fiduciary powers should be exercised over the distribution of income and principal. The trustee has a duty to administer the trust in the sole interest of the beneficiary, to act impartially if there are multiple beneficiaries, and to exercise powers exclusively for the benefit of the beneficiaries.

... In the absence of some compelling reason to do so, which respondent has not shown, we are not inclined to infer any kind of fraudulent side agreement between Mrs. Wall and First Wisconsin as to how the administration of these trusts would be manipulated by Mrs. Wall. Instead, since the language of the trust indentures provides maximum flexibility as to distributions of income and principal, the trustee would be expected to look to the circumstances of the beneficiaries to whom sole allegiance is owed, and not to Mrs. Wall, in order to determine the timing and amount of discretionary distributions.” 101 T.C. at 312-313.

The court concluded by relying on the Supreme Court’s analysis of Section 2036 in *U.S. v. Byrum*, 408 U.S. 125 (1972), to concluded that the grantor did not retain an ascertainable and enforceable power to affect the beneficial enjoyment of the trust property. 101 T.C. at 313.
Following its losses in *Estate of Vak* and *Estate of Wall*, the IRS changed its position in Revenue Ruling 95-58, 1995-2 C.B. 1. The ruling revokes Revenue Ruling 79-353 and Revenue Ruling 81-51. In addition, it modified Revenue Ruling 77-182 “to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent would not have retained a trustee’s discretionary control over trust income.” In effect, the ruling allows a safe harbor based on the facts of the *Vak* case. The safe harbor is that Sections 2036 and 2038 will not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was “not related or subordinate to the decedent” within the meaning of Section 672(c). (Interestingly, this position is consistent with the removal provisions in the income tax regulations for grantor trusts. Treas. Reg. § 1.674(d)-2.)

Thus, the grantor can retain an unlimited right to remove the trustee, and there is no requirement that a successor corporate trustee be appointed. However, the IRS does add the requirement that, to come within the safe harbor, the successor trustees must not be a “related or subordinate party.”

In many situations, the grantor will want to have a removal power and have the power to appoint someone other than the grantor, but the grantor may want to keep the ability to name relatives or others who would not come within the safe harbor. The grantor will need to weigh the desire for the retained flexibility vs. the comfort of coming within the safe harbor of Revenue Ruling 95-58. If the grantor decides to keep the more expansive ability to appoint relatives as successor trustees, the grantor would rely on the broad language in *Estate of Wall* relying primarily on the fiduciary duty of any trustee who might be appointed.

h. **Power to Remove and Replace Trustee—Section 2042.** Revenue Ruling 79-353, 1979-2 C.B. 325 held that retaining the ability to remove a trustee gave the grantor all of the powers of the trustee for purposes of Sections 2036 and 2038, but did not address Section 2042.

Technical Advice Memo 8922003 held, in reliance on Revenue Ruling 79-353, 1979-2 C.B. 325, that the ability of the insured to remove the trustee *without cause* and appoint someone other than the insured as successor trustee resulted in the insured holding incidents of ownership.

Revenue Ruling 95-58, 1995-2 C.B. 1, revoked Revenue Ruling 79-353 (which addressed Sections 2036 and 2038) and provided that those Sections would not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was “not related or subordinate to the decedent” within the meaning of Section 672(c).

The revocation of Revenue Ruling 79-353 seems to imply that the extension of its rationale to Section 2042 in TAM 8922003 is no longer valid. Furthermore, Letter Ruling 9832039 cited Revenue Ruling 95-58’s revocation of Revenue Ruling 79-353 to support its conclusion that the power to remove a trustee *for cause* did not trigger Section 2042. (However, the citation to Revenue Ruling 95-58 was not
necessary because the power to remove a trustee for cause was probably not an incident of ownership even prior to Revenue Ruling 95-58.) See Janson, Life Insurance Potpourri—Recent Developments and Private Split Dollar Plans, 34TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 401.5.C. (2000).

The IRS has not addressed the effect of a removal power without cause for purposes of Section 2042, but it would probably be treated the same as for Sections 2036 and 2038 under Revenue Ruling 95-58. See Ltr. Rul. 200314009 (if trustee ceased to serve or was removed, insured could appoint successor trustee who was not related or subordinate to insured; held that section 2042 did not apply; ruling did not clarify whether insured held a removal power, but the reasoning of the ruling seems to apply Rev. Rul 95-58 for §2042 purposes); Covey, Recent Developments in Transfer Taxes and Income Taxation of Trusts and Estates, 35TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 120 (2001) (suggesting that the IRS likely will not take a harsher position under Section 2042 than under Sections 2036 and 2038, observing that the IRS has taken same position in PLR 9746007 regarding the effect of removal powers on a beneficiary under Section 2041).

i. Disability of Grantor. The disability of the grantor will have no impact on powers that may be held by the grantor with respect to any of the prior subsections regarding trustee appointment powers. See section II.B.3.d.(5) of this outline.

j. Summary of Selection of Trustee Issues Regarding Trustee Removal and Appointment Powers. If the trustee holds powers that would cause estate inclusion if the grantor held the powers directly, the following restrictions apply regarding appointment procedures to avoid estate inclusion by reason of the appointment powers. The grantor cannot have the power to appoint himself—even a power contingent upon the occurrence of future conditions outside his control. Also, the grantor cannot serve as a co-trustee or have a power to veto actions by the trustee. The grantor can, however, keep the power to appoint a successor or series of successor trustees in the future (apparently) or to add co-trustees. The grantor can keep the power to remove and replace the trustee (with someone other than the grantor) as long as the successor is someone who is not related or subordinate to the grantor. If the grantor wants to have the ability to remove and appoint a successor (other than himself) is who a related party, the parties would have to rely on the reasoning of Vak and Wall that any successor trustee would be subject to fiduciary duties, but that procedure would not be within the safe harbor that is clearly recognized by the IRS.


a. Minor’s Trusts Under Section 2503(c). If the grantor serves as trustee of a minor’s trust created under Section 2503(c) (to qualify for the gift tax annual exclusion), the trust assets will be included in the grantor’s estate for under Sections 2036 and 2038 if he dies while serving before the termination of the trust. See Alexander v. Comm’r, 81 T.C. 757 (1983); Estate of O’Connor v. Comm’t, 54 T.C. 969 (1970).
Under Section 2503(c), there can be no “substantial restrictions” on the trustee’s exercise of the discretionary power to make distributions for the minor beneficiary. Treas. Reg. § 25.2503-4(b)(1). A discretionary power to make distributions for “support, education, care, comfort and welfare” will qualify under Section 2503(c). Rev. Rul. 67-70, 1967-2 C.B. 349. Even that standard, however, is probably too expansive to satisfy the ascertainable standard exception under Section 2036 and 2038 (as discussed in Section II.B.3.g. of this outline). (In addition, estate inclusion would result if the grantor resigns as trustee within three years of his death. I.R.C. § 2035(a).)

Accordingly, the grantor should not serve as trustee or co-trustee (or have the power to appoint himself as trustee or co-trustee) of a Section 2503(c) trust. In addition, the grantor’s spouse generally should not be the trustee either. If the spouse dies before the trust terminates, the assets may be included in the spouse’s estate, because she would have the power to make distributions in satisfaction of her legal obligation of support. Treas. Reg. § 20.2041-1(c)(1). Furthermore, when the child becomes of majority age, so that the spouse no longer owes a legal obligation of support, the IRS may argue that a lapse of the spouse’s general power of appointment occurs, thus resulting in a gift from the spouse to the trust. See generally Zaritsky, Tax Planning for Family Wealth Transactions, ¶ 4.05[1][a].

The trustee’s discretionary power over distributions in a Section 2503(c) trust is not a grantor trust power. See I.R.C. § 674(b)(7).

b. Special Needs Trust. A “special needs trust,” designed to provide benefits for a disabled beneficiary that would not disallow governmental benefits, must provide complete discretion to the trustee in making distributions. Obviously, the grantor cannot be the trustee or co-trustee (or have the power to appoint himself as trustee or co-trustee.)

c. Qualified Domestic Trust. Bequests of other transfers at the death of a spouse to a surviving spouse who is not a citizen of the United States will qualify for the estate tax marital deduction only if the transfer is made to a qualified domestic trust. I.R.C. 2056A. One of the statutory requirements is that the trust instrument require that one trustee of the trust be an individual citizen of the United States of a domestic corporation. I.R.C. § 2056A(a)(1)(A). In the addition, the regulations add various requirements that must be satisfied depending on the size of the trust. If the trust is over $20 million in value, the trust must meet one of three additional requirements. Treas. Reg. § 20.2056A-2(d)(1)(i). The easiest of those three requirements is to have at least one co-trustee that is a domestic bank or the United States branch of a foreign bank (in which event there must be another co-trustee (individual or a domestic corporation) that is a United States citizen. Treas. Reg. § 20.2056A-2(d)(1)(i)(A). (An additional option is available if the QDOT has assets under $2.0 million, namely that the trust instrument provide that no more than 35% of the fair market value of the trust assets, determined annually, may be invested in real property that is located outside the United States, Treas. Reg. § 20.2056A-2(d)(1)(ii).)
d. **S Corporation.** Only certain types of trusts can qualify as shareholders of an S corporation. These include (1) a grantor trust, (2) a “Section 678” trust requiring that all income be taxable to a trust beneficiary, (3) a Qualified Subchapter S Trust, (“QSST”) or (4) an electing small business trust. (“ESBT”). I.R.C. § 1361(c)(2)(A). If a trust is not a grantor trust (as to the grantor under Section 671-677 or as to the beneficiary under Section 678), it is often preferable for the trust to qualify as a QSST, due to the complexity of administering ESBTs and the requirement that all S corporation income attributable to an ESBT will automatically be taxed at the trust’s highest marginal rates. I.R.C. § 641(c). One of the requirements of a QSST is that there be only one current income beneficiary, and that corpus distributions may only be made to the current income beneficiary. I.R.C. §1361(d)(3)(A)(i-ii). Another requirement is that all of the income must be distributed currently to the income beneficiary. I.R.C. § 1361(d)(3)(B).

If a trust instrument allows distributions to more than one beneficiary, and if the grantor anticipates that the trust may at some point own or acquire stock in an S corporation, the trust instrument may include a provision permitting the trustee to divide the trust into separate trusts for the beneficiaries, so that there is a separate single-beneficiary trust for each beneficiary; the S corporation stock would be distributed to those separate trusts. Furthermore, the special S corporation authority will typically provide that if such separate trusts are created for each income beneficiary, there will be a mandatory income requirement with respect to those separate trusts (so that the trust will not be at risk for losing S corporation status for all of the shareholders of the S corporation by inadvertently failing to distribute all of the trust’s accounting income during the year). If that type of provision is included, and if the grantor is the trustee or co-trustee (or may become the trustee or a co-trustee), the authority to acquire stock of an S corporation and to divide a sprinkle trust into separate trusts and to convert a discretionary income provision into a mandatory income provision may cause estate inclusion for the grantor under Sections 2036 and 2038.

e. **Charitable Remainder Trust.** Subject to several limitations, a grantor may serve as the trustee of a charitable remainder trust. See e.g., Ltr. Rul. 7730015; but see Ltr. Rul 9442017. However, difficulties arise if difficult-to-value assets are held in a charitable remainder unitrust (“CRUT”). A CRUT’s assets must be valued annually. I.R.C. § 554(a)(2)(A). Regulations adopted in 1998 provide that “unmarketable assets” (defined as assets that are not cash, cash equivalents or assets that can be readily sold for cash or cash equivalents, Treas. Reg. § 1.664-1(a)(7)) must be valued either (1) by an “independent trustee”, or (2) by a qualified appraiser. Treas. Reg. § 1.664-1(a)(7). For this purpose, an independent trustee is a person who is not the grantor, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor’s spouse, or a noncharitable beneficiary (within the meaning of Section 672(c)).

Accordingly, if there are any difficult-to-value assets in a CRUT, an independent trustee (as defined above) must be used if the grantor does not want to have to incur the expense of obtaining a formal qualified appraisal of the trust assets each year.
f. **Grantor Retained Annuity Trust (GRAT).** The grantor typically serves as the trustee of the GRAT during the term of the annuity payments. (The assets will be included in the grantor’s estate in any event if the grantor dies before the annuity payments end.) Generally, there is no requirement that the grantor live at least three years after ceasing to serve as trustee (because Section 2035(a)(1) provides that the three year rule applies if a Section 2036 or 2038 power is “relinquished”; the grantor does not “relinquish” anything at the end of the GRAT term, instead the instrument mandates that the annuity ends.)

If the grantor continues to serve as trustee following the end of the annuity term, the other requirements discussed in this outline in order to avoid estate inclusion under Sections 2036 and 2038 with respect to retained powers must be satisfied.

There is a special three-year problem if the GRAT owns stock in a “controlled corporation” and if the grantor has the right as a trustee (or co-trustee) to vote such stock. The grantor would have to cease serving as trustee or otherwise relinquish any voting rights at least three years before his death in order to avoid estate inclusion under Section 2036(b). See section II.B.4.k.(1) of this outline. If the grantor serves as trustee of a GRAT that may hold stock of a “controlled corporation,” as defined in Section 2036(b), the trust instrument should specify that the grantor will not have the right to vote such stock, and there should be a co-trustee who has the right to vote such stock.

g. **Sales to Grantor Trusts.** A popular estate planning strategy is to have a donor create a grantor trust (i.e., a trust that the grantor is deemed to own for income tax purposes but not for estate and gift tax purposes). The donor would give some assets to the trust, then would sell other assets to the trust in return for a fixed interest note. Hopefully, the income and appreciation of the asset that is sold to the trust will be larger than the interest on the note, so that net accumulation will occur in the trust.

One of the risks of the sale to grantor trust strategy is that under extreme circumstances, it is possible that the IRS may take the position that the note is treated as a retained equity interest in the trust rather than as a mere note from the trust. If so, this would raise potential questions of whether some of the trust assets should be included in the grantor’s estate under §2036 and §2702. It would seem that §2036 (which generally causes estate inclusion where the grantor has made a gift of an asset and retained the right to the income from that asset) should not apply to the extent that the grantor has sold (rather than given) the asset for full market value. See Letter Rulings 9436006 (stock contributed to grantor trust and other stock sold to trust for 25-year note; ruling holds §2702 does not apply); 9535026 (property sold to grantor trust for note, interest-only AFR rate for 20 years with a balloon payment at end of 20 years; held that the note is treated as debt and “debt instrument is not a retained interest” for purposes of §2702; specifically refrained from ruling on § 2036 issue).

One letter ruling concluded that Section 2036 did apply to property sold to a grantor trust in return for a note, based on the facts in that situation. Letter Ruling 9251004 (transfer of $5.0 million of stock to trust in return for $1.5 million note in
“sale/gift” transaction; ruling held that §2036 applies to retained right to payments under note, reasoning that note payments would constitute a major share, if not all, of the trust income, thus causing inclusion of trust property in estate). For a listing of cases that have addressed the application of section 2036 in the context of private annuity transactions where are the grantor is retaining the right to receive substantial payments from a trust, see Hesch & Manning, Beyond the Basic Freeze: Further Uses of Deferred Payment Sales, 34 UNIV. MIAMI INST. EST. PL. ¶ 1601.1 n. 55 (2000).

One commentator has suggested that there is a significant risk of section 2036(a)(1) being argued by the IRS if “the annual trust income does not exceed the accrued annual interest on the note.” Covey, Practical Drafting 4365-4370, at 4367. Much of the risk of estate inclusion seems tied to the failure to have sufficient “seeding” of equity in the trust prior to the sale. One commentator summarizes the possible risks of thin capitalization as follows--

a. includibility of the gross estate under section 2036,
b. a gift upon the cessation of section 2036 exposure,
c. applicability of section 2702 to such a gift,
d. the creation of a second class of equity in the underlying property with possible consequences under section 2701,
e. possible loss of eligibility of the trust to be an S Corporation,
f. treatment of the trust as an association taxable as a corporation,
g. continued estate tax exposure under section 2036 for three years after cessation of section 2036 exposure, and
h. inability to allocate GST exemption during the ensuing ETIP.

The section 2036 problem may go away as the principal on the note is paid down, or as the value the purchased property (the equity) appreciates, but the ETIP problem would remain.” Aucutt, Installment Sales to Grantor Trusts, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 613, 669 (April 2013).

Various cases have addressed when promissory notes will be respected for general tax purposes. Estate of Deal v. Commr, 29 T.C. 730 (1958) (intent to forgive notes at time they were received cause gift treatment at outset); Estate of Holland v. Commr, T.C. Memo 1997-302 (loan owed by estate not treated as valid loan qualifying for estate tax debt deduction; “The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax is consistent with a loan.”); FSA 1999-837 (if intent to forgive loan as part of prearranged plan, loan will not be treated as consideration and donor makes gift to the full extent of the loan). The same nine objective factors listed in Estate of Holland were also described in Miller v. Commissioner, T.C. Memo 1996-3, aff’d, 113 F.3d 1241 (9th Cir. 1997). See also Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104.
If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller's gross estate under §2036.

The Rosen case reiterated some of these same factors in determining that advances from an family limited partnership should be treated as equity distributions rather than being recognized as advances in return for a note. Estate of Rosen v. Comm'r, T.C. Memo 2006-115 (decedent never intended to repay the advances, demand note with no fixed maturity date, no written repayment schedule, no provision requiring periodic payments of principal or interest, no stated collateral, no repayments by decedent during lifetime, no demand for repayment, only one note was prepared during lifetime even though numerous “advances” were made, decedent had no ability to honor a demand for repayment, no interest payments on the note, repayment of the note depended solely on the FLP’s success, transfers were made to meet the decedent’s daily needs, adequacy of interest on the note was questioned). For an excellent discussion of the impact of the Rosen case on potential estate inclusion, see Blattmachr & Zeydel, Comparing GRATs and Installment Sales, 41ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶202.3[C][2](2007).

John Porter reports that he has had several cases in which the IRS took the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the “economic realities of the arrangement ... do not support a part sale,” and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (This position conflicts with Treas. Reg. § 25.2512-a, which provides that transfers are treated as gifts “to the extent that the value of the property transferred by the donor exceeds the value in money or money’s worth of the consideration given therefore.”)

If the note term is longer than the seller’s life expectancy, the IRS may have a stronger argument that §2036 applies.

The IRS has questioned the validity of a sale of limited partnership interests to a grantor trust in the Karmazin case, which was settled in a manner that recognized the sale. T.C. Docket No. 2127-03, filed Feb. 10, 2003. That case was ultimately settled (favorably to the taxpayer), but the wide ranging tax effects of having the note treated as equity rather than debt were highlighted.

Practical Planning Pointers: One respected commentator summarizes planning structures to minimize the estate tax risk.

“The reasoning in Fidelity-Philadelphia Trust suggests that the estate tax case is strongest when the following features are carefully observed:

a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.

b. The note yield and payments should not be tied to the performance of the sold asset.
c. The grantor should retain no control over the trust.

d. The grantor should enforce all available rights as a creditor.”

Aucutt, Installment Sales to Grantor Trusts, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 615, 667 (April 2013).


1. Foreign Trust Status and Effects.

a. Tax Concerns With Being Foreign Trust. Various tax complexities arise for foreign trusts. A few of them are described.

(1) Reporting Requirements. U.S. beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the IRS on Form 3520. (Additional required information is described in Notice 97-34.) In addition, a U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made. In addition, the foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust may be liable for a 5% penalty of the value of the trust assets that are treated as owned by that person. I.R.C. § 6677(b). If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S. grantor must report the transfer. I.R.C. § 679(a)(5).

(2) Foreign Grantor Trust. If a U.S. grantor establishes a foreign trust for the benefit of U.S. beneficiaries, it is treated as a grantor trust. I.R.C. § 679. Upon termination of grantor trust status (i.e., at the death of the grantor or if there are no longer any U.S. beneficiaries), Section 684 imposes a tax on the unrealized appreciation. However, if that occurs because of the death of the grantor, the step-up in basis under Section 1014 should avoid having any gain to which Section 684 would apply.

(3) Foreign Nongrantor Trust. If a foreign trust is not treated as a grantor trust (which, for example, could occur despite Section 679 if it is created in a testamentary transfer at the death of the U.S. grantor, or it is created by a non-U.S. grantor, or if it is created during the lifetime of a U.S. grantor and does not have any U.S. beneficiaries) special income tax rules apply. It is subject to U.S. income tax only on certain types of income (primarily income effectively connected with a U.S. trade or business, I.R.C. § 871(b), U.S. source fixed or determinable annual or periodic income [such as interest, dividends, and rents], I.R.C. § 871(a)(1)(A), U.S. source gains, I.R.C. § 871(a)(1)(B & D), or income on the disposition of U.S. realty, I.R.C. § 871(a)(1)(A)).

U.S. beneficiaries of foreign nongrantor trusts are subject to several special rules. DNI of a foreign nongrantor trust is determined under special rules, a primary distinction of which is that capital gains are included in DNI. I.R.C.
§643(a). The ticking time bomb for foreign nongrantor trusts is that if all of
the DNI is not distributed each year, accumulation distributions (again
determined under very special rules in Section 665(b)) are subject to the
imposition of a tax under the throwback rule, I.R.C. § 665(d). Furthermore, the
tax under the throwback rule is increased by an interest charge. I.R.C. §§
667(a)(3) & 668. The interest rate is the floating interest rate under Section
6621 that applies to underpayments of tax generally.

(4) Cannot Be S Corporation Shareholder. A foreign trust is not an eligible S
corporation shareholder. I.R.C. § 1361(c)(2) (last sentence).

(5) Bottom Line—Substantial Complexity and Possible Increased Tax Costs. The
extremely brief preceding summary of some of the tax effects of foreign trusts
demonstrates that the tax rules become substantially more complex, with huge
penalties for failure to file required information to the I.R.S., and with
potentially increased taxes (with interest charges).

b. Selection of Trustee Can Cause Foreign Trust Treatment. A trust is a foreign trust
unless both of the following tests are satisfied: (1) courts in the U.S. must be able to
exercise primary supervision over the trust; and (2) one or more U.S. persons have
the authority to control all substantial decisions of the trust. I.R.C. §§
7701(a)(30)(E) & (31)(B). A foreign person is someone who is not (among other
things) a U.S. citizen or resident, or a U.S. domestic corporation. If a foreign
person has control over only one “substantial decision,” foreign trust status results.
“Substantial decisions” are defined in the regulations to mean “all decisions other
than ministerial decisions.” Treas. Reg. § 301.7701-7(d)(1)(ii). Examples are
included that are very expansive, including not only the power to determine the
timing, amount and selection of beneficiaries, but other administrative actions such
as making income/principal allocations, investment decisions, and compromising
claims. The definition even includes the power to appoint a successor trustee
(unless it is restricted so that it cannot change the trust’s residency) and the power
to remove, add, or replace a trustee. Id.

c. Summary of Selection of Trustee Issues Regarding Foreign Trusts. Do not appoint a
foreign person (anyone other than a U.S. citizen or resident or a U.S. domestic
corporation) as a trustee with the power to control any substantial decision—unless
the planner (who really knows what he or she is doing with foreign trusts)
purposefully wants the trust to be a foreign trust. (This generally means that any
non-U.S. person or persons must be less than half of the trustees, and no decisions
are left specifically to their control even though non-U.S. persons are a minority
vote.)


a. Grantor Report Income For Income Tax Purposes. If the trust is a grantor trust, the
grantor would report on his or her income tax return all income, deductions, and credits
attributable to the trust property. The grantor should understand that the grantor trust
rules could impose substantial liability on the grantor to pay income taxes on the trust’s
income.
Having trust income taxed in the grantor's income tax bracket may be advantageous if the grantor is not in the highest tax bracket (in 2013, applicable for married individuals having taxable income exceeding $450,000). Undistributed income of a trust is subject to the top brackets at $11,950 of income (in 2013). Furthermore, the 3.8% Medicare tax may not apply if the grantor materially participates in a business that is owned by the trust if the grantor trust rules apply; the tax does not apply to non-passive trade or business income. The law is more unclear as to how a trust can materially participate in a business and therefore qualify for that exception as to undistributed trust income.

b. **Gift Tax Effects of Grantor's Payment of Income Taxes on Trust's Income.** Payment by the grantor of income taxes with respect to the trust's income permits the trust to grow at a faster rate (because it does not have to pay income taxes). At one time, the IRS took the position in a private ruling (Letter Ruling 9444033, later revised to delete the relevant sentence) that the grantor's payment of income taxes with respect to a grantor trust was a taxable gift. The IRS has now changed its position. Revenue Ruling 2004-64, 2004-2 C.B. 7 held that the grantor’s payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause “the full value of the Trust’s assets” at the grantor’s death to be included in the grantor’s gross estate under section 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor’s legal obligation. (Situation 2).

c. **Income Tax Reimbursement Provision.**

The IRS at one time required that the grantor be reimbursed for income taxes borne by the grantor with respect to income in excess of the annuity amount in order to get a private ruling approving a GRAT. In PLR 9444033, the IRS stated in dicta that the failure to reimburse the grantor for income taxes would be considered a gift by the grantor to the remaindemen. The IRS subsequently reissued the ruling without the dicta in PLR 9543049 and has yet to challenge taxpayers on this issue. Rulings have approved various types of reimbursement provisions. PLRs 9415012, 9416009, 9353004, and 9353007.

In light of this position, some planners have drafted GRAT instruments to require the trustee to reimburse the grantor for income taxes, but only to the extent necessary for the trust to create a "qualified annuity interest" under section 7520. (However, that approach would no longer be advisable following the issuance of Revenue Ruling 2004-64, as discussed below.)

The IRS's position created a dichotomy, because including an income tax reimbursement provision would seem to create some risk that the trust would be included in the grantor's estate under section 2036 (by providing for payment of legal obligations of the grantor.) See Treas. Reg. § 20.2036-1(b)(2). Various IRS private rulings previously held that there would be no inclusion under Section 2036(a). See Ltr. Ruls. 2001120021; 199922062; 199919039; 9710006; 9709001; 9413045. However, the IRS changed its position in Revenue Ruling 2004-64, 2004-2 C.B. 7.
Revenue Ruling 2004-64 held that the grantor’s payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause “the full value of the Trust’s assets” at the grantor’s death to be included in the grantor’s gross estate under section 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor’s legal obligation. (Situation 2) (The statement that the “full value of the trust assets” would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor’s benefit at his or her death.) In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor’s creditors to reach the trust under applicable state law. (Situation 3) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor’s estate with respect to any trust created before October 4, 2004. Some planners suggest allowing a third person to authorize the trustee to reimburse.

Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust.

d. **S Corporation Shareholder.** The trust will be a permissible shareholder of S corporation stock if the trust is a grantor trust as to income and corpus. I.R.C. §1361(c)(2)(A)(i). *E.g.*, Ltr. Rul. 200001015.

e. **Sales Between Trust and Grantor.** No capital gain or loss should be recognized on sales between the trust and the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor). In that ruling, the I.R.S. indicated that it would not follow Rothstein U.S. 735 F.2d 704 (2d Cir. 1984) to the extent it would require a different result. *See* Rev. Rul. 2007-13, 2007-11, I.R.B. 684 (Situation 1, of ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts); Rev. Rul. 92-84, 1992-2 C.B. 216 (gain or loss on sale of asset by QSST, which is grantor trust, is treated as gain or loss of the grantor or other person treated as owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to corpus rather than to income).

f. **Exclusion of Gain From Sale of Personal Residence.** The $250,000 ($500,000 for joint returns) capital gains exclusion under Section 121 for the sale of a principal residence by an individual is available if the residence is owned by a grantor trust. *See* Rev. Rul. 85-45, 1985-1 C.B. 783; Ltr. Rul. 9118017 (prior section 121 provision excluding gain on sale of residence by individual over age 55).
3. **Grantor Trust—Trust Provisions that Cause Grantor Trust Status.**

   a. **Power of Disposition by Related or Subordinate Parties Not Governed by Reasonably Definite External Standard.**

   (1) **Overview.** A power in trustees, more than half of whom are related or subordinate parties, to sprinkle or accumulate income or corpus of the trusts without a “reasonably definite standard” will not qualify for any of the exceptions from grantor trust treatment under Section 674(c)-(d). Furthermore, the trust can be planned to avoid the exceptions in Section 674(b)—generally by giving the trustee “spray” powers without having separate shares for the beneficiaries. Therefore, the trust would be a grantor trust under the general rule of Section 674(a).

   (2) **Section 674(a) General Rule.** Section 674(a) triggers grantor trust treatment if the grantor or a non-adverse party holds a power of disposition over trust assets. As long as the participation of the grantor or a non-adverse party is required (for example, if one of two co-trustees is non-adverse, thus requiring consent of the non-adverse party), Section 674(a) is triggered. A non-adverse party is generally someone who is not a beneficiary and does not have a legal obligation to support a beneficiary. Various exceptions in Sections 674(b), 674(c), and 674(d) can negate grantor trust treatment. Therefore, to rely on a trustee’s general power of disposition to trigger grantor trust status requires very careful navigating of all of those exceptions.

   (3) **Section 674(b)(5) Exception for Corpus.** Section 674(b)(5) is an exception from grantor trust treatment as to corpus if there is a reasonably definite standard (§674(b)(5)(A)) or if separate shares are created for the respective beneficiaries (§674(b)(5)(B)). Therefore, to avoid this exception, there should be no “reasonably definite standard” for the distributions, and the trustee should have a spray power and not have to charge any distributions of corpus against the beneficiary’s proportionate share of corpus.

   (4) **Section 674(b)(6) Exception for Income.** Section 674(b)(6) is an exception from grantor trust treatment as to income if any of the following apply:

   (a) Income accumulated for a beneficiary must ultimately be payable to that beneficiary, to his estate, or to his appointees including anyone other than his estate, his creditors, or the creditors of his estate, §674(b)(6)(A),

   (b) Income accumulated for a beneficiary must ultimately be payable on termination of the trust or in conjunction with a distribution of corpus that includes accumulated income to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, §674(b)(6)(B), or

   (c) Income accumulated for a beneficiary is payable to the beneficiary’s appointees or to one or more designated alternate takers (other than the grantor or grantor’s estate) if the beneficiary dies before a distribution date that could
reasonably be expected to occur within the beneficiary’s lifetime, §674(b)(6)(second paragraph).

The regulations provide that these rules generally mean that the exception from grantor trust treatment will not apply “if the power is in substance one to shift ordinary income from one beneficiary to another.” Treas. Reg. §1.674(b)-1(b)(6)(i)(c). An exception from this general summary of the income exception applies if the grantor or a nonadverse party has the power to shift income from one beneficiary to another by accumulating income with a provision that at a later distribution date the accumulated income will be distributed to current income beneficiaries in shares that are irrevocably specified. For example, an instrument might provide for payment of income in equal shares to two daughters but permit withholding the distribution from either daughter. When the youngest daughter reaches age 30, the remaining trust would be distributed equally between the two. If income is withheld from a daughter, this has the effect of ultimately shifting one-half of the accumulated income from one daughter to the other. However, this shift would not negate the exception from grantor trust treatment. Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 1).

Accordingly, provisions that would flunk this exception include the following. Permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries. See Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 2). Alternatively, if the grantor wishes to provide for “separate shares” for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and does not distribute accumulated income to the beneficiary’s estate or give the beneficiary a testamentary power of appointment.

(5) Section 674(c), Independent Trustees. Section 674(c) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if no more than half of the trustees are related or subordinate parties and they have the power to distribute or accumulate income or corpus for a class of beneficiaries. To avoid this exception, more than half of the trustees would have to be “related or subordinate parties who are subservient to the wishes of the grantor.” The term “related or subordinate party” is defined in Section 672(c), and includes the grantor’s spouse (if living with the grantor), father, mother, issue, brother, sister, as well as an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, and a subordinate employee of a corporation in which the grantor is an executive.

(6) Section 674(c), “Subservient to the Wishes of the Grantor.” The Section 674(c) exception from grantor trust treatment provides that no more than half of the trustees can be related or subordinate parties “who are subservient to the wishes of the grantor”. Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor. This presumption is difficult to overcome, and would require a finding that the trustee is not acting in “accordance with the grantor’s wishes.” S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).
A federal district court concluded (in a securities law case, not a tax case) that the independent trustee exception in §674(c) did not apply in a fact scenario in which the grantors actually made all trust decisions over a long period of time. SEC v. Wyly, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) (discussed in Section II.B.2.f of this outline). That case rejected the approach of the Tax Court to apply the §674(c) independent trustee exception even in a case in which the grantor made all decisions regarding the trust administration, including distribution decisions, with the acquiescence of the trustee. Estate of Goodwyn v. Commissioner, T.C. Memo. 1976-T.C. Memo. 238.

The requirement that the trustee be “subservient to the wishes of the grantor” to cause grantor trust treatment raises an interesting estate tax question. If the person who holds the power to make distributions without a standard is in fact subservient to the wishes of the grantor, does a potential estate inclusion issue arise under Sections 2036 and 2038? See Estate of Goodwyn v. Comm’r, 1973 T.C. Memo. 153 (de facto control of trustee was insufficient to cause inclusion in grantor’s estate under §2036).

(7) Section 674(d), Reasonably Definite External Standard. Section 674(d) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if the trustees (other than the grantor or grantor’s spouse) have the power to make or withhold distributions of income or corpus, if the power is limited by a reasonably definite external standard. Observe that this is not the same as an “ascertainable standard” under §2041. For example, an “emergency” standard appears to be a reasonably definite external standard, but may not be an ascertainable standard under §2041.

(8) Spousal Unity Rule. The grantor is treated as holding any power or interest held by (a) any individual who was the spouse of the grantor at the time of the creation of such power of interest (i.e., even if there is a subsequent divorce), or (b) any individual who subsequently became the spouse of the grantor, but only as to periods after such person became the grantor’s spouse. §674(e). This rule may come into play with a number of the other grantor trust rules.

(9) Summary of Trust Provisions to Trigger Grantor Trust Status Under Section 674. Navigating all of the exceptions based on a dispositive power of the trustee requires very careful planning. A non-adverse party must serve as trustee with a power of disposition over trust assets (Section 674(a)). The instrument must not have reasonably definite external standards for distributions (to avoid Section 674(d)), and more than half of the trustees must be related or subordinate parties (to avoid Section 674(c)). In addition, the trustee should have a spray power over corpus distributions and not have to charge any distributions of corpus against the beneficiary’s proportionate share of corpus (to avoid Section 674(b)(5)). Also, the trust should permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries (to avoid Section 674(b)(6)). (Alternatively, to avoid Section 674(b)(6), if the grantor wishes to provide for “separate shares” for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and do not distribute accumulated
income to the beneficiary’s estate or give the beneficiary a testamentary power of appointment.)

(10) **Does Not Have the Appearance of Just Being a “Grantor Trust” Provision.** An advantage of qualifying for grantor trust treatment under this approach is that it does not have the appearance of merely being a provision added to confer grantor trust status. The provision has real-life economic consequences that are of major importance to trustors—the decision of who has the power to control distributions.

(11) **Giving Grantor’s Spouse Power to Control Distributions Without a Reasonably Definite Standard.** One possible method of using this approach to cause grantor trust status would be to give the grantor’s spouse the power to distribute income or corpus to third parties without including a “reasonably definite external standard”. As long as the spouse did not make any contributions to the trust, this power should not result in estate inclusion for the spouse (as long as the spouse cannot distribute to himself or herself or in satisfaction of his or her legal obligations). Observe that this would result in grantor trust treatment even following a divorce if the prior spouse continued to serve as trustee (although the grantor may not want that person to continue to serve as trustee for other reasons). The trust instrument should carefully plan who the successor trustees would be in the event the spouse ceases to serve, to assure that more than half of the trustees would be related or subordinate parties. To guard against the possibility of a divorce, the trust might give the grantor the power to remove and replace a divorced spouse in a manner that complies with Rev. Rul. 95-58.

b. **Power of a Non Adverse Person to Distribute to or Accumulate Income for the Grantor or the Grantor’s Spouse, §677(a)(1) or (2).**

(1) **May Result in Grantor Trust Treatment Only as to Income.** The literal language of Section 677(a) would suggest that income and corpus of the trust would be treated as a grantor trust. I.R.C. Section 677(a) (“the owner of any portion of a trust...whose income...is, or...maybe” distributed or accumulated for distribution to the grantor or the grantor’s spouse). However, an example in the Regulations very specifically indicates that the Section 677 power only results in the grantor being treated as the owner of the income portion of the trust and not the corpus. Treas. Reg. §1.677(a)-1(g), Ex. 1.

Despite the very clear example in the regulations, the IRS has issued several private letter rulings holding that both the income and corpus portion of a GRAT would be treated as owned by the grantor under the grantor trust rules because the annuity amount would be payable from principal to the extent that income was insufficient. Letter Rulings 9504021, 9451056, 9449012, 9444033, and 9415012. See also Ltr. Rul. 9501004 (CRUT treated as grantor trust as to income and corpus under §677(a) because of the possibility that income allocable to principal could be used to satisfy the unitrust payment). However, the IRS is currently taking the position that a retained annuity alone no longer confers grantor trust status as to both the income and corpus portion of a GRAT. Letter Ruling 9625021.
(2) Grantor or Grantor’s Spouse as Discretionary Beneficiary Plus Power of Appointment May Cause Grantor Trust Status As to Income and Corpus. Various rulings have indicated that a combination of Sections 677 and 674(b)(3) can be used to confer grantor trust status as to income and corpus for a GRAT. The authority to make distributions of the annuity payments would result in grantor trust treatment as to the income under Section 677. If the grantor retains a testamentary power of appointment to appoint the trust assets (for example, in the event the grantor dies before the stated termination of the GRAT), this power will result in grantor trust treatment as to the corpus under Sections 674(a) and 674(b)(3). See Treas. Reg. §1.674(b)-1(b)(3) (“if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion”); Letter Rulings 200001013 & 200001015 (grantor trust treatment as to income because trustee had discretion to pay all of GRAT’s income—if any is remaining after payment of the annuity payments—to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 9707005 (GRAT is a grantor trust as to income and corpus under §674(a) and §677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder); 9625021.

The IRS has reiterated this position, even for trusts requiring mandatory income distributions to the grantor, if capital gains are not allocated to income. Ltr. Rul. 201326011. In that ruling (which involved a trust other than a GRAT), all income was payable to the grantor at least quarterly, and the grantor had a testamentary power of appointment over trust income and corpus. The trust provided that receipts from the sale of trust property shall be allocated to principal. The ruling held that the trust is a grantor trust as to income under §677(a)(1). Also, the trust is a grantor trust as to corpus under §674(a) because the grantor’s testamentary power of appointment did not come within the exception in §674(b)(3). Section 674(b)(3) provides that §674(a) does not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for disposition by the grantor or may be accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. The “exception to the exception” in §674(b)(3) might seem not to apply because there is a mandatory income distribution requirement and income is not accumulated. (Similarly, see the discussion of this testamentary power of appointment exception in Reg. §1.674(b)-1(b)(3).) However, in the ruling, capital gains were allocated to corpus and therefore were not subject to the mandatory distribution requirement. The ruling reasoned:

“Because Grantor has a testamentary power of appointment over the corpus of Trust (and any accumulated income allocable to corpus) and, pursuant to the document, capital gains are added to corpus, Grantor will be treated as the owner of the corpus of Trust during the trust term under §674(a).”
(3) Grantor Trust Status May Be Unintended. Additional economic flexibility can be created for the parents engaged in transfer planning if one of the parents transfers his or her separate property into a trust that would include the spouse as a discretionary beneficiary. The trust should specifically restrict the use of trust income to discharge the grantor’s obligation of support. Treas. Reg. §20.2036-1(b)(2). (Each spouse cannot name the other as beneficiary or the reciprocal trust doctrine may apply.) By including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the unlikely event that the spouse ever needed distributions from the trust. However, the parties should be aware that including this provision will cause the trust to be a grantor trust as to the income under Section 677.

(4) Difficult to Relinquish Grantor Trust Status if Spouse is Discretionary Beneficiary. If the spouse is included as a potential beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift from the spouse may result (unless the relinquishment is a qualified disclaimer within nine months of the creation of the interest.) One possible planning strategy would be to give an independent party the power to remove the spouse as a discretionary beneficiary.

(5) Grantor Status Would Be Terminated at Spouse’s Death. If Section 677 is being utilized to confer grantor trust status by including the grantor’s spouse as a potential beneficiary, the death of the spouse would result in the trust no longer being a grantor trust (unless one of the other grantor trust provisions applies.)

(6) No Estate Tax Inclusion For Spouse Even if Split Gift Election is Made. As long as the spouse does not make any contribution to the trust, merely including the spouse as a potential discretionary beneficiary will not cause inclusion in the spouse’s estate for estate tax purposes (as long as the spouse does not have a general power of appointment under §2041). For purposes of applying §§2036 and 2038, the spouse is not a grantor to the trust, so those sections would not apply. This is true even if the split gift election is made, because the split gift election applies just for gift tax and GST exemption allocation purposes. I.R.C. §2513(a)(1) & 2652(a)(2); there is no analogous estate tax provision. E.g., Rev. Rul. 74-556, 1974-2 C.B. 300 (no §2038 inclusion). Observe that the split gift election is not available if the spouse's interest in the trust cannot be quantified. See generally Zeydel, Gift Splitting—A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules, 106 J. TAX’N 334 (June 2007).

(7) Estate Tax Inclusion Risk if Grantor is Discretionary Beneficiary. If the grantor, rather than the grantor's spouse, is a discretionary beneficiary, there is a likelihood that the trust assets would be included in the grantor’s estate under §2036 unless the trust is formed in a state which has adopted a Domestic Asset Protection Trust statute (where a settlor can be a discretionary without subjecting the trust assets to the settlor’s creditors.) Even in such a “self-settled trust” state, however, if the trustee actually makes distributions to the grantor, a concern may arise under §2036 as to whether there was an implied agreement about distributions to the grantor, which could trigger §2036 inclusion even apart from creditors rights. (Some attorneys respond to that concern by noting that the donor would only
receive trust distributions if he has lost all of his other assets, in which case he may not care about estate taxes.) Some attorneys suggest providing that if the grantor is included as a discretionary beneficiary (in a self-settled trust state), give a third party the power to eliminate the grantor as a potential beneficiary; the 3-year rule under §2035 should not apply if the removal is exercised, even shortly before the grantor's death, because there is no transfer (or relinquishment) by the grantor. The §2036 and creditors rights issue is discussed at length in Section II.B.2.d. of this outline.

c. Power of Non-Adverse Person to Use Income to Pay Life Insurance Premiums on Life of Grantor or Grantor's Spouse, §677(a)(3).

(1) Statutory Provision. The grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor’s spouse. I.R.C. §677(a)(3). This statutory provision appears to be very broad. Literally, giving a trustee the power to pay life insurance premiums on income of a trust would conceivably cause all of the income and corpus of the trust to be a grantor trust.

A Field Attorney Advice (20062701F) takes the position that the mere power to purchase life insurance on the grantor's life causes grantor trust treatment. The complete analysis about §677(a)(3) in that ruling is as follows: “Article II of B Trust Agreement authorizes the trustee to purchase life insurance on taxpayer. There does not appear to be any limit on the amount the trustee may apply to the payment of premiums. Therefore, pursuant to section 677(a)(3), taxpayer is treated as the owner of B.” (However, that was a ruling involving a complicated foreign trust situation where it was in the IRS's interest that the trust be a grantor trust.). Cases have been more restrictive.

(2) Grantor Trust Treatment May Apply Only as to Actual Payment of Life Insurance Premiums. The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. §1.677(a)-1(b)(2). However, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. Weil v. Comm'r, 3 T.C. 579 (1944), acq. 1944 C.B. 29; Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd, 116 F.2d 929 (8th Cir. 1940), cert. denied, 313 U.S. 594 (1941); Moore v. Comm'r, 39 B.T.A. 808, 812 (1939), acq., 1939-2 C.B. 25; Letter Ruling 6406221750A (June 22, 1964). But see Letter Ruling 8852003 (power to pay premiums causes entire trust to be grantor trust). See also Letter Ruling 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income). See generally Zaritzky,

A troubling concept is that the IRS might extend this reasoning to more of the grantor trust triggers. This would suggest the wisdom of using a power of disposition in a non-adverse party as described in Item II.C.3.a. above.

(3) Not Useful to Assure Grantor Trust Status. Due to the case law limitations discussed above, the power is not useful as a tool to assure that a trust will be treated as a grantor trust. However, if the draftsman wishes to use this as one of multiple grantor trust triggers, provide in the trust agreement that the trustee may pay insurance premiums from income or principal, to build the best possible argument that the trust is a grantor trust as to both income and principal.

d. Actual Borrowing of Trust Funds by Grantor or Grantor’s Spouse Without Adequate Interest Or Security, §675(3).

(1) Actual Borrowing Required. Under §675(3), if the grantor has (directly or indirectly) actually borrowed corpus or income from the trust and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated a grantor trust. Grantor trust treatment will not result if the loan provides for adequate interest or security and if the loan is made by a trustee other than a related or subordinate party. Under the statute, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status.

(2) Grantor Trust Status if Loan Outstanding Any Time During the Year. The statutory language suggests that grantor trust status depends upon whether a loan is outstanding at the beginning of a taxable year. Under that interpretation, if borrowing occurs during year one, but is repaid before year two, grantor trust status would not exist in either year one or year two. However, the IRS interprets §675(3) as imposing grantor trust status if the loan to the grantor has been outstanding any time during the year. Rev. Rul. 86-82, 1986-1 C. B. 253, following Mau v. United States, 355 F. Supp. 109 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/07 and repaid on 1/2/08, the grantor would be treated as owning the trust for all of 2007 and 2008 under Revenue Ruling 86-82. There is the intriguing possibility of just making a loan on December 30 of a year to make the trust a grantor trust for the entire year. That may be used in year-end planning, (but there is the possibility that the IRS might take the position at some point that this is an abusive strategy, despite the outstanding Revenue Ruling and case support.)

Repurchase of Asset For a Note. Most attorneys overlook that Revenue 85-13 (which concluded that transactions between grantor and grantor trusts do not result in gain recognition) says that a non-grantor trust can be converted into a grantor trust by having the grantor just buy back the trust asset for a note, and the grantor trust treatment is effective even as to that sale. Rev. Rul 85-13 stands for more than just no gain recognition. It is unresolved whether the amount of the borrowing impacts the portion of the trust that is treated as a grantor trust. (See the
following paragraph.) However, the Second Circuit held that such a purchase of trust assets for a note caused the trust to be a grantor trust as to future transactions, but the purchase transaction itself resulted in gain recognition. Rothstein v. U.S., 735 F.2d 704 (2nd Cir. 1984).

(3) Unclear as To Portion of Trust Treated as Grantor Trust. It is not clear whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus which could have been borrowed if some borrowing occurs. Compare Bennett v. Comm’r, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; held that grantor was taxable on portion of current year’s income which the principal of the loan at the beginning of the year bears to the total trust income from the trust inception) with Benson v. Comm’r, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; held that grantor should be taxed on all trust income). Unless the grantor borrows the entire corpus, there can be no assurance that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

(4) Permits Toggling, But Close Supervision Required. Because grantor trust status is predicated on actual borrowing, it would be possible to toggle grantor trust status on and off. If the grantor wanted to achieve grantor trust status in any particular year, the grantor could borrow all of the trust funds for some period of time during the year (if the trustee is not a related or subordinate party, the borrowing should not provide for adequate interest or security. However, if the trustee is a related or subordinate party, the borrowing could provide for adequate interest and security and still result in grantor trust status.) The grantor would need to repay the entire amount of the loan before the end of the taxable year, so that the grantor could make an independent decision in the following year whether the grantor trust status was desired in the following year.


(1) Statutory Provision. Section 675 provides that the existence of various administrative powers will cause a trust to be a grantor trust for income tax purposes. Section 675(4) lists several general powers of administration, which if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment. One of those powers, listed in § 675(4)(C), is “a power to reacquire the trust corpus by substituting other property of an equivalent value.”

(2) Grantor Trust as to Both Corpus and Income. Even though §675(4)C) refers to a power to reacquire “trust corpus,” this power causes the grantor to be treated as the owner of trust corpus and income (including ordinary income not allocable to corpus). Treas. Reg. § 1.671-3(b)(3).

(3) Nonfiduciary Capacity Determination. The regulations provide that “the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances
surrounding its creation and administration.” Treas. Reg. §1.675-1(b)(4). The IRS has taken the position in several rulings that whether the grantor holds the power in a nonfiduciary capacity for purposes of section 675 is a question of fact to be determined by the district director after returns have been filed. Ltr. Ruls. 199942017, 9645013, 9525032, 9407014, 9352007, 9352004, 9337011, 9335028, 9248016, 9253010. Other letter rulings have not applied the facts and circumstances requirement, but have held that the substitution power caused the trust to be a grantor trust. Ltr. Ruls. 9451056, 9352017, 9351005, 9345035, 9248016. Some rulings have applied a compromise approach, stating that the grantor trust determination depends on the facts and circumstances but that, assuming exercise of a Section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. E.g., Letter Ruling 9810019 (charitable lead trust).

(4) Trustee Should Not Hold Power. Because grantor trust status depends upon the power being held in a “non fiduciary” capacity, the power of substitution should not be held by the trustee. Similarly, a trustee’s approval or consent should not be required. Regulation §1.675-1(b)(4) provides that if a power is exercisable by a person “as trustee,” there is a rebuttable presumption that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Similarly, a trustee’s approval or consent should not be required (or else the requirement in the initial sentence of §675(4) will not be satisfied.)

The power should not be held by an adverse party. Even though several clauses of § 675 require that a power be exercisable by a nonadverse party (§675(1) & (2), §675(4), which deals with general powers of administration, merely refers to powers held “by any person” without requiring that the power be held by a nonadverse party. However, Regulation §1.675-1(b)(4) refers to powers of administration held in a nonfiduciary capacity “by any nonadverse party.” Despite the clear contradiction of the statute, it is possible that the regulation might be upheld under the broad deference standard announced in Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). Accordingly, the substitution power should not be held by a trust beneficiary.

(5) Retention of Power by Grantor. Can the grantor retain a nonfiduciary power to substitute assets of equivalent value without causing inclusion in the grantor’s estate for estate tax purposes? (If you’re not interested in the gory historical details, jump to paragraph 6 for a discussion of the current state of the law in light of Revenue Ruling 2008-22.)

(a) Historical Perspective. A power of the grantor to substitute assets of equivalent value does not cause Section 2036 or 2038 to apply where it is held in a fiduciary capacity. State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a “very close” case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply). Despite the State Street decision (where the court barely found the predecessor to Section 2036 to apply when the donor, albeit as a fiduciary, could exchange assets with the
trust without regard to values), the IRS again argued that a substitution power for equal value held by the grantor-trustee constituted a power to alter amend or revoke the instrument in Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975). The court disagreed, reasoning that any property substituted should be 'of equal value' to property replaced, so the grantor was thereby prohibited from depleting the trust corpus. The court viewed that as being no different than the case where a settlor retains the power to direct investments. The IRS subsequently acquiesced in the case. 1977-2 C.B. 1.

What if the grantor retains a substitution power in a nonfiduciary capacity (to cause the trust to be a grantor trust under Section 675(4)(C))? In Jordahl, the grantor who held the substitution power was a trustee, and held the power in a fiduciary capacity. However, the court’s reasoning suggests that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

"Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprived the remainder of benefits or to deprive an income beneficiary of property.] Substitutions resulting in shifted benefits would not be substitutions of property 'of equal value.'"

Commentators have generally concurred that the Jordahl result should apply even where the substitution power is held in a nonfiduciary capacity. See Practical Drafting 3753-3757 (R. Covey ed. 1994). In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl): 9227013, and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

PLR 200603040 addresses a trust with a substitution power where “the instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity.” The PLR concluded that the substitution power would not cause estate inclusion under §§2033,
2036(a), 2036(b), 2038 or 2039. The PLR focused on the fact that the instrument said that the substitution power could only be exercised in a fiduciary capacity. In *Jordahl*, the decedent was a co-trustee so one might infer that all powers held by the grantor in that case were held in a fiduciary capacity. However, the PLR interpreted *Jordahl* as follows: “Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.” Under this reasoning, would any substitution power be exercisable only in a fiduciary capacity? That reasoning might suggest why the IRS refuses to rule in PLRs whether a substitution power is held in a nonfiduciary capacity (to be a grantor trust trigger under §675(4)) even though the instrument specifically says the power is not held in a fiduciary capacity.

Similarly, PLR 200606006 said that §2036 would not apply in a situation where the substitution power was held in a fiduciary capacity. Without changing the trust under state law so that the trustee would hold the substitution power in a fiduciary capacity, the IRS would not give a favorable ruling on §2036. (In the facts of that ruling, there were other grantor trust triggers, so the trust was a grantor trust even without a nonfiduciary substitution power. The substitution power was important to the grantor in that ruling, because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests.) Despite the existence of dozens of previous private letter rulings saying that §2036 does not apply to a substitution power even if it is held in a nonfiduciary capacity, the IRS is no longer willing to grant favorable §2036 rulings to nonfiduciary substitution powers.

*Jordahl* is often quoted to say that a substitution power does not trigger §2036, but under the facts of *Jordahl*, the grantor held the power in fiduciary capacity. However, the regulations and other authority under §§2036 and 2038 say that it makes no difference how the power is held. Treas. Reg. §§20.2036-1(b)(3) (“it is immaterial ... in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent”) & 20.2038-1(a) (“immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent”). If there is a bad power, it does not help that it is held in a fiduciary capacity. So if the substitution power was bad in *Jordahl*, holding it in a fiduciary capacity would not have helped. Stated differently, if holding a power in a fiduciary capacity does not help to cure a §2036/2038 problem, then holding a power in a nonfiduciary capacity should not hurt in causing a §2036/2038 problem. Therefore, *Jordahl* does seem to provide protection from §2036 inclusion.

(b) **Revenue Ruling 2008-22**. Revenue Ruling 2008-22, 2008-16 IRB 796, provides very helpful guidance, indicating that a grantor non-fiduciary
substitution generally will not trigger estate inclusion under §2036 or 2038. The Ruling cites Jordahl, but says that it did not apply §2038 because the decedent was bound by fiduciary standards. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, “the trustee has a fiduciary duty to prevent the exercise of the power.” The ruling reasons that (1) the trustee “has a fiduciary obligation to ensure that the assets exchanged are of equivalent value,” and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee’s power to reinvest assets and the trustee’s duty of impartiality regarding the beneficiaries.

The precise holding of the ruling states (the indentions and words in ALL CAPS are added for clarity):

“A grantor’s retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate under §2036 or 2038, provided

the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, AND

further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. [The Ruling does not suggest how that might occur, but it does provide some safe harbors against the possible shifting of benefits in the next sentence.]

A substitution power cannot be exercised in a manner that can shift benefits if:

(a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus AND a duty of impartiality with respect to the trust beneficiaries [Observe, state law would generally impose both of these duties unless the trust instrument negates these duties]; OR

(b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.”

Attorneys have differed as to drafting approaches to assure that the trustee must satisfy itself that assets of equivalent value are substituted and that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Some attorneys recommend relying on state law and
general fiduciary principles. Other attorneys have suggested drafting those requirements into the trust instrument. In an initial reaction to the ruling, Jonathan Blattmachr and Michael Graham suggest the following:

“Without reducing or eliminating the fiduciary duties imposed upon the Trustee acting hereunder under the terms of this instrument or applicable law, the Trustee shall ensure the Substitutor’s compliance with the terms of this power by being satisfied that the properties acquired and substituted by the Substitutor are in fact of equivalent value within the meaning of Rev. Rul. 2008-22; further, this power to substitute property shall not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22; without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries at all times while this power of substitution is in effect, within the meaning of Rev. Rul. 2008-22.”

A somewhat more detailed example form clause is provided by Diana Zeydel, Miami, Florida, and Jonathan Blattamchr, New York, New York:

“During the settlor’s lifetime, the settlor shall have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of section 675(4) of the Internal Revenue Code), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire the trust estate (other than any direct or indirect interest in stock described in section 2036(b) of the Internal Revenue Code or any policy insuring the life of the settlor) by substituting other property of an equivalent value, determined as of the date of such substitution.

This power to substitute property is not assignable, and any attempted assignment will render this power void. Without reducing or eliminating the fiduciary duties imposed on the trustees under this agreement or applicable law, the settlor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value and the trustees shall have a fiduciary obligation to ensure the settlor’s compliance with the terms of this power to substitute property by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact or equivalent value, within the meaning of Revenue Ruling 2008-22.

This power to substitute property shall not be exercised in a manner that can shift benefits among the trust beneficiaries within the meaning of Revenue Ruling 2008-22. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the trustees shall have the power to reinvest the principal of the trust and, except in the case of an Marital Trust, the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect, unless the trustees shall have absolute discretion in making distributions of principal and income among the trust beneficiaries so that the power to reinvest the principal of the trust
and the duty of impartiality are not required in order to avoid this power of substitution potentially causing a shift of benefits among trust beneficiaries, all with the meaning of Revenue Ruling 2008-22."

Attorneys have also differed as to whether the trust instrument should give the trustee the power to prevent the substitution if the trustee thinks the value is not equivalent, or if the trustee can merely sue after-the-fact if the substituted assets have a lower value than the assets being reacquired. The rationale for the position that the trustee cannot prevent the sale if the value is too low is that §675 refers to a “power of administration ... exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.” On the other hand, Rev. Rul. 2008-22 specifically says that if a trustee believes that the substituted assets have a lower value, “the trustee has a fiduciary duty to prevent the exercise of the power.” One attorney’s approach is to provide that if the trustee believes the property sought to be substituted is not in fact property of equivalent value, the Trustee shall seek a determination by a court of competent jurisdiction to assure that the equivalent value requirement of the substitution provision is satisfied. Treasury and IRS officials expressed their personal views at the American Bar Association Section of Real Property Trust & Estate Law Section 2008 Spring Meeting that the trustee would exercise its fiduciary duty to question the value issue before the transfer if the trustee believes that the value being substituted was not equivalent, and that is different than requiring “approval or consent” of the trustee.

Revenue Ruling 2011-28, 2011-49 I.R.B. 830 (December 1, 2011) is a follow-up to Revenue Ruling 2008-22. It says that a nonfiduciary substitution power generally will not trigger estate inclusion under §2042. (See sub-paragraph (6) below.)

Both Rev. Rul. 2011-28 and 2008-22 condition the conclusion that assets are not included in the estate under §§2036, 2038 or 2042 on the fiduciary “satisfying itself that the properties acquired and substituted by the grantor were, in fact, of equivalent value.” Interestingly, under §675(4), in order for a nonfiduciary substitution power to cause a trust to be a grantor trust, the power must be exercisable “without the approval or consent of any person in a fiduciary capacity.” Apparently, satisfying that the substituted property is of equivalent value is different than giving “approval or consent.”

(4) **Substitution Power Held By Third Party.** Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor’s brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). In addition, allowing a third party to hold the substitution power could create additional flexibility to “turn off” or to “toggle” grantor trust status (as discussed below).
The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power “exercisable in a nonfiduciary capacity by any person”); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by “any non adverse party”). However, the statute refers to the power to “reacquire” trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. (If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under §4941(d).) Letter Ruling 9037011 gave one of the trustees a power to “acquire any property that held in trust by substituting property...”. The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to “reacquire” trust assets.

Observe that the “reacquire” possible IRS argument does not exist if the grantor’s spouse holds the substitution power, because any power or interest held by the grantor’s spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. §672(e).

The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status. Similarly, Rev. Proc 2008-45 uses the same approach for the sample inter vivos CLUT grantor trust form.

Observe that several private letter rulings have held (apparently incorrectly and inadvertently) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power. E.g., PLRs 201216034, 9311021.

(5) Substitution Power Held by Grantor’s Spouse. If someone other than the grantor can hold the substitution power (as discussed above), the grantor’s spouse could be given the substitution power. For example, a spousal substitution power might be used for voting stock of a controlled corporation. The grantor’s spouse could be given the substitution power without risk that the “reacquire” language would cause §675(4)(C) not to apply, because §672(e) treats that grantor as holding any powers or interests that are held by the grantor’s spouse. However, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under Section 672(e).

(6) Power of Substitution Held by Insured Not an Incident of Ownership. Revenue Ruling 2011-28, 2011-49 I.R.B. 830 (December 1, 2011) is a follow-up to Revenue
Ruling 2008-22. It says that a nonfiduciary substitution power generally will not trigger estate inclusion under §2042.

A 1979 Revenue Ruling, however, provides that the IRS position is that a power to purchase a policy does create an incident of ownership. Revenue Ruling 79-46, 1979-1 C.B. 303, takes the position that an employee has an incident of ownership if the insured’s employment contract gives the insured the right to buy the policy at any time for its cash surrender value. The ruling reasons that the right to buy the policy amounted to a power to veto the policy’s cancellation, and that constituted an incident of ownership. The IRS lost that argument in Estate of Smith v. Commissioner, 73 T.C. 307 (1979), acquiesced in result, 1981-1 C.B. 2, but the acquiescence in result only disagrees with the Tax Court’s reasoning of what constitutes an incident of ownership, and Rev. Rul. 79-46 has never been withdrawn. Interestingly, Rev. Rul. 2011-28 does not retract the prior seemingly inconsistent ruling, and does not even mention the Estate of Smith case, which directly supports the conclusion of Rev. Rul. 2011-28.

The valuation issue of determining an “equivalent value” could be particularly difficult for life insurance policies, which by their nature can be very difficult to value. However, as a practical matter, the substitution power over a life insurance policy typically would never be exercised. The important planning point is that the mere existence of the substitution power causes the trust to be a grantor trust, and that power can now safely be used for life insurance policies as well as other assets. Caution should be exercised if the powerholder ever wishes to actually exercise the power.

(7) Potential Application of Section 2036(b) Indirect Power to Control Voting of Stock of Controlled Corporation. Similarly, some planners suggest providing that the power could not be exercised to acquire to any voting stock of a “controlled corporation” for purposes of §2036(b). A “controlled corporation” is, generally speaking, a corporation in which the decedent held, at any time after a transfer of stock and within three years of the decedent’s death, the right to vote stock possessing at least 20% of the combined voting power of all classes of stock, after applying the attribution rules of §318 and including a right to vote held in conjunction with another person. §2036(b)(2). For this purpose, any relinquishment or cessation of voting rights within three years of the date of death triggers a special §2035 rule. §2036(b)(3).

A substitution power might conceivably be treated indirectly as the power to control the voting of the stock under §2036(b). The issue under §2036(b) is whether the power to reacquire stock is a “retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation” within the meaning of §2036(b). Cf. Letter Ruling 200514002 (involving a trust agreement providing that the grantor’s substitution power did not extend to stock of a controlled corporation). However, the explicit holding of the Revenue Ruling is that a grantor nonfiduciary substitution power by itself will not cause inclusion under §2036 or §2038 (which obviously includes §2036(b)), even though the ruling does not specifically address the reasoning of the potential application of §2036(b). Extending the concept of an indirect power to vote stock to the power to repurchase stock by paying full value.

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for the stock seems a huge stretch. In any event, there should be no necessity of excepting out partnerships from substitution powers (in light of the fact that §2036(b) only applies to corporations and not partnerships).

The Tax Court decided in Jordahl that the right to buy an asset for its fair market value is not a retained right or interest for purposes of §2036 or §2042, and the IRS acquiesced in the result of the case. Some planners point out that if a right to purchase assets constitutes a retained right under §2036, questions could be raised about the application of §2036 to a buy-sell agreement that gives a donor of stock a right of first refusal if the donee elects to sell the stock or a right to buy back the stock if the donee predeceases the donor. Also, questions would be raised regarding the impact under the charitable split-interest rules of a contribution of voting stock (or other asset) to a charity that is subject to such buy-sell provisions, exercisable either by the donor or by other persons.

(8) Valuation If Substitution Power is Exercised. If the grantor or a third party exercises the substitution power, if marketable securities are included, should values at the close of the day be used, or should the mean between the high and low on the day of substitution be used (for valuing both the assets acquired from the trust as well as the substitution assets? Because the “mean between the high and the low” is the general valuation approach for estate and gift tax purposes, most planners use that method (which may required a small adjustment on the following day if the exact high and low prices are not known on the day of the substitution).

f. Power of Non-Adverse Trustee to Make Loans to the Grantor and/or Grantor’s Spouse Without Adequate Security, §675(2).

(1) Mere Existence of Power Sufficient. The mere existence of the power exercisable by the grantor or a non adverse party that enables the grantor to borrow corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security, will confer grantor trust status. I.R.C. §675(2). The mere existence of the power is sufficient to cause grantor trust status regardless whether the power is actually exercised. (Contrast this provision with Section 675(3), discussed below, which requires an actual borrowing of trust funds by the grantor to confer grantor trust status.)

(2) Grantor Treated as Owner of Entire Trust. As long as the power extends to borrowing corpus or income from the trust, grantor trust status will result as to the entire trust. (Some of the other grantor trust powers will result only in partial grantor trust treatment.)

(3) Power to Borrow Without Adequate Security is Sufficient. If the grantor has the power to borrow funds either without adequate security or without adequate interest, the trust will be treated as a grantor trust. Grantor trust status can be achieved if the trustee has the power to lend unsecured, even if the loan provides for adequate interest. Letter Rulings 199942017 (grantor has authority to borrow all or any of the corpus or income “without adequate security”), 9645013, and
9525032. To avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate tax inclusion, the lending power should be limited to the authority to make loans without security, and should not include the authority to make loans to the grantor without adequate interest. Furthermore, in order to assure that the “adequate” requirement is satisfied, the power is typically drafted in a manner that would explicitly permit making loans without any security to the grantor. See Ltr. Ruls. 9645013 (non-adverse party authorized to lend to the grantor without security) and 9525032 (grantor’s power to borrow without security causes GRAT to be grantor trust). However, in Letter Ruling 199942017, the IRS issued a ruling that the trust would be a grantor trust where the grantor retained the power to borrow all or any portion of the corpus or income of the trust “without adequate security”. (Presumably, the result would be the same if the trustee merely had the power to lend without adequate security as opposed to the grantor having the power to borrow without adequate security.) Interestingly, in that ruling, the S corporation and the grantor who were seeking the grantor trust ruling represented that their intention was “that this section allows Settlor to exercise this power unconditionally, without the approval of the trustees, or any other party”.

(4) Non Adverse Party Other Than Grantor Should Hold the Power. A provision giving the grantor the power to make loans to himself or herself without adequate security would cause grantor trust treatment under Section 675(2), but could risk estate inclusion for estate purposes if the IRS were to determine that the power gave the grantor the authority to receive trust assets for less than full and adequate consideration. To minimize this estate inclusion risk, the power should be held by a non-adverse party other than the grantor. The safest course would be to use someone who is not a “related or subordinate party” to the grantor, by analogy to Revenue Ruling 95-58, 1995-2 C.B. 191, which permits a grantor to remove a trustee without risking estate inclusion under Sections 2036 or 2038 as long as the replacement trustee must be someone who is not a related or subordinate party within the meaning of Section 672(c).

g. Power of Non-Adverse Party to Add Beneficiaries, §674(b), §674(c), 674(d).

(1) Statutory Provisions. Section 674(a) states the general rule that a grantor is treated as the owner of the trust the beneficial enjoyment of which is subject to a power of disposition. Exceptions are provided in Sections 674(b), 674(c), and 674(d). The provisions for many of those exceptions provide that the exceptions will not apply if “any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children”. If such a power to add beneficiaries exists, the exceptions provided in Section 674(b), (c), and (d) will not apply, so the general rule in Section 674(a) provided for grantor trust treatment would apply.

Who Should Hold the Power? The exception to the exceptions in Sections 674(b), (c), and (d) applies if “any person” holds the power to add beneficiaries. Therefore, there is no limitation on who can hold the power as far as whether the power will result in grantor trust status. The general rule of Section 674(a), which triggers
grantor trust treatment where there is a power of disposition over trust property, applies only if the power of disposition is exercisable “by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.” However, as long as a non-adverse party holds a power over dispositions, there is no requirement that the person who holds the power to add beneficiaries be a non-adverse party. However, a beneficiary should not hold the power to add non-charitable beneficiaries, or else gift consequences might result from its exercise.

**Practical Planning Strategies.** Document that the person who holds the power is aware of its existence, to show that the power is not “illusory.” Consider actually exercising the power at some point, to show that it is not “illusory” such as by adding the spouse of a particular beneficiary as a potential discretionary beneficiary. Typically, the power to add beneficiaries is discontinued following the grantor’s death. A possible planning strategy might be to provide that the person who has the power to add beneficiaries also has the power to remove any beneficiary that was added as a potential beneficiary by that same person. Another possibility if there is a desire to keep as much flexibility as possible would be to give someone the power to add a beneficiary for that particular calendar year.

(a) **Grantor.** The grantor should not hold the power to add beneficiaries because that retained power would cause the transfer to result in an incomplete gift. Treas. Reg. 25.2511-2(c)(f). In addition, the assets may be included in the grantor’s estate under Sections 2036(a)(2) or 2038.

(b) **Grantor’s Spouse.** The power could be held by the grantor’s spouse without risking estate inclusion as long as no property is contributed to the trust by the spouse and as long as the spouse is not controlled by the grantor. (However, a successor holder of the power should be provided or else the death of the spouse could cause a termination of grantor trust status.)

(c) **Beneficiary.** The power to add beneficiaries should not be held by a beneficiary. An exercise of the power by a beneficiary might result in a deemed gift. Perhaps a gift would not result if the beneficiary merely has the power to add to the class of permissible beneficiaries but another trustee holds the power to make discretionary distributions to the added beneficiary.

(d) **Trustee.** The power to add beneficiaries is sometimes granted to the trustee of the trust. See Letter Rulings 199936031 (trustee who was a non-adverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date), 9709001 & 9010065 (independent trustee holds power to add charities as beneficiaries). Query whether fiduciary principles would place any constraint on the ability of the trustee to add a beneficiary. One commentator summarizes this fiduciary problem:

“One must face the dilemma that a trustee ordinarily would have no reason consistent with fiduciary duty to voluntarily relinquish powers that might be exercised in the future in the best interests of the trust beneficiaries. This is particularly true when an obvious result of such
relinquishment would be to subject the trust or its beneficiaries to an income tax that they otherwise would avoid. Broad discretion in the trust instrument might not be sufficient to authorize the trustee to relinquish a power when there is no reason to do so. Mere accommodation of the grantor does not appear to ever by a proper reason. Recent family limited partnership cases under section 2036(a) should give us pause.” Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1555 (April 2007).

(Ron Aucutt suggests that one possible solution to this dilemma is to provide that the trustee acquires a desirable power by relinquishing the power that makes the trust a grantor trust. For example, the Trustee might acquire the power to vary the shares of family members or to broaden the standard for distributions by relinquishing the power to add charitable beneficiaries. Id.)

If the client would really like the prospect of adding charitable beneficiaries of the trust in certain circumstances, perhaps the instrument could give guidance to the trustee regarding the situations in which the trustee should particularly consider adding charitable beneficiaries. However, the instrument should not add objective standards that may likely never be satisfied before a charitable beneficiary could be added. A court might determine in that situation that no real ability to add charitable beneficiaries existed.

(2) Classes of Beneficiaries That May Be Added. The statute provides that the power to add beneficiaries “to provide for after-born or after-adopted children” would not cause grantor trust status. There appears to be no other limitations on the permissible class of added beneficiaries.

(a) Charities. Various cases and rulings have recognized grantor trust status where there is a power to add charities as beneficiaries. Eg. See Madarin v. Comm’r, 84 T.C. 667 (1985) (power of trustee to add charitable organizations causes grantor trust treatment); Ltr. Rulings 199936031 and 9709001. Another permissible way of limiting the types of charities that could be added would be to permit only the addition of charitable remainder trusts or charitable lead trusts with the grantor’s issue as the noncharitable beneficiaries.

(b) Specified Classes of Individuals. The power could be granted so broadly as to permit adding any person as a permissible additional beneficiary. However, most grantors would be uncomfortable granting that broad of discretion to any individual. The permissible classes of additional beneficiaries could be limited in any manner desired by the grantor. For example, the power could be given to add members of a specific group, such as nieces and nephews, spouses of children, or more remote relatives. However, it is not clear that a power to “add” persons who are already contingent remote beneficiaries would be treated as a power to “add” beneficiaries that would trigger grantor trust treatment. “Adding” beneficiaries in that situation arguably just elevates their beneficiary status, but really does not “add” them as beneficiaries.
(3) **Special Power of Appointment.** A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status. See Letter Ruling 9643013 (trustee for one trust and grantor’s spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor’s descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the §674(c) exception did not apply).

(4) **Checks and Balances.** Because of the very broad power granted to an individual to add beneficiaries, the grantor may feel more comfortable with a “checks and balances” system to assure that various individuals concur with the addition. (However, the consent of beneficiaries should not be required (because the actual grant of consent by beneficiaries may be a deemed gift)).

An approach used by some planners to provide “checks and balances” is to give someone other than the trustee the power to add beneficiaries, but to provide that the trustee would make the decision of when to make distributions to the new beneficiaries, the same as for all trust beneficiaries. However, one commentator has suggested that under section 674(a), the same person who has the power to add beneficiaries must “also have the power, without the approval or consent of an adverse party, to direct a distribution to such added beneficiaries.” Aucutt, Installment Sales to Grantor Trusts, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 615, 631 (April 2013) (recognizing that “some estate planners … do not share this concern and regard this precaution as unnecessarily conservative”). Even if the person who has the power to add beneficiaries does not have the power to cause distributions, there would still be a non-adverse party who has a power of disposition over trust assets, thus triggering §674(a), and none of the exceptions in §674 would seem to apply.

h. **Inter Vivos Power of Appointment.** Carlyn McCaffrey suggests giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment, at least during the grantor’s lifetime. The third party must be a nonadverse party (so a beneficiary cannot hold the power). Because the person is not a trustee, the exception in §674(c) would not apply. □ Consider using a related or subordinate party if there is any concern that the power may be deemed to be held in a fiduciary capacity; in that event, § 674(c) still would not apply. □ Because there is no standard, the exception in §674(d) would not apply. The testamentary power of appointment exception in §674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in Section 674 would apply, so the general rule of §674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset. Provide a succession of power holders during the grantor’s lifetime—so that the trust will continue as a grantor trust if the initial power holder dies before the grantor.
i. **Foreign Grantor Trust.** If a U.S. grantor establishes a foreign trust for the benefit of U.S. beneficiaries, it is treated as a grantor trust. I.R.C. §679. Upon termination of grantor trust status (i.e., at the death of the grantor or if there are no longer any U.S. beneficiaries), Section 684 imposes a tax on the unrealized appreciation. However, if that occurs because of the death of the grantor, the step-up in basis under Section 1014 should avoid having any gain to which Section 684 would apply.

j. **Foreign Grantor.** Section 672(f) provides that the grantor trust rules will not apply if they would cause someone other than a U.S. citizen or resident or domestic corporation to be treated as the owner of the income. Therefore, if a foreign person is the grantor of a trust, the grantor trust rules will not apply as to that person. For example, a foreign person could create a trust for a U.S. beneficiary, who might be the trustee of the trust, and who might also be treated as the owner of the income of the trust under section 678 if the beneficiary has a Crummey withdrawal power over all contributions to the trust. Broad dispositive powers could be granted without fear of causing the foreign person to be treated as the owner of the trust under the grantor trust rules.

k. **Converting Non-Grantor Trust to Grantor Trust.** Possible ways of converting a non-grantor trust to a grantor trust include the following:
- If the trust allows distributions without an ascertainable standard, change trustees so that more than half of the trustees are related or subordinate parties (§674(c)). (This strategy can also be used to toggle between grantor trust and non-grantor trust status.)
- Turn the trust into a foreign trust (§679) [but many other complexities arise with being a foreign trust].
- Actual borrowing of assets from the trust by the grantor without giving adequate security (§675(3)). (See Section V.I.4 of this Part for a more detailed discussion of this alternative.)

**Grantor Trust Conversion During a Year.** If a non grantor trust is converted into a grantor trust, as of what date does it become a grantor trust? Generally, the trust does not become a grantor trust for the entire year, but only for a fraction of the year. However, for some triggers (such as borrowing from the trust), the trust would become a grantor trust for the entire year.

l. **Summary of Selection of Trustee Issues With Respect to Grantor Trust Rules.** The trust will be a grantor trust if the trust may make distributions to the grantor or grantor’s spouse (probably only as to trust income) or if premium payments may be made on life insurance on the life of the grantor or grantor’s spouse (probably only as to the amount of premiums actually paid during the year.)

If the planner wants to avoid grantor trust status, use one of the following exceptions. (1) Use an independent trustee (no more than half of whom are related or subordinate parties) and give them the authority to distribute assets among a designated class of beneficiaries. (2) Use a trustee other than the grantor or grantor’s spouse, whose distribution powers are limited by a reasonably definite external standard. (3) With no limitation on who is the trustee—as to corpus use a reasonably definite distribution standard (or have separate shares for the
beneficiaries), and as to income, either have (i) a vested trust for a single beneficiary, (ii) provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, or (iii) provide that on termination the assets may be appointed to appointees (other than the grantor or grantor’s estate) if the trust is reasonably expected to terminate during the current beneficiary’s lifetime. (4) Use an adverse party as trustee. Even if one of those exceptions is satisfied, also make sure the trust is not a foreign trust and that none of the proscribed administrative powers in Section 675 are present.

If the planner wants to trigger grantor trust status, use one (or more to be safe) of the following. (1) Select trustees and dispositive powers to flunk all of the exceptions in Section 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions. (2) Give a non-adverse party the power to add beneficiaries. (3) Give a non-adverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan. (4) Give the grantor a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case.)

m. Non Grantor Trusts With Grantor as Discretionary Beneficiary. “Delaware Incomplete Non-Grantor” Trusts are trusts used to avoid state income tax by having the trust sitused in a jurisdiction that will not tax the accumulated and capital gains income in a non-grantor trust. (Income of a grantor trust would presumably be subject to tax in the state of the grantor’s residence.) The trust is merely designed to avoid state income tax. For example, if a New York resident creates a Delaware trust with the settlor as a discretionary beneficiary, any undistributed income that is not Delaware source income would not be subject to income tax in either New York (because there is no New York trustee or administration in New York or New York source income) or Delaware (because the trust is not deemed to be a Delaware resident trust that is subject to Delaware income taxes). Because the goal is merely to avoid state income tax, the donor most certainly does not want to risk having to pay federal gift taxes (at a 40% rate) to have an argument of avoiding state income taxes at a much lower rate.

The “DING trust” (these are also sometimes referred to as “NING trusts” when Nevada law applies) typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor’s lifetime. The grantor retains a testamentary limited power of appointment. Various rulings have ruled that the transfer to the trust is an incomplete gift for gift tax purposes, and some (the rulings in 2006 and 2006) have also ruled that the distribution committee members do not have gift tax consequences. The general fact scenarios of the rulings prior to 2013 have generally involved distribution committees comprised of two individuals, each of which are also discretionary beneficiaries under the trust agreement. Distributions can be made (1) by approval of both distribution committee members, or (2) action of one distribution committee member and consent by the grantor. There, a distribution to any beneficiary (including the grantor) will be made only with the consent of
some adverse party as to that individual.  E.g., PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005.

No DING Trust rulings had been issued for five years prior to the issuance of PLRs 201310002-201310006 (described below). The status of DING Trust rulings has been in doubt for several reasons.

(i) Gift tax consequences for distribution committee members. IR-2007-127 (July 9, 2007) announced that the IRS was reconsidering its position in these rulings with respect to the gift tax consequences of trust committee members. The IRS expressed concern that the prior letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158. The IRS announcement says that those Revenue Rulings indicate that “because the committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust corpus.” The ABA Real Property Trust and Estate Law Section submitted comments to the IRS on September 26, 2007. The letter was prepared by prominent members of the estate planning bar, including Jonathan Blattmachr, Prof. Mitchell Gans, Carlyn McCaffrey, Diana Zeydel, and others. The letter concludes that the DING PLRs are not inconsistent with Rev. Ruls. 76-503 and 77-158 (or 79-63). The letter points out various distinctions, and that the co-powerholders in the DING rulings situations have considerably more adversity to each other than the co-powerholders in the revenue rulings. It also points out that the regulation at issue does not necessarily require succession to a power on the powerholder’s death to create adversity; it merely gives that as an additional way that a co-holder of a power can be deemed to be adverse if his only interest in the trust is as a co-holder of a power. In addition, it reasons that no one can have a general power of appointment over property the transfer of which is incomplete (addressing a revenue ruling, a case and several PLRs that might arguably be inconsistent with that proposition). As a corollary to this argument, the letter states that if the original donor has not made a gift to a beneficiary, the beneficiary should not be able to make a gift back to the donor by agreeing to a distribution to the grantor.

(ii) Incomplete gift treatment for grantor. CCA 201208026 concluded that retained testamentary powers of appointment over a trust under which the grantors were not beneficiaries cause the remainder interest to be an incomplete gift, but concluded that the testamentary powers of appointment relate only to the remainder interest. During the grantors’ lifetimes, they had no ability to keep the trustee from making distributions among the potential trust beneficiaries — which might potentially include all of the trust assets. Therefore, the CCA reasoned that the gift was complete as to the “beneficial term interest” that existed before the grantors’ deaths — but was an incomplete gift as to the remainder interest. (Reg. §25.2511-2(b) states that if the donor is the discretionary income beneficiary, a retained testamentary power of appointment causes the transfer to the trust to be an incomplete gift.) The issue then became to determine the relative values of the term interest (a completed gift) and the remainder interest (an incomplete gift). The CCA reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to “applicable family members”) was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest
was the full value transferred to the trust. CCA 201208026 raised concerns that merely reserving a testamentary limited power of appointment in the grantor may be insufficient by itself to cause the transfer to a DING trust to be an incomplete gift by the grantor.

PLRs 201310002-201310006. PLRs 201310002-201310006, issued March 8, 2013, address the grantor trust and gift tax issues for DING trusts.

The trusts are believed to be Nevada DING trusts (though the rulings do not state explicitly that they are Nevada trusts) Based on local law limitations, it is clear that this cannot be a Delaware trust.

The rulings all involve identical fact situations, and the rulings are identical (except that PLR 201310003 inadvertently [apparently] deleted a phrase in the paragraph about Grantor’s Consent Power in the discussion of Rulings 2 and 3).

Basic Facts. Grantor created an irrevocable trust of which Grantor and his issue were discretionary beneficiaries. There was a corporate trustee, who was required to distribute income or principal at the direction of a distribution committee or principal upon direction from Grantor. The distribution committee consists of Grantor and each of his four sons. Three alternative methods are provided for distribution directions: (1) Grantor consent power—distribute income or principal upon direction of a majority of the distribution committee members with the written consent of Grantor; (2) Unanimous member power—distribute income or principal upon direction by all distribution committee members other than Grantor; and (3) Grantor’s sole power—distribute principal to any of Grantor’s issue (not to Grantor, and not income) upon direction from Grantor as Grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

There must always be two “eligible Individuals” (defined) serving as distribution committee members. “A vacancy on the Distribution Committee” must be filled by the eldest of Grantor’s adult issue other than then serving members of the committee (with alternate successors if there are no such surviving adult issue). (The rulings do not clarify whether this is interpreted to mean that a vacancy occurs when any member ceases to serve or only when there are less than two members serving. Some commentators say that a distribution committee member is not replaced unless there is only one remaining committee member, and that this provision may be important in resolving the IRS’s concern that prior DING rulings may be inconsistent with Rev. Ruls. 76-503 and 77-158. Under this reasoning, it is not clear whether the distribution committee members would have a general power of appointment once the committee has been reduced to only two individuals. See Bill Lipkind on PLR 201310002: DING Redux, LEIMBERG EST. PL. EMAIL NEWSLETTER #2076 (March 12, 2013).) The distribution committee ceases to exist upon Grantor’s death.

There is a decanting power, authorizing the distribution committee to distribute assets to qualified trusts. Grantor has a testamentary power of appointment to appoint the assets to any persons or entities other than Grantor’s estate, creditors,
or creditors of the estate. In default of exercise of the power appointment, the assets will pass to the issue of Grantor’s deceased father.

**Rulings.** The IRS gave four important rulings.

1. **Non-Grantor Trust.** The trust is not a grantor trust. Without any explanatory analysis, the ruling merely concludes that §§673, 674, 676, and 677 do not apply. Whether §675 applies is a question of fact to be determined when federal income tax returns of the parties are filed. Section 678 does not apply because no beneficiary can unilaterally vest trust income or corpus in himself.

   Section 674(a) provides that a grantor is treated as the owner of any portion of a trust for which the beneficial enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, *without the approval or consent of any adverse party*. Similarly, §§676(a) and 677(a) provides that a grantor is treated as the owner of a trust subject to certain other powers that can be exercised without the approval of an adverse party. Section 672(a) provides that for purposes of the grantor trust rules, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. With respect to the grantor consent power and unanimous member power, distributions can be made only with the consent of an adverse party. (The rulings do not specifically reason that the distribution committee members are adverse to the grantor for this income tax purpose, but that must be the basis of the rulings’ conclusion. Observe that the rulings conclude that the distribution committee members are NOT adverse to Grantor for gift tax purposes, as discussed in the discussion below regarding the impact of Grantor’s consent power on the issue of whether the transfer to the trusts is an incomplete gift by Grantor.)

   With respect to the “Grantor’s sole power” alternative, the grantor has the power to distribute principal *(not income)* in a nonfiduciary capacity *(the nonfiduciary capacity element is important as a basis for finding that the transfer to the trust is not a completed gift by Grantor, as explained below)*, §674(b)(5)(A) has an exception for the power to distribute corpus that is limited by reasonably definite standard.

2. **Incomplete Gift by Grantor.** The rulings give four reasons that Grantor does not make a completed gift upon creation of the trust.

   - **Grantor’s consent power.** Under Reg. §25.2511-2(b) a gift is complete if the donor “has so part with dominion and control as to leave him in no power to change its disposition.” Grantor’s consent power is deemed to be such a power over disposition (which makes the gift incomplete), because a donor is considered as having a power exercisable in conjunction with someone else as long as the other person does not have a substantial adverse interest in the disposition of the transferred property. Reg. § 25.2511-2(e). The rulings conclude that the other distribution committee members do not have interests adverse to Grantor for this purpose. Reg. §25.2511-2(c) does not define “substantial adverse interest,” but Reg. §25.2514-3(b)(2) states
that a “taker in default of appointment under a power has an interest which is adverse to an exercise of the power.” The ruling gives no explanation as to why the four sons are not deemed to be “takers in default” if a distribution is not made. (Perhaps it is because of Grantor’s retained testamentary limited power of appointment, so that none of the four sons could be assured of receiving any undistributed trust assets, but the rulings do not discuss that reasoning.) The next two sentences of Reg. §25.2514-3(b)(2) state:

“A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor’s death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate.”

Rather than treating this as merely a possible method of showing adversity, the rulings reason that continued holding of the power after the possessor’s death is a prerequisite to showing adversity by the coholder of a power:

“Under §25.2514-3(b)(2), a coholder of a power is only considered as having an adverse interest where he may possess the power after the possessor’s death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. In this case, the Distribution Committee ceases to exist upon Grantor’s death. Accordingly, the Distribution Committee members do not have interests adverse to Grantor under §25.2514-3(b)(2) and for purposes of §25.2511-2(c).” (Emphasis added).

The comments submitted to the IRS by the ABA Real Property Trust and Estate Law Section on September 26, 2007 take the position that the regulation does not necessarily require succession to a power on the power holder’s death to create adversity, but merely gives that as an additional way that a coholder of the power can be deemed to be adverse if his only interest in the trust is as a coholder of the power.

In any event, the rulings conclude that Grantor’s consent power (i.e., the ability to join with the other distribution committee members in making distributions by consenting to distributions that a majority of the distribution committee members want to make) “causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes.”

- **Grantor’s sole power over principal.** Grantor’s sole power to make distributions (for health, maintenance, support or education) causes the transfer of property to the trust to be “wholly incomplete” for federal gift tax purposes. The rulings do not specifically discuss how this provision causes the transfer to be “wholly incomplete” even though it is only a power over principal and not income. The rulings do not discuss regulations providing that a transfer will not be incomplete for gift tax purposes if the donor has a power to change beneficial interest but the power is held in a fiduciary capacity and is subject to a “fixed and ascertainable standard.” Reg. §§25.2511-2(c) & 25.2511-2(g). In this situation, however, Grantor’s authority to direct distributions was held in a nonfiduciary capacity.
Interestingly, the IRS treats whether a grantor holds a substitution power in a nonfiduciary capacity for purposes of §675(4)(C) as a question of fact to be determined in each year for income tax purposes. The IRS gave no analysis of whether Grantor actually held the power in a nonfiduciary capacity as a factual matter.

Grantor’s sole power over principal in effect gives Grantor a lifetime power of appointment. CCA 201208026, discussed immediately below, held that a mere testamentary power of appointment caused the trust to be incomplete only as to the remainder interest. A lifetime power of appointment in effect would cause the transfer to be incomplete as to the term interest as well prior to the termination of the trust. However, if including this provision is essential to cause incomplete gift treatment, the plan could not be used in states such as Delaware that do not permit the grantor to retain a lifetime power of appointment in order for a self-settled trust to be protected from claims of the grantor’s creditors (and if the grantor’s creditors can reach the trust, it would be a grantor trust). See Delaware Qualified Dispositions in Trust Act §§3570(11)b.2 & 3571.

- **Grantor’s testamentary limited power of appointment.** The rulings reiterate the limitation under CCA 201208026 on incompleteness by merely retaining a testamentary limited power of appointment. The rulings state that the testamentary power of appointment causes “a retention of dominion and control over the remainder,” and concludes that the retention of the testamentary power causes the transfer of property to the trust to be incomplete “with respect to the remainder” for federal gift tax purposes. Accordingly, retaining a testamentary limited power of appointment would not, under the reasoning of these rulings or CCA 201208026, cause a transfer to be incomplete as to the term interest prior to the termination of the trust.

- **Unanimous member power does not remove Grantor’s dominion and control.** Grantor retains dominion and control over the income and principal until the distribution committee members exercise their unanimous member power. Therefore the existence of the unanimous member power does not remove Grantor’s ability to shift beneficial interests under the other two alternatives for giving distribution directions to the trustee (thereby causing the gift upon transfer property to the trust to be incomplete).

(3) **No Completed Gift by Distribution Committee Members Upon Making Distribution to Grantor.** The rulings reason very simply that “any distribution from Trust to Grantor is merely a return of Grantor’s property. Therefore, we conclude that any distribution of property by the Distribution Committee from Trust to Grantor will not be a completed gift subject to federal gift tax, by any member of the Distribution Committee.” (This adopts the reasoning of the comments from the ABA Real Property Trusts and Estate Law Section submitted on September 26, 2007.)
(4) No Completed Gift by Distribution Committee Members Upon Making Distribution to Another Person Other Than Grantor. The issue is whether distribution committee members have general powers of appointment; if so, the exercise or release of a general power of appointment is treated as a transfer by the individual possessing the power under §2514(b). The rulings conclude that the distribution committee members do not have general powers of appointment. Distribution committee members can participate in distribution decisions under the (1) Grantor’s consent power, or (2) Unanimous member power.

- With respect to the Grantor’s consent power, §2514(c)(3)(A) provides that if the power is exercisable only in conjunction with the creator of the power, it is not deemed a general power of appointment.

- With respect to the unanimous member powers, §2514(c)(3)(B) provides that a power is not a general power of appointment if it can be exercised only “in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise of the power in favor of the possessor.” The rulings rely on the statement in the regulations quoted above about the coholder of a power having an adverse interest if the coholder may exercise the power after the possessor’s death in favor of himself, his estate, his creditors, or the creditors of his estate. Reg. §25.2514-3(b)(2). That regulation goes on to provide an example:

  “Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y’s death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y.”

For example, under the facts of the rulings, if the distribution committee directs a distribution to Son 1, the sons are considered adverse to each other as to that decision, so the power to make a distribution, held jointly with the other sons, is not a general power of appointment. If a distribution committee member ceases to serve, the remaining distribution committee members continue to serve. Contrast the reasoning as to this issue with the reasoning regarding the issue of whether the “Grantor consent power” results in an incomplete gift by Grantor. For purposes of that issue, the sons were not considered to have an interest adverse to Grantor because their jointly held powers do not continue after Grantor’s death. However, as to the interests of the sons among themselves, a son’s jointly held power to make distributions does not cease to exist at the death of any of the other sons.

The IRS had expressed concern in IR-2007-127 that the prior favorable DING Trust letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 because those rulings suggest that because distribution committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust
corpus. PLRs 201310002-201310006 do not give any indication whatsoever how the IRS resolved that issue, or whether particular attributes of the trusts involved in the rulings were central to the IRS’s favorable ruling as to this power of appointment issue.

Miscellaneous Observations in Rulings. The rulings make various miscellaneous observations in addition to the formal rulings described above. (a) The fair market value of the trust assets is includible in Grantor’s gross estate for federal estate tax purposes. (b) Any distribution to any beneficiary other than Grantor will be a gift by Grantor for federal gift tax purposes. (c) The rulings specifically decline to express an opinion about the effect of the decanting authority to make distributions to other trusts.

The IRS addressed these general types of DING trusts in various subsequent rulings. E.g., PLRs 201430003-201430007 (Feb. 7, 2014), 201410001-201410010 (Oct. 21, 2013). PLR 201426014 (Feb. 24, 2014) addresses the incomplete gift issue but not the grantor trust issues.


a. Desirability of Flexibility. A grantor may be concerned with being liable for what could potentially be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to “turn off” the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to “toggle” grantor trust status could be achieved. For an excellent discussion of these issues, see Van Hoften, Planning With Intentionally Defective Grantor Trusts, ALI-ABA Video Law Review 207 (March 26, 1997).

b. General Guidelines to Maximize Flexibility.

(1) Use Different Persons to Trigger Power Versus Right to Relinquish or Reacquire Power. If the grantor has the right to relinquish a power that causes grantor trust status but has the right to reacquire that power, the relinquishment would not be given effect. The regulations provide specifically that if the grantor has a power broad enough to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under Section 675, he will be treated as the owner of the portion from the trust’s inception. Treas. Reg. §1.675-1(a). Therefore, at a minimum, if the grantor has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power (to toggle back “on” the grantor trust status.) Furthermore, the grantor’s retention of the right to toggle grantor trust status might arguably constitute a Section 2036(a)(2) estate inclusion power or arguably result in an incomplete gift.

(2) Adverse or Non-Adverse Party Could Hold Power to Relinquish and Reinstate The Grantor Trust Power. Many of the grantor trust powers must be exercisable by a non adverse party in order to result in grantor trust status. However, the power to
relinquish or reinstate a grantor trust power could be held by either an adverse party or a non-adverse party. (Non-adverse party status is only important for the person who holds the grantor trust power, and has no relevance to a person who has the authority to relinquish or reinstate that power.) An example of this is Letter Ruling 9010065, where the grantor’s descendants (who were beneficiaries of the trust and, therefore, adverse parties) held the power to terminate the trustee’s grantor trust power.

(3) Spouse Holding Power to Relinquish or Reacquire Grantor Trust Powers. The grantor’s spouse could have the power to exercise the grantor trust power directly, or could be authorized to relinquish the grantor trust power. (This may be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor’s spouse.) However, beware of Section 672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes. Accordingly, if the grantor’s spouse is given the power to relinquish and to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

(4) Using Different Persons May Provide Helpful Checks and Balances. The powers used to result in grantor trust status may be very “powerful” powers. Giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers. Letter Ruling 9010065 illustrates an intricate checks and balances system. An unrelated trustee could add a qualified charity (which would cause grantor trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer’s spouse (but if the spouse were not living, with the approval of the taxpayer’s brother). Other parties (a majority of the taxpayer’s adult descendants) were given the power to cut off grantor trust status by terminating the trustee’s authority to designate additional beneficiaries.

(5) Relinquishment Should Address Whether it Binds Successors; Only Permit Reinstatement in Subsequent Year. The relinquishment of a grantor trust power should specifically indicate whether it is binding on successor trustees or successor persons holding the relinquishment power. Maximum flexibility could be retained by not having the relinquishment binding on all successors, so that a third party could reinstate the power. In that case, perhaps provide that the reinstatement power could only be exercised in a subsequent taxable year, to help clarify that the trust is not a grantor trust in the year in which the relevant power is relinquished.

(6) Consideration From Grantor for Terminating Grantor Trust Status? If the grantor trust status of the trust is terminated, the grantor is benefited by being relieved of the substantial income tax liability. Could the grantor pay consideration to the trust in return for the termination of the grantor trust status by the trust or other third person on behalf of the trust, without being treated as having made an additional taxable gift to the trust? If so, this could help relieve fiduciary concerns for the trustee to take steps to terminate the grantor trust treatment if that were
desirable for some reasons (for example, if having a grantor trust subjects the trust to state income that otherwise could be avoided), even though doing so would subject the trust to federal income taxation.

(7) Notice 2007-73 Identifies Certain “Toggling” Grantor Trusts as Transactions of Interest. Notice 2007-73 identifies two rather complicated series of transactions involving grantor trusts. In each, a grantor trust would be formed that creates unitrust interest and a noncontingent remainder interest for the grantor. The noncontingent remainder interest would cause grantor trust status. A substitution power would arise at a stated date in the future. The grantor would give the unitrust interest, and after certain transactions, would sell the retained remainder interest (which allegedly would remove grantor trust status). The institution of the substitution power at the later date would allegedly reinstate grantor trust status for the trust. Later, the grantor would purchase the unitrust interest. The goal of the scenarios is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain. The Notice states that “transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest” that require disclosure. Therefore, the Notice addresses the complicated transactions described in the two scenarios, and does not appear to apply to “garden variety” grantor trusts (even thought grantor trust status has been toggled). The Notice states explicitly that merely terminating grantor trust status does not invoke the Notice:

“The transactions in this notice, as described above, do not include the situation where a trust’s grantor trust status is terminated, unless there is also a subsequent toggling back to the trust’s original status for income tax purposes.”

c. Examples of Toggle Arrangements.

(1) Removal and Replacement Power of Trustees Where Power to Make Discretionary Distributions by Trustee Who is Not “Related or Subordinate” is Used to Cause Grantor Trust Status. The power of a trustee, more than half of who are related or subordinate parties, to make discretionary distributions not covered by a reasonably external standard will result in grantor trust treatment as to the entire corpus and income of the trust. See section II.C.3.a. of this outline. A third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause more than half of the co-trustees to be related or subordinate parties (if grantor trust status was desired) or that would cause no more than one-half of the trustees as being related or subordinate parties (if grantor trust status was not desired.) The grantor should not hold the power to remove and replace successor trustees unless any such successor must be someone who is not a related or subordinate party in order to meet the “safe harbor” provided in Revenue Ruling 95-58, 1995-2 C.B. 191.

Using this mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee. If the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, it would be
difficult to determine whether the next successor should be a related or subordinate party or not at the time that the trust agreement was prepared.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries.

(2) Third Party Having Authority to Cancel and Reinstate Substitution Power. Grantor trust status could be toggled by giving someone other than the grantor the right to cancel and reinstate a power of substitution under Section 675(4)(C).

(3) Power to Loan to Grantor Without Adequate Security. Either the trustee or the grantor could be given the authority to relinquish the trustee’s power to make loans to the grantor without requiring adequate security. Someone other than the grantor could be given the power to reinstate the power to loan without adequate security. To provide additional checks and balances, different persons could be given the authority to terminate and reinstitute the power to lend without adequate security. However, if desired, a single person, who is not related or subordinate to the grantor (to put the grantor in the best position to argue that the power to lend without adequate security does not cause estate inclusion) could be given the power to both terminate and reinstate the lending power.

(4) Power to Add Beneficiaries. The person who is given the authority to add beneficiaries could also be given the authority to relinquish the right to add beneficiaries. If a potential toggle is desired, another party should be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries.) Even if different persons are used, some commentators are concerned that the IRS may view the two persons together as still holding the power. Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1359 (April 2007) (“The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a ‘protector’), that probably only means that the trustee and the protector together still have the power.”).

d. Income Tax Effects of Toggling Off Grantor Trust Status. A change in the grantor trust status of a trust may cause unexpected income tax consequences. For an excellent review of potential income tax effects, see Peebles, “Mysteries of the Blinking Trust,” 147 Tr. & Est. 16 (Sept. 2008) (addressing issues involving pass-through entities, estimated payments, suspended losses and deductions, basis, and carryovers). A Chief Counsel Advice suggests that toggling will not necessarily trigger income recognition. CCA 200923024. That CCA is discussed in Section II.C.8 of this outline.

5. Grantor Trust Issues With Life Insurance Trusts.
a. **Transfer to Grantor Trust Does Not Violate Transfer for Value Rule; Rev. Rul 2007-13.** The IRS has ruled privately in various rulings that transfers of a life insurance policy among grantor trusts do not trigger the transfer for value rule. PLRs 200514001, 200514002, 200518061 and 200606027 all held that an exchange of a policy between grantor trusts was not a taxable event and did not trigger the transfer for value rule because the grantor was the treated as the owner of both trusts for income tax purposes. Some of the rulings have also relied on the “same basis” exception in the transfer for value rule [§101(a)(2)(A)].

Life insurance proceeds are generally excludable from income under §101(a)(1), but if the policy has been transferred for consideration, the death proceeds are taxable income to the extent the proceeds exceed the consideration paid for the policy and premiums or other amounts later paid by the purchaser of the policy. §101(a)(2). There is an exception to the transfer for value rule if the policy is transferred to the insured, a partner of the insured, a partnership of which the insured is a partner, or a corporation in which the insured is a shareholder or officer. §101(a)(2)(B).

Rev. Rul. 2007-13 addresses a transfer of a policy between grantor trusts and from a non-grantor trust to a grantor trust. Rev. Rul. 2007-13 covers two situations. In Situation 1, the Ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts. The "wholly-owned" term apparently means that the trust is a grantor trust as to both income and principal of the trust, and that the grantor is the only grantor of the trust. Cf. Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975) (transfer of policy to a grantor trust did not constitute a transfer for value, but only to the extent of the grantor's 91% of contributions to the trust).

In Situation 2, the Ruling reasons that the sale of the policy from a non-grantor trust to a grantor trust is a “transfer” for income tax purposes. Accordingly, the sale could generate taxable gain if the consideration paid exceeds the owner’s basis in the policy. While the Ruling does not specifically address the gain issue, other private letter rulings have addressed that transfers between two grantor trusts do not result in gain recognition. E.g., Pvt. Ltr. Rul. 200606027. However, the Ruling concludes that the transaction is treated as a transfer to the grantor, so the "transferred to the insured" exception to the transfer for value rule applies if the policy insures the grantor's life. We've been waiting since Swanson for the IRS to rule that “grantor trust equals the insured” for transfer for value purposes. This was particularly important in Situation 2, because the ruling could not rely on the “same basis” exception to §101, but had to conclude that the transfer was treated as a transfer to the insured-grantor.

b. **Reconfirming Position That Grantor Is Treated as Owner of Trust Assets For Income Tax Purposes.** The IRS officially restates its often cited 20-year-old position in Rev. Rul 85-13, 1985-1 C.B. 184, which treats the grantor as the owner of the trust assets of a grantor trust for income tax purposes. (Some commentators have suggested that the grantor trust rules are now being used proactively by taxpayers and that the IRS may seek to retreat from that position at some point. This ruling reiterates that the IRS is not changing its position anytime soon.)
Therefore, transfers between grantors and grantor trusts do not trigger gain for income tax purposes.

c. Advantages of Transferring Policies Between Trusts. Transfers of policies to or between grantor trusts are very helpful for two reasons. First, sales of policies may help avoid the three-year rule of §2035 that generally applies if an insured gives a life insurance policy on his life within three years of his subsequent death (and the ruling makes clear that a sale can be made to a grantor trust without violating the transfer for value rule.) There is an exception from the three-year rule under §2035(a)(2) if the transfer is for full consideration. (This may be more than the gift tax value, and should take into consideration the value of the policy in the secondary market for insurance policies.) Furthermore, the IRS might argue, based on the old Allen case, that the full consideration exception to §2035 only applies if the amount of the consideration is the amount that would otherwise have been included in the grantor’s gross estate. United States v. Allen, 293 F.2d 916 (10th Cir. 1961). However, the IRS has ruled privately that sales of policies for their gift value would not require inclusion in the gross estate under §2035 if the insured died within three years of the sales. E.g., Pvt. Ltr. Rul.9413045 (sale of policies for interpolated terminal reserve value plus the value of any unexpired premiums). Interestingly, the ruling did not cite Allen. A difference with Allen is that a transfer of a life insurance policy requires future investment to bring it to fruition. Even if Allen does not apply, what is the value of the policy for purposes of the full consideration rule in §2035? The interpolated terminal reserve value was developed when the only cash value life insurance was whole life. However, for a universal policy, it is not clear that additional premiums will be paid. So, it is safest if the policy is issued directly to the trust; but if that is not done, a sale may avoid the three year rule and a sale is permitted without violating the transfer for value rule if the transfer is to a grantor trust.

Second, a transfer to a new grantor trust may provide helpful flexibility if the insured decides that he or she becomes unhappy with the terms of the original irrevocable trust (and may be unwilling to contribute additional gifts for paying future premiums.) The existing trust might sell the policy to a new grantor trust having acceptable trust terms. (The trustee of the selling trust would have to exercise diligence to assure that the trust is receiving full value for the policy.) The transfer to the new wholly-owned grantor trust would not trigger the transfer for value rule.

d. Planning Concerns With Transfers Between Trusts. There are several reasons to be cautious with these kinds of transfers between trusts.
1) The sale should be at fair market values, and the life settlement industry might suggest higher prices than just the cash surrender value. (The regulations under §2042 refer to the cost of a comparable policy.)
2) If a beneficiary thinks the trust sold the policy for too low a price, there are fiduciary liability possibilities.
3) Make sure that the trusts are grantor trusts or else the transfer for value rule may cause the proceeds to become taxable.
4) A typical plan is to move a policy from an old “bad” trust to a new “good” trust. If the “good” trust is better because it cuts out certain beneficiaries or restricts the
rights of beneficiaries, there may be fiduciary liability concerns that individual trustees often totally overlook.

e. **Using Partnership to Assure Transfer for Value Rule Not Violated.** Some attorneys like to have a partnership in which the trust and grantor are partners. In case it is not a grantor trust for some reason, the transfer is still protected from transfer for value rule under the partnership exception in §101(a)(2)(B). There have been several private rulings where the partnership was formed moments before the transfer for that purpose—and IRS still held it worked. (But reliance on that position would not seem appropriate in the planning stage.) A simpler solution would be for the grantor trust and the insured to buy units of a master limited partnership. However, that may not work. The legislative history to §101 suggests that §101 refers to a true partnership of partners joining together and not an investment vehicle.

f. **Transfer to Insured (or Grantor Trust) Cleanses Prior Transfer for Value Problems.** The regulations under §101 say that if a policy is transferred to the insured, that cleanses all prior transfers for value. Treas. Reg. §§1.101-1(b)(3)(ii) & 1.101-1(b)(5)(Ex. 7). So if there has been a transfer for value “hiccup” somewhere in the history of the policy, the problem can be cleansed by a transfer to a grantor trust.

g. **Achieving Grantor Trust Status for Life Insurance Trusts.** If the trust does not prohibit paying premiums on life insurance policies on the life of the grantor, is that sufficient to make the trust a grantor trust? (One attorney has reported having an agent take the position that trust is a grantor trust if it does not expressly prohibit paying life insurance premiums of the life of the insured, because the trustee would have the authority to purchase a policy.) For a detailed discussion of the power to pay life insurance premiums as a grantor trust trigger, see Section II.C.3.c of this outline. For a discussion of the effects of a Crummey clause on the grantor trust status of a trust, see Section III.E.1.g of this outline.

6. **Grantor Trusts With Split Purchase Transactions.** A transaction may be structured as split purchase transactions where the “retained income interest” that is purchased by the parent is in the form of a qualified interest under section 2702 (either a qualified interest in a residence or a qualified annuity interest). An old ruling said that the parties would be treated as an association rather than a trust if there are successive interests. To avoid any possible such income tax consequences, some planners structure split purchase transactions so that the grantor or a grantor trust are on all sides of the transaction.

7. **Structure to Give Beneficiary Power of Withdrawal Rather Than Having Stated Termination Date During Grantor’s Lifetime.** Letter Ruling 200840025 concluded that the power of the nonadverse trustee to make loans to the grantor, with or without security, caused the trust to be a grantor trust under § 675(2) so long as the grantor is alive and the nonadverse trustee has not released the power with respect to a particular trust. Under the trust instrument, a beneficiary could withdraw assets upon reaching a specified age. The ruling concluded that the grantor would continue to be treated as the
sole owner of the trust, even after the beneficiaries reach those specified ages, so long as the grantor is alive and the nonadverse trustee has not released the lending power. The ruling acknowledged that the withdrawal powers held by the beneficiaries would otherwise cause them to be treated as the owners of the trust under §678 after they reach the age for making withdrawals.

Practical Planning Pointer: Instead of requiring terminating distributions as the beneficiary reaches specified ages, instead give the beneficiary a power of withdrawal. This gives the beneficiary the flexibility to keep the assets in trust to maintain the grantor trust treatment.

8. Conversion From Nongrantor to Grantor Trust Status Not a Taxable Event: CCA 200923024. In Chief Counsel Advice 200923024, the Chief Counsel’s office addressed what seems to be an abusive transaction. The basic (way oversimplified) facts are that a nongrantor trust sold appreciated property for a private annuity, so that the gain would be recognized ratably over the duration of the annuity. The purchaser sold the asset, recognizing no gain because the sale proceeds did not exceed its cost basis (i.e., the value of the annuity). [Actually, the purchaser was a partnership with a § 754 election in effect and the partnership sold the assets for a price about equal to its inside basis as a result of the § 754 election.] The nongrantor trust later converted to grantor trust status (by a change in the trustee to someone who was a “related or subordinate person”), with the result that the grantor would not realize gain on any subsequent annuity payments received from his grantor trust. An IRS agent argued that the conversion from nongrantor to grantor trust status was a taxable event, and that the transferee grantor trust would recognize gain. The CCA disagreed. It recognized that the transaction appears to be abusive, and observed that it was not addressing the possible applicability of the step transaction, economic substance or other judicial doctrines. However, it observed that treating the conversion as a taxable transaction would have an impact on non-abusive transactions, noting that nongrantor trusts may be converted to grantor trusts by various ways, including a change of trustees, borrowing of the trust corpus, or payment of the grantor’s legal obligation. It noted that Rev. Rul. 85-13, which held that the conversion of a nongrantor trust to a grantor trust (by reason of the trust’s purchase of assets from the grantor for a note, which constituted an indirect borrowing by the grantor) did not result in taxable income to the grantor.

An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of “Example 5” (Reg. § 1.1001-2(c) Ex. 5), Madorin, and Rev. Rul. 77-402, the CCA observed:

“We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.” (emphasis added)

III. BENEFICIARY TAX ISSUES
A. Gift Tax Issues.

1. Exercise of General Power of Appointment. Gift tax consequences for the beneficiary can arise if the beneficiary has a general power of appointment over the trust assets (meaning that the beneficiary has a power over the assets exercisable in favor of the beneficiary, his estate, his creditors, or the creditors of his estate.) I.R.C. § 2514(c). In that case, if the beneficiary exercises the power, or releases the power, the beneficiary makes a taxable gift. I.R.C. § 2514(b). Accordingly, if a beneficiary ever has a general power of appointment over trust assets (perhaps through inadvertent inclusion of expansive discretionary distribution powers in a situation where the beneficiary at some point becomes the trustee), the beneficiary will have not be able to divest himself of that power without being treated as making a transfer (if the power lapses during the beneficiary’s lifetime, I.R.C. § 2514(b)) or as being included in the beneficiary’s estate (if the beneficiary never releases the power, and dies holding the general power of appointment, I.R.C. § 2041(a)(2).)

While a release of the general power of appointment is treated as a transfer, whether it is a completed gift depends on whether the beneficiary still retains the power to shift benefits among a group of individuals. For example, assume the beneficiary is trustee and can make a discretionary distribution (with no standards) to a group of persons, including himself, and assume that he relinquishes the power to make a distribution to himself but can still make distributions among the remaining class of beneficiaries. No taxable gift has occurred, because “the possessor of the power has retained the right to designate the ultimate beneficiaries of the property over which he holds the power and since it is only the termination of such control which completes a gift.” Treas. Reg. § 25.2514-3(c). See section II.A.3.a of this outline.

If the power holder retains a power that causes the gift to be incomplete, that retained power would cause estate inclusion under Section 2036 or 2038 if the power holder were the grantor. In that situation, Section 2041 includes the assets subject to that power at the decedent’s death in the power holder’s estate, the same as if the power holder still had the power to distribute the property to himself. I.R.C. § 2041(a)(2).

Despite the seemingly permanent taint if a beneficiary ever acquires a general power of appointment, as discussed above, options to avoid taxation may be available. In Letter Ruling 201132017, a provision in a bypass trust for a surviving wife required that the trust assets be used to pay the debts, taxes and expenses of the wife’s estate. Therefore the wife would have a general power of appointment causing inclusion of the trust assets in her estate under § 2041. A state court reformed the trust to remove the offensive provision based on various provisions in the trust document itself suggesting that the cross reference to the bypass trust as the trust to pay the debts, taxes and expenses was a scrivener’s error and based on affidavits from the attorney and surviving spouse that the intent was to save taxes and to avoid taxation of the bypass trust at the surviving spouse’s death. The IRS ruled that the wife would no longer hold a general power of appointment over the trust, would not be deemed to have released the power during her life for gift tax purposes, and was not deemed to have made a gift. The ruling reasoned that documentation “strongly indicates that Decedent and Surviving Spouse did not intend to have any control over the assets held in the By-Pass Trust, and that the provision ... was the result of a scrivener’s error.”
2. Exercise Limited Power of Appointment. A limited power of appointment is the power to appoint property to a class of persons, which can be as broad as anyone other than the power holder, his estate, his creditors, or the creditors of his estate. If the person who holds the limited power of appointment over trust property is also a beneficiary of that trust, an exercise of the limited power of appointment to another individual reduces the pool of assets that might eventually be distributed to the beneficiary. In that circumstance, is the exercise of the limited power of appointment a gift? This is an important issue, because persons who hold limited powers of appointment over trust assets often are also beneficiaries.

a. Mandatory Income Interest. If the power holder also has a mandatory income interest in the trust, the Tax Court and the IRS maintain that a taxable gift occurs if the beneficiary/power holder exercises the limited power of appointment over a portion (or all) of the trust corpus. Estate of Regester v. Comm’r, 83 T.C. 1 (1984); Rev. Rul. 79-327, 1979-2 C.B. 342; Treas. Reg. § 25.2514-1(b)(2); Letter Ruling 200427018. The Court of Claims, in a 1956 case, concluded that no gift results in that situation. Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956). However, the IRS amended its regulations after the Self case to make its position clearer, and the regulations carry a presumption of correctness. See National Muffler Dealers Ass’n v. U.S., 440 U.S. 472, 477 (1979). See generally Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.3 (1986).

b. Discretionary Beneficial Interest. If the power holder is merely a potential discretionary, and does not have a mandatory income interest, it is not clear at all that a gift should result from a lifetime exercise of the limited power of appointment to appoint some of the trust assets to others. Particularly if there are still some assets in the trust, the beneficiary/power holder may be able to receive as many distributions as a beneficiary that he would have received had the pool of assets not been depleted by the exercise of the power of appointment.

If the beneficiary/power holder is entitled to receive distributions under a HEMS standard, and if he exercises a limited power of appointment to appoint trust assets to his children, an example in the regulations says that there would be no taxable gift under Section 2514 (because the power to distribute to himself under the HEMS standard falls within the ascertainable standard exception, so a lapse of that right is not a gift under Section 2514.). Treas. Reg. § 25.2514-3(c) Ex. 2. However, the regulation does not address whether the power holder has made a gift of the value of his right to distributions under the ascertainable standard under the general gift principles of Section 2511. See Henkel, Estate Planning and Wealth Preservation, ¶3.04[2] (2001).

The IRS has taken the position in private letter rulings that taxable gifts can result where the power holder who exercises a limited power of appointment is merely a discretionary beneficiary under the trust. Ltr. Ruls. 8535020 (IRS did not say how to value the gift); 9419007 (two daughters were beneficiaries of separate trusts and had power with a co-trustee to make distributions to herself with a HEMS standard; each daughter planned to appoint the trust assets to the other daughter; ruled that each daughter would make a gift of her right to receive HEMS distributions); 200745015
(daughter entitled to receive discretionary distributions of income for her support, maintenance and medical expenses as well as for other purposes; daughter can request $a annually from the trust and the trust has the discretion to distributed principal in excess of that; daughter’s relinquishment of beneficial interest is a gift that would be valued in accordance with the general valuation principles contained in Reg. § 25.2512-1, and the interest “has more than a nominal value” [citing Rev. Rul. 67-370]).

Observe that this issue may not directly impact the selection of trustee issue—because the beneficiary/holder of the power of appointment may have the same potential gift tax consequences whether or not he or she is the trustee.

c. **Summary.** If the instrument grants an inter vivos limited power of appointment to a trust beneficiary, the planner must recognize that the beneficiary will face this gift issue if he or she ever decides to appoint some or all of the trust assets during his lifetime. The gift tax issue could be avoided by giving the inter vivos power of appointment to someone other than the beneficiary. For example, the power of appointment might be granted to the beneficiary’s spouse.

3. **Gift By Beneficiary If Fail to Exercise Rights.** If a beneficiary has ascertainable interests under the trust instrument, and if the beneficiary fails to enforce those rights, a taxable gift may result. See Dickman v. Comm’r, 465 U.S. 330 (1984) (failure to charge adequate interest on demand loan constituted continuing gift each year the loan remained outstanding); Snyder v. Comm’r, 93 T.C. 529, 546-47 (1989) (holder of preferred stock, which held a 7% noncumulative dividend had right to convert to another class of preferred that had a 7% cumulative dividend; held that annual failures to convert constituted continuing gifts to common shareholders of the preferred dividends that could have been paid by the corporation). But see Rev. Rul. 74-492, 1974-2 C.B. 298 (amount of elective share that could have been acquired if the election had been made during the statutory period is not includable under §2014; “which the widow is considered to acquire only if she exercises her right to take it. The widow must accept the benefits of the state law through exercise of the personal right of election or else the inchoate right is, in effect, renounced by operation of law.”).

4. **Gift if Beneficiary/Trustee Makes Distribution to Another Under Discretionary Standard.** A regulation indicates that a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a “reasonably fixed or ascertainable standard” (and the regulation goes on to give examples of standards that would qualify). Treas. Reg. § 25.2511-1(g)(2). The implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift would result.

For example, assume that Tom is trustee of a trust, and can makes distributions to himself for “health, support and maintenance.” In addition, he can make distributions to his siblings for their “health, support, maintenance, or happiness.” Under the regulations, distributions from Tom to his siblings appear to be a gift. The regulation applies to any trustee that has “a beneficial interest in trust property.” (Indeed, that language would suggest that the same gift result might occur if the trustee is not a current potential beneficiary but only has a contingent remainder interest.) Another unresolved issue is whether a power to make distributions in the discretion of the trustee, but not exceeding
amounts needed for health, education, support and maintenance would be treated as a “reasonably fixed or ascertainable standard” for purposes of this regulation. There have been no cases or rulings interpreting that regulation in this context. However, commentators have advised planners of the potential issue. E.g., Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 503.2 (1986). That commentator suggests including a “savings clause” provision in instruments providing “that no trustee shall have any discretionary power, other than a power described in Regulations Section 25.2511-1(g)(2), to pay to other than himself any trust property in which he personally has a beneficial interest.” Id. at ¶ 506, p. 5-70 (1986).

Planners often focus on limiting the trustee’s ability to make distributions to himself to only ascertainable standards, so that the trustee does not hold a general power of appointment. However, this regulation, if it is upheld, means that planners also need to limit the ability of trustees to make distributions for other beneficiaries to an ascertainable standard also if the trustee has any beneficial interest in the trust.

Several recent letter rulings, while not addressing regulation § 25.2511-1(g)(2), would seem to cast doubt on the implications suggested above. The rulings would seem to avoid the gift tax consequences upon a beneficiary-trustee making a distribution to another person if there are multiple beneficiary-trustees who must join in that decision in making a distribution to someone other than the beneficiary-trustees making that distribution. The rulings involved trusts that allowed discretionary distributions to the grantors but were specifically designed not to be grantor trusts (by requiring adverse parties [i.e., other beneficiaries] to consent to distributions to the grantors). The rulings concluded that the distribution committee members who consent to the distributions do not make taxable gifts if they consent to distributions to the grantor even though they are also discretionary beneficiaries. The rulings reason that the distribution committee members do not hold general powers of appointment, because of the exception for joint powers held by an adverse party in the definition of a general power of appointment. Letter Rulings 200502014, 200612002, 201310002-201310006. (There is a detailed discussion of the reasoning of the IRS in PLRs 201310002-201320006 in Section II.C.3.m above.)

5. Gift if Beneficiary/Trustee Makes Distribution to Another Where Trustee’s Determination “Is Conclusive”. Trust instruments sometimes attempt to protect a trustee against demands (and lawsuits) by beneficiaries to distributions by providing that “the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power” (or words to that effect.). The regulation addressed above specifically says that type of language means the distribution power is “not limited by a reasonably definite standard.” Treas. Reg. § 25.2511-1(g)(2). Therefore, the possibility exists, under the regulation, that a distribution under that type of clause to a person other than the beneficiary-trustee would be treated as a gift.

6. Gift if Beneficiary/Trustee Fails To Makes a Distribution to Himself. What if a beneficiary-trustee has the discretion to make distributions to himself within stated standards, and the trustee does not make any distributions to himself? Can the IRS argue that the trustee has made a gift to the other beneficiaries? There are no cases where this issue has been raised. However, the possibility of the argument has been noted by commentators. See
Pennell, Avoiding Tax Problems For Settlors and Trustees When An Individual Trustee is Chosen, EST. PL. 264, 271 (September 1982).

7. Summary of Application of Selection of Trustee to Gift Tax Issues. Once a beneficiary becomes trustee or otherwise acquires a power that constitutes a general power of appointment, there is a permanent taint that is difficult to shed. If the beneficiary realizes that there is a problem while he is still alive, getting rid of the problematic power generally will cause the beneficiary to make a completed gift for gift tax purposes (unless he still has the power to shift benefits among other beneficiaries.)

In granting ascertainable distribution rights to beneficiaries, (including a trustee who is a beneficiary) realize that the IRS might conceivably argue for a gift if the beneficiary does not enforce his legal rights. If a trustee has any beneficial interest in the trust, the regulations imply that the trustee makes a gift if he makes a distribution to other beneficiaries under a discretionary power to make distributions that is not limited by an ascertainable standard. To be safe, provide that any trustee who also has a beneficial interest in the trust is limited to a HEMS standard in making distributions to other beneficiaries as well as to himself and do not provide that the trustee’s determination in that regard is “conclusive” (or other words to that same effect).


1. Section 2041—General Rules.

a. General Rule. If a decedent has at his death a “general power of appointment” over property, or if the decedent released or exercised the general power of appointment over property while retaining powers over the property that would cause the property to be included in his estate under Sections 2306-2038 if he were the grantor of such property, the decedent will have to include the trust property in his estate. I.R.C. § 2041(a)(2). (There are substantially different rules under Section 2041 for powers created on or before October 21, 1942 compared to powers created after that date. This outline only addresses powers created after October 21, 1942.)

Section 2041 applies to powers over property that do not cause estate inclusion under Sections 2036 to 2038. Treas. Reg. § 20.2041-1(b)(2). Therefore, powers of a grantor are analyzed under those Sections. Powers of individuals other than the grantor are analyzed under Section 2041.

b. General Power of Appointment. An individual has a “general power of appointment” if he has the power to determine who (including himself) may become the owner of the property.

Under Section 2041, a decedent has a general power of appointment if he has a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; unless the power satisfies one of several important exceptions, discussed in the following subsections c-f below.

Sometimes the planner specifically wants to create a general power of appointment in a beneficiary (for example, to cause the trust assets to be included in the beneficiary’s
estate for estate tax purposes rather than being subject to the generation-skipping transfer tax.) Even though the general power of appointment is needed for some tax purpose, the settlor may wish to limit, as much as possible, the beneficiary's ability to divert the assets away from the settlor's family. The IRS has acknowledged that merely allowing exercise in favor of the creditors of the beneficiary's estate is sufficient to create a general power of appointment. E.g., Ltr. Rul. 8836023.

e. **Ascertainable Standard Exception.** If the power to consume, invade or appropriate property for the decedent is limited by an ascertainable standard relating to his health, education, support, or maintenance, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(A). This exception is addressed in detail in section III.B.4. of this outline below.

d. **Joint Power—Exercisable With Grantor.** If the power is exercisable only in conjunction with the creator of the power, it is not a general power of appointment. I.R.C. § 2041(b)(1)(B). (The policy behind this exception is that the creator of the power will likely have to include the property in his estate under Sections 2036 or 2038 if the grantor holds this power jointly with the power holder. See section II.B.3.d.(2-4) of this outline.)

e. **Joint Power—Exercisable With Person With Adverse Interest.** If the power is exercisable only in conjunction with a person who has a “substantial interest” in the property which is adverse to the exercise of the power in favor of the decedent, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(C)(ii).

As to the “substantial” requirement, the regulations merely say that an interest is substantial if its value in relation to the total value of the property subject to the power is “not insignificant.” Treas. Reg. § 20.2041-3(c)(2). The IRS has ruled privately that the actuarial value of the interest of the other party must be at least five percent of the trust’s value to be “substantial.” Ltr. Rul. 8911028.

The regulations provide several examples of “adverse” interests. A taker in default of exercise of the power is an adverse party. Treas. Reg. § 20.2041-3(c)(2). In addition, a coholder has an adverse interest if the coholder may possess the power to appoint the property to himself after the decedent’s death. I.R.C. § 2041(b)(1)(C)(2); Treas. Reg. § 20.2041-3(c)(2).

A person is not adverse merely because he is a coholder of the power or because he is a potential appointee under the decedent’s power. Id.; Miller v. U.S., 387 F.2d 866 (3rd Cir. 1968); Estate of Towle v. Commissioner, 54 T.C. 368 (1970). A person is not adverse just because he is a trustee of the trust. Miller v. U.S., 387 F.2d 866, 869-70 (3rd Cir. 1968); Rev. Rul. 82-156, 1982-2 C.B. 216. Furthermore, naming the spouse of a person who would have an adverse interest does not satisfy the adverse party requirement—because the spouse has no chance for direct personal benefit from the property. Stephens, Maxfield, Lind & Calfree, Federal Est. & Gift Tax’n ¶4.13[4][c] (2001).

f. **Joint Power—Exercisable With Person Who is Potential Appointee.** A coholder of a power of appointment who is a potential appointee under the decedent’s power of
an appointment does not have an adverse interest, for purposes of the prior exception. However, a further exception applies in that situation. In that situation, each of the coholders could, in conjunction with the other, appoint the property to himself. Accordingly, each coholder of the power is deemed to have a general power of appointment as to a fractional part of the property. The fractional part is based on the number of persons (including the decedent) in whose favor the power is exercisable. I.R.C. §2041(b)(1)(C)(iii). This rule is based on a self-interest concept. Conceivably, each person would give consent to the other person’s exercise of the power only if the power is exercised in favor of all such persons equally. Thus, if three persons must join in the exercise only one-third of the value of the property would be included in the first decedent’s estate.

g. Other Joint Powers. Powers of appointment which must be exercised in conjunction with any other person (not described in the prior three subsections) do not fall within an exception, and the decedent will be treated as having a general power of appointment even though the decedent cannot control the exercise of the power.

Section 2041 uses very similar language as Sections 2036 and 2038 in referring to powers exercised “in conjunction with another person.” Accordingly, the conclusions reached by cases addressing the effects of joint powers by those Sections should apply to Section 2041. For example, it is sufficient that the other person must merely consent to exercise of the power; it is not required that the other person be able to initiate an exercise of the power (assuming both coholders agree). However, in that situation, the person who must merely consent to the exercise of the power by someone else is not elevated to the position of a coholder of the general power of appointment, so the fractional inclusion rule does not apply. Rev. Rul. 79-63, 79-1 C.B. 302 (at any time during the decedent’s lifetime the decedent, with the consent of one of the decedent’s children, could direct the trustees to distribute all or any part of the trust property to anyone, including the decedent).

h. Contingent General Powers of Appointment and Impact on Formula General Powers of Appointment. If the existence of the power is by its terms contingent upon an event that did not occur before the decedent’s death, it is not a power “which the decedent has at the time of his death”—which is a requirement for estate inclusion under Section 2041. The regulations address powers of appointment subject to a contingency:

“However, a power which by its terms is exercisable only upon the occurrence during the decedent’s lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent’s death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent’s death if the condition precedent to its exercise had not occurred.” Treas. Reg. § 20.2041-3(b).

The courts have interpreted this regulation to conclude that the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be “illusory” and must have independent significant non-tax consequences.
The primary case regarding powers of appointment subject to contingencies is Kurz v. Commissioner, 101 T.C. 44 (1993), aff’d, 68 F.3d 1027 (7th Cir. 1995). In Kurz, the decedent was a beneficiary of both a marital trust and a family trust. The decedent was entitled to all income and the right to withdraw principal of the marital trust. She could request distributions from the family trust subject to two conditions: (1) the principal of the marital trust must have been exhausted; and (2) she could withdraw no more than 5% per year from the family trust. In fact, the decedent did not withdraw all of the principal from the marital trust, so could not withdraw any principal from the family trust at her death. However, the IRS argued that she had a general power of appointment over 5% of the family trust because the contingency to be able to exercise that power was within the decedent’s control (i.e., she could have withdrawn all of the principal from the marital trust so that contingency would have been satisfied). The estate argued that the decedent’s access to the principal of the family trust was subject to a contingency that did not occur, so she did not have a general power of appointment under Reg. §20.2041-3(b) (“However, a power which by its terms is exercisable only upon the occurrence during the decedent’s lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent’s death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent’s death if the condition precedent to its exercise had not occurred.”). The Tax Court interpreted this regulation to conclude that the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be “illusory” and must have independent significant non-tax consequences:

“...the event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent’s ability to exercise the power.... We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent’s power to appoint the property for his own benefit is illusory.”

The Tax Court analogized to the contingency provisions under §2038, and gave two examples of situations involving independent consequences:

“For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of "independent significance", whose effect on the trust is "incidental and collateral", such acts are also deemed to be beyond the decedent’s control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of "independent significance", whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); see also Estate of Tully v. United States, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 [AFTR2d 76-1529] (1976) ("In reality, a man might divorce his wife, but to assume
that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038.7

The Seventh Circuit affirmed, agreeing with the reasoning of the Tax Court that merely stacking or ordering withdrawal powers does not exclude the powers that come later in the list.

“By contrast, the sequence in which a beneficiary withdraws the principal of a series of trusts barely comes within the common understanding of “event or...contingency”. No one could say of a single account: “You cannot withdraw the second dollar from this account until you have withdrawn the first.” The existence of this sequence is tautological, but a check for §2 removes that sum without satisfying a contingency in ordinary, or legal, parlance...
No matter how the second sentence of sec. 20.2041-3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have withdrawn all of the Marital Trust and 5 percent of the Family Trust by notifying the Trustee of her wish to do so.”

Kurz makes clear that contingencies that would have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. Indeed, the contingency in Kurz was as non-independent as could be imagined. It involved a mere sequencing of withdrawal powers. The assets of trust 2 could not be withdrawn before the assets of trust 1 were withdrawn. The decedent still had clear authority to withdraw all of the assets from both trusts. The Tax Court questioned whether this was even a contingency at all.

As an example of how this doctrine might apply is the granting of formula general powers of appointment for basis optimization purposes. For example, if the formula refers assets valued at greater than the decedent’s remaining exemption amount, the decedent’s power during his lifetime to make gifts using up his exemption amount might be deemed to give the decedent a general power of appointment over all of the trust (whether or not the gifts are made). Similarly, the power to make marital or charitable bequests is within the decedent’s control, and if the formula refers to the maximum amount that could pass without estate tax at the decedent’s death, the formula could be interpreted to assume that the decedent would leave all of his estate to a surviving spouse or charity and therefore give the decedent a general power of appointment over all of the trust (up to the decedent’s exemption amount) even if the decedent in fact did not leave his estate to a
surviving spouse or charity. The contingency to have a general power of appointment over the trust up to the maximum amount is within the decedent's control.

Under Kurz, contingencies that would have independent significant non-tax consequences are to be ignored. The decision to make large lifetime gifts or to leave a bequest to a spouse or charity has much greater independent non-tax consequences than the mere ordering of withdrawal powers among trusts in Kurz. In any event, Kurz raises uncertainties about such formulas.

As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under such a formula, such bequests would seem to be acts of independent significance. However, to avoid that argument, the formula could refer to

“the largest portion of the assets of the Bypass Trust which would not increase any federal estate tax payable by the estate of the Surviving Trustor without taking into consideration any charitable or marital gift by the Surviving Trustor that would be deductible by the estate of the Surviving Trustor pursuant to Section 2055 or Section 2056 of the Internal Revenue Code.” See Al Golden, Back to the Future – The Marital Deduction from Before ERTA to After ATRA, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013)(excerpt from formula general power of appointment form suggest by Mr. Golden).

Other commentators have made the same observation regarding the impact of possible marital or charitable bequests on the operation of formula general powers of appointment.

“Making charitable or spousal bequests should logically be deemed to be acts of independent significance, such that they would not be deemed to control the grant of a general power of appointment, but it is not certain that a court would so hold, and it is very possible that the IRS would assert this position and the taxpayer would need to litigate.

One could minimize this risk by drafting the formula clause granting a general power of appointment based on the surviving spouse’s taxable estate, determined without regard to marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result.” Howard Zaritsky, PRACTICAL ESTATE PLANNING IN 2011 AND 2012.

For various form suggestions, see Ed Morrow, The Optimal Basis Increase and Income Tax Efficiency Trust (2013)(available from author); Al Golden, Back to the Future – The Marital Deduction from Before ERTA to After ATRA, STATE BAR OF TEXAS
i. **Existence of General Power of Appointment Prior to Acceptance of Office as Trustee.**

Under the principles regarding contingent powers of appointment discussed above, the IRS has taken the position that the mere fact that a testamentary trust was not funded and the decedent had not accepted office as trustee, under which he would have the power to make distributions for his “reasonable comfort” or “best interests,” did not preclude the decedent from being deemed to have a general power of appointment at his death. Tech. Adv. Memo. 9125002. The IRS reasoned that under local law, an interest in property established by a will takes effect at the time of death unless the will provides otherwise. See *Estate of Bagley v. United States*, 443 F.2d 1266 (5th Cir. 1971) (husband and wife were killed in automobile accident; husband’s will said wife would be deemed to survive in a common accident and gave wife a general power of appointment over property to qualify for marital deduction; wife’s estate argued it did not have a general power of appointment because will had not been probated at time of her death; held, that power of appointment existed in the theoretical instant in which wife survived husband); Treas. Reg. § 20.2041-1(c) (“power of appointment created by will is, in general, considered as created on the date of the testator’s death”).

The effect of these rules regarding contingencies is that once conditions have occurred such that a beneficiary is qualified to accept office as trustee (with overly broad distribution powers), the beneficiary has a general power of appointment. The beneficiary cannot avoid the general power of appointment taint by merely declining to accept office as trustee. However, a power holder may “disclaim” a power, and not be considered as having released the power, if the requirements of Section 2518 are met. Treas. Reg. § 20.2041-3(d)(6)(i), referencing Reg. § 25.2518-2(c)(3); see Ltr. Rul. 9521032. An attempt to disclaim a general power of appointment by limiting it to a limited power to appoint to others, or by limiting it to an ascertainable standard may not be recognized. Ltr. Rul. 8149009; Goudy v. United States, 86-2 USTC ¶ 13,690 (D. Ore. 1986), *revd. in unpub. opinion* (5th Cir. 1988); Treas. Reg. § 20.2041-3(d)(6). Under Section 2518, the power holder generally must disclaim the power within nine months after the transfer creating the power. Treas. Reg. § 25.2518-2(c)(3).

k. **Reciprocal Powers.** The IRS applied an analogy of the reciprocal trust doctrine to general powers of appointment in Letter Ruling 9235025. By analogy to that doctrine, where beneficiaries of two trusts can appoint property to each other, unrestricted by an ascertainable standard, the IRS stated that the trusts would be uncrossed, and each beneficiary would be considered to have a general power of appointment over the trust of which he is a beneficiary. In that ruling, the IRS cited Matter of Spear, Jr., 553 N.Y.S.2d 985 (Sur. Ct. 1990), in which the court adopted the reciprocal trust theory to find that trust beneficiaries had general power of appointments to qualify for the “Gallo exemption” that was available for GST purposes prior to 1990. The IRS again observed that the possible application of the reciprocal trust theory to powers of appointment in private letter ruling 9451059. In that ruling, the settlors’ two daughters had a power to appoint the trust property to any descendant of the settlor other than herself, including the other daughter. While noting the potential application of the theory, the IRS concluded that the particular factual situation did not justify its application.

Each of PLRs 201345004, 201345026, 201345027, and 201345028, involving the same fact pattern, permitted the modification of irrevocable pre-1985 trusts to add a “distribution trustee” who could make distributions in addition to an independent trustee to the beneficiary under a non-ascertainable standard. The facts of the PLRs stipulated that the distribution trustee could not be a related or subordinate party, and “a cousin cannot serve as a Distribution Trustee for a trust if the beneficiary is serving as the Distribution Trustee for the cousin’s trust.” The rulings concluded that the beneficiaries would not have §2041 general powers of appointment and the GST grandfathered status of the trust was preserved. There is no way of knowing whether the IRS required the limitation of not having reciprocal cousins as trustees of each other’s trust as a condition on granting a favorable ruling.

One ruling that might be the basis of an argument that the reciprocal trust doctrine does not apply in the context of §2041 is PLR 200748016, which stated that the reciprocal trust doctrine is only applicable under §§2036 and 2038. The reciprocal trust doctrine was not relevant to the §2041 issue under the facts of that ruling.

One planning strategy might be to have somewhat differing trust terms for the two trusts, by analogy to the Levy case and Letter Ruling 200426008, as discussed in Section II.B.1.a of this outline.

2. **Independent Trustee With Complete Discretion.**

a. **General Rule—No General Power of Appointment.** If a trustee is someone other than a beneficiary, Section 2041 generally will not apply to the beneficiary, even if the trustee has very broad discretion in making distributions to the beneficiary. For example, in Estate of Cox, 59 T.C. 825 (1973), acq., 1973-2 C.B. 1, the court held that, under Texas law, the income beneficiary did not hold a power of invasion or appointment with respect to a testamentary trust that provided the trustee (the testator's son) was to have the “sole and exclusive right of management” of the trust property, and that if the income was insufficient to comfortably and adequately supply the beneficiary with all comfort and necessities, then the beneficiary's comfort and necessities were to be provided for by the trustee selling trust assets. In reaching its decision that the trustee and not the beneficiary had the power of appointment or invasion, the court
determined that neither the words of the will nor the extrinsic evidence indicated an intent by the testator to grant such a power to the income beneficiary. It thus decided that to attribute to the beneficiary an implied power of invasion would be inconsistent with the testator's intent and with the will provision expressly granting the trustee 'sole and exclusive' management powers.

The IRS addressed this issue in detail in Revenue Ruling 76-368, 1976-2 C.B. 271, and concluded that an invasion power that is not limited by an ascertainable standard that is held by independent trustee, cannot be imputed to the decedent so as to render the power taxable in the decedent's gross estate under Section 2041. In the facts of that ruling, the trustee, an independent bank, was authorized to invade the trust corpus and pay portions thereof to or for the use and benefit of the decedent in such manner as the trustee, in its sole and unfettered discretion, deemed advisable should the decedent be in need of funds in excess of the trust income for 'health, comfort, maintenance, welfare, or for any other purpose or purposes.' The trustee was directed to liberally exercise its discretionary power of invasion. Prior to the decedent's death in 1976, numerous requests had been made to the trustee for additional funds and all such requests of the decedent had been honored by the trustee. The ruling pointed to various cases holding that an independent trustee's powers should not be imputed to a beneficiary.

b. Power to Bring Judicial Action to Compel Trustee to Make Distributions. The fact that a beneficiary might be able to go to court and force a trustee to make distributions within a broad standard does not mean that the beneficiary has a general power of appointment. The IRS made that very argument in Security-Peoples Trust Co. v. U.S., 238 F. Supp. 40, 46 (W.D. Pa. 1965). The IRS in that case argued that under Pennsylvania law, the beneficiary could compel the trustee to distribute principal under the “health, comfort, maintenance or welfare” standard, and thus could control the disposition of the trust property. The court rejected the IRS's argument, and pointed out that the trustee alone held the power to distribute and that this power could not be imputed to the beneficiary.

The IRS agreed that it would not pursue making this argument in the future in Revenue Ruling 76-368, 1976-2 C.B. 271. The IRS specifically pointed to the Security-Peoples decision in support of its conclusion that the power of an independent trustee could not be imputed to the beneficiary. In that ruling, the IRS acknowledged directly that a beneficiary could bring a lawsuit had the trustee, in the judgment of the decedent, failed to exercise liberally its discretionary power of invasion on the decedent's behalf. However, the IRS concluded that this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary of the trust.

That is to be distinguished, however, from a situation in which a beneficiary has a power under the terms of the trust instrument to direct the trustee to make distributions to the beneficiary. See Tech. Adv. Memo. 8606002.

c. Giving Trustee Extremely Broad Discretion. A settlor with spendthrift children may wish to utilize extremely broad standards, or even no standards at all, but instead leave the trustee with extremely broad discretion to determine when to make (and not make)
distributions. If beneficiaries are not trustees, using a broader standard than a HEMS standard may provide helpful flexibility. For example, the trust agreement may authorize distributions for the “best interests” of the beneficiaries. Actions taken under a broad distribution standard are subject to judicial review but generally merely to correct for an abuse of discretion considering the trust terms and settlor intent. See section I.F. of this outline.

Giving the trustee extremely broad discretion does not endanger Section 2041 inclusion. The IRS specifically addressed that issue in Revenue Ruling 76-368, 1976-2 C.B. 271. Under the facts of that ruling, the bank-trustee was authorized to invade the trust corpus for the use and benefit of the decedent in such manner as the trustee, in its sole and unfettered discretion, deemed advisable should the decedent be in need of funds in excess of the trust income for 'health, comfort, maintenance, welfare, or for any other purpose or purposes.' The Ruling’s reasoning saw no problem with giving such broad discretion to the trustee. In fact, that extremely broad discretion helps thwart any possible argument that the beneficiary has control to force distributions to himself by bringing a court action to force distributions.

Even if the trust instrument purports to give the trustee “sole and uncontrolled discretion” and provides that the trustee’s decisions will be “final and conclusive,” there are cases indicating that the trustee’s discretion is still not absolute. Lucas v. Lucas, 365 S.W.2d 372, 376 (Tex. Civ. App.—Beaumont 1962, no writ). Courts may intervene if the trustee acts “outside the bounds of a reasonable judgment.” To determine that, the test is whether the trustee acts “in that state of mind in which the settlor contemplated that it should act.” First National Bank of Beaumont v. Howard, 229 S.W.2d 781, 784-85 (Tex. 1950). Restatement (Second) of Trusts § 187, cmt. j (1959) (“trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment”).

Absolute discretion does not mean absolute discretion — the trustee still owes fiduciary duties, even if the instrument says the trustee has the same discretion as if the trustee owned the assets individually. Courts will generally uphold the trustee’s decisions under an absolute discretion standard. The trustee is entitled to a presumption of good faith. Possible court intervention may occur if there is bad faith on the trustee’s part or disregard of the trust purposes.

3. **Beneficiary as Co-Trustee.** Naming the beneficiary as a co-trustee (with someone who does not have a substantial adverse interest) does not help at all in avoiding Section 2041 if the co-trustees have the authority to make distributions to the beneficiary that are not subject to an ascertainable standard. See section III.B.1.g. of this outline.

 Naming a co-trustee to serve with the beneficiary, however, can be very helpful if the trust instrument restricts the beneficiary/co-trustee from participating in any decision to make distributions to himself beyond an ascertainable HEMS standard. As long as the beneficiary has no right to succeed to the powers held by that co-trustee, the broad distribution powers of the co-trustee will not be imputed to the beneficiary.
Indeed, it is wise to use a “savings clause” that automatically restricts the beneficiary from taking any actions that might possible be construed as a personal benefit, unless those actions are limited by a HEMS standard, and to provide that any such actions would be taken only by the co-trustee. If no co-trustee is acting, the beneficiary/trustee could take steps to have the next successor trustee appointed as a co-trustee for the sole purpose of making that decision. See Section IV of this outline.

4. Beneficiary as Trustee—Distributions to Self as Beneficiary. The practical difficulty of applying Section 2041 in practice comes in the very common situation where the settlor wishes to name a beneficiary as trustee and give the beneficiary the authority to make distributions to himself.

a. Ascerturable Standard Exception. As discussed above, there is an exception in the statutory language of Section 2041 for “a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent.” I.R.C. § 2041(b)(1)(A). (This is unlike Sections 2036 and 2038, which contain no ascertainable standard exception in the statute. But that has not deterred the courts in fashioning an ascertainable standard exception for those sections also.)

b. Regulations. The regulations give a variety of detailed examples of language that constitutes an ascertainable standard:

“A power is limited by such a standard if the extent of the holder’s duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words ‘support’ and ‘maintenance’ are synonymous and their meaning is not limited to the bare necessities of life. ... Examples of powers which are limited by the requisite standard are powers which are limited by the requisite standard are powers exercisable for the holder’s ‘support,’ ‘support in reasonable comfort,’ ‘maintenance in health and reasonable comfort,’ ‘support in his accustomed manner of living,’ ‘education, including college and professional education’ ‘health,’ and ‘medical, dental, hospital and nursing expenses and expenses of invalidism.’” Treas. Reg. § 20.2041-1(c)(2).

The regulation also gives the following examples of standards that do not constitute an ascertainable standard:

“A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard.” Id.

c. Slight Difference in Language Can Be Critical. A very slight difference in language may produce a different result. For example, in Estate of Vissering v. Comm’r, the trustee authorized distributions “required for the continued comfort” of the beneficiary, as well as other standards. 990 F.2d 578 (10th Cir. 1994), rev’d, 96 T.C. 749 (1991). The Tenth Circuit acknowledged that the use of the word “comfort,” without further qualifying language, creates a general power of appointment. However, the trust language puts a limit on this word, saying it permits distributions only as “required”, not as “determined” or “desired.” Furthermore, the court observed that the invasion
must be for the beneficiary’s “continued” comfort, implying amounts reasonably necessary to maintain the accustomed standard of living. The Court concluded that such words did not constitute a general power of appointment.

When the stated standards differ from the safe harbor standards described in the regulation, it is often impossible to rationalize results that have been reached in varying cases. For example, in Whelan v. U.S., the court held that an invasion power “for the reasonable support, care and comfort of such beneficiary” constituted an ascertainable standard. 81-1 USTC ¶ 13,393 (S.D. Cal. 1981). Seven years earlier, the very same court held that a standard permitting invasion of corpus for “reasonable care, comfort and support” was not an ascertainable standard. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974).

Another example of the impossibility of rationally categorizing the cases based on the language in the instrument is Brantingham v. U.S., 631 F.2d 542 (7th Cir. 1980). The decedent’s will contained a provision stating that “my wife shall have and is hereby given the uncontrolled right, power and authority to use and devote such of the corpus thereof from time to time as in their judgment is necessary for her maintenance, comfort and happiness.” Those words are typically held not to constitute an ascertainable standard. However, the court analyzed Massachusetts law, and concluded that this language constituted an ascertainable standard. The IRS has indicated that it will not follow the Brantingham case. Rev. Rul. 82-63, 1982-1 C.B. 135.

The Vissering case and the combination of the Whelan and Tucker cases illustrate the extreme danger in modifying, even slightly, the standards given as safe harbor language in the regulations. The Brantingham case illustrates that using some of the magic “bad” words may nevertheless be sanctioned by a court, but one certainly cannot rely on such a result.

d. Two-Fold Analysis Approach; Combination of Clauses and Total Context of Standards Control, Not Presence of Single Words. The courts have reviewed trust instruments in their entirety rather than just focusing on “magic” words that are or are not present. One commentator has suggested applying a two level analysis. First, are the powers of invasion of trust assets limited to ascertainable standards related to the beneficiaries’ health, education, support or maintenance, thus bringing the trust assets within the safe harbor language of Section 2041(b)(1)(A)? Second, are the standards expanded (or restricted) elsewhere in the trust documents? See Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990).

e. Summary of Standards that Typically Are Not Ascertainable. While there is no uniform consistency in the cases, courts have typically found certain words not to be ascertainable:

“For example, the federal courts have repeated concluded that the presence of any of the condemned, operative words—‘welfare’ and ‘happiness’—prevents a standard from being ascertainable. Other synonymous words and phrases not limited to an ascertainable standard include: ‘well-being,’ ‘benefit,’ ‘use and
benefit of,’ ‘enjoyment,’ ‘pleasure,’ ‘as she may require,’ ‘as she may see fit,’ ‘business purpose,’ and ‘any purpose whatsoever.’” Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 244 (1981).

f. Example Cases and Rulings Finding Ascertainable Standard Exists. A detailed compilation of cases that have addressed the ascertainable standard exception under Section 2041 are contained in several differing articles. See Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 247-49 (1981) (chart compilation of cases and rulings); Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt. Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990) (chart summarizing cases under Sections 2036 and 2038 and separate chart summarizing cases under Section 2041). The following is a sampling of some of the cases and rulings that have found that an ascertainable standard exists. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974) (“reasonable care, comfort, and support”); Estate of Vissering v. Comm’r, 990 F.2d 578 (10th Cir. 1994) (“required for the continued comfort”); Martin v. U.S., 780 F.2d 1147, 1150 (4th Cir. 1986) (“[i]n the event of the illness of Theo N. Martin or other emergency”); court said clear that IRS argument “was a loser”, and if argument was not “frivolous” before, it became so after Sowell decision of Tenth Circuit was issued); Finlay v. U.S., 752 F.2d 246 (6th Cir. 1985) (“right to encroach if she desires”); De Oliveira, Jr. v. U.S., 767 F.2d 1344 (9th Cir. 1985) (“for the benefit of”); Sowell v. Comm’r, 708 F.2d 1564 (10th Cir. 1983) (“in case of emergency or illness”); Pittsfield Nat’l Bank v. U.S., 181 F. Supp. 851 (D.C. Mass 1960) (“as he may from time to time request, he to be the sole judge of his needs”); Estate of Anderson v. U.S., 96-1 USTC ¶ 60,223 (D. Neb. 1995) (“reasonably necessary for ... comfort, support and maintenance”); Whelan v. U.S., 597 F. Supp. 1293 (W.D. Pa. 1984) (“should any emergency arise”); Estate of Strauss v. Comm’r, 69 TCM 2825 (1995) (“care and comfort, considering his standard of living as of the date of ... death”); Estate of Duvall v. Comm’r, 66 T.C.M. 164 (1993) (“to do as she pleases”); Hunter v. U.S., 81-1 USTC ¶ 13,393 (S.D. Cal. 1981) (“reasonable support, care and comfort”); Estate of Chancellor v. Comm’r, T.C. Memo. 2011-172 (“necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures ... taking into consideration the [beneficiary’s] standard of living...”; court substituted what it believed Mississippi courts would determine and concluded that the provisions beyond the strict ascertainable standard were merely a “rounding out” of the standard); Rev. Rul. 78-398 (“maintenance and medical care”).

The IRS has been surprising lenient in a number of private letter rulings in interpreting standards to come within the ascertainable standard requirement. E.g., Ltr. Rul. 200028008 (construing reference to “other emergency” following an ascertainable standard as limited to the type of emergency covered by that standard); 200013012 (“actual living expenses only”); 9728023 (“comfortable” modified “support and maintenance”); 9713008 (treats “care” equivalent to “support”); 9516051 (such distributions as the trustee deemed requisite or desirable under the circumstances if the trust income were insufficient to met the beneficiary’s reasonable needs); 9203047 (“maintenance, support and comfort, in order to defray expenses incurred by reason of sickness, accidents, and disability;” reference to “comfort” is qualified by other language limiting payment to medical costs); 9012053 (to relieve emergencies affecting beneficiaries; power to invade for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of Martin v. U.S. decision).
Example Cases and Rulings Finding That Ascertainable Standard Does Not Exist. Miller v. U.S. 387 F.2d 866 (3rd Cir. 1968) (“proper maintenance, support, medical care, hospitalization, or other expenses incidental to her comfort and well-being”); Strite v. McGinnes, 330 F.2d 234 (3rd Cir. 1964) (“reasonable needs and proper expenses or the benefit or comfort” of beneficiaries); Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985) (one paragraph of the will authorized distributions “for her own proper maintenance;” that paragraph was nullified by more expansive powers in the next paragraph to use the assets “for whatever purpose she desires”); First Virginia Bank v. U.S. 490 F.2d 532 (4th Cir. 1974) (“right to dispose, sell, trade, or use (the stock) during her lifetime for her comfort and care as she may see fit”); Doyle v. U.S., 358 F. Supp. 300 (E.D. Pa. 1973) (“comfort, maintenance and support”); Estate of Jones v. Comm’r, 56 T.C. 35 (1971) (“in cases of emergency, or in situations affecting her care, maintenance, health, welfare and well-being;” court says that words “comfort” and “well-being” and “comfort, welfare or happiness” are not ascertainable); Lehman v. U.S., 448 F.2d 1318 (5th Cir. 1971) (holder of life estate could “consume, invade, or appropriate” the corpus for her “support, maintenance, comfort and welfare,”); Hyde v. U.S., 950 F. Supp. 418 (D. NH 1996) (“as in her sole discretion shall be necessary and desirable” court rejected taxpayer’s argument that the power was limited to emergencies); Estate of Schlotterer v. U.S., 421 F. Supp. 85 (W.D. Pa. 1976) (“comfort and pleasure” court focused on “pleasure” saying it is synonymous with gratification, enjoyment and pursuit of happiness); Forsee v. U.S., 2001-1 USTC ¶ 60,393 (D. Kan. 1999) (“happiness, health, support and maintenance”); Renfro v. U.S., 78-1 USTC ¶ 13,241 (E.D. Tx. 1978) (holder of life estate could “sell, mortgage or otherwise dispose of such property at such times and on such terms as to her may seem proper”); Franz v. U.S., 77-1 USTC ¶ 13,182 (E.D. Ky. 1977) (“care, maintenance and welfare”, stating “one cannot escape the import of the word ‘welfare’ as being ‘very broad’ and indicating ‘the extent of the discretion given to the trustee’”); Stafford v. U.S., 236 F. Supp. 132 (E.D. Wis. 1964) (“use and enjoy the principal … for his care, comfort, and enjoyment”); Estate of Little v. Comm’r, 87 T.C. 599 (1986) (“proper support, maintenance, welfare, health and general happiness in the manner to which he was accustomed at the time of the death of [his wife];” court reasoned that standard did not relate just to HEMS, giving example of travel as an unrelated item to HEMS that might have been permissible under the standard in the agreement); Estate of Penner, 67 T.C. 864 (1977) (“business purpose”); Estate of Lanigan v. Comm’r, 45 T.C. 247 (1965) (“use and benefit”); Estate of Beyer v. Comm’r, T.C. Memo 1974-24 (“sole discretion … for any purpose whatsoever”); Rev. Rul. 82-63, 1982-1 C.B. 135 (“maintenance, comfort, and happiness”); Rev. Rul. 77-194, 1077-1 C.B. 283 (“proper comfort and welfare”); Rev. Rul. 77-60, 1077-1 C.B. 282 (“as desired to continue an accustomed standard of living”); Rev. Rul. 76-547 (“health, care, maintenance, and enjoyment”); Ltr. Rul. 9344004 (“comfort,” “happiness,” and “welfare”); Ltr. Rul. 9318002 (“comfort,” “happiness,” and “welfare”; ruling subsequently revoked without explanation by Letter Ruling 9510001); Tech. Adv. Memo. 9344004 (“health, maintenance, support, comfort, and welfare at the standard of living to which he had become accustomed”, applying Texas law); Ltr. Rul. 9125002 (“reasonable comfort, best interest, and welfare”); Ltr. Rul. 9113026 (“care, support, maintenance, and welfare”); Ltr. Rul. 9030032 (“‘if that spouse’s income from other sources is not sufficient for the surviving souse’s ‘support and comfort in the manner in which she was accustomed’”, reasoning that “support in reasonable comfort” is an ascertainable
standard while “comfort” standing alone is not); Tech. Adv. Memo. 8606002 (provision for distributions for ascertainable standard, coupled with power to distribute for “emergency needs”); Tech. Adv. Memo. 8304009 (“any great emergencies which may arise in the lives and affairs ... such as extra needed medical services or hospitalization”); Ltr. Rul. 7841006 (“emergency”); Ltr. Rul 7812060 (“as may be necessary for the well-being of my son”).

h. Rulings Related to Standard of Living. The Regulations provide that “support in his accustomed manner of living” is an ascertainable standard. Treas. Reg. § 20.2041-1(c)(2). The following cases and rulings have held that references to a standard of living constituted an ascertainable standard. Estate of Vissering v. Comm’r, 990 F.2d. 578 (10th Cir. 1994) (“continued comfort” implies amounts reasonable necessary to maintain the accustomed standard of living); Estate of Klafter v. Comm’r, 32 T.C.M. 1088 (1973) (discretion to distribute income “to maintain [beneficiary’s] standard of living in the style to which she has been accustomed” is an ascertainable standard under Section 2036); Ltr. Ruls. 9036048 (“determines to be advisable, considering resources otherwise available to them . . . to provide for their health, education, support and maintenance in the manner of living to which they have become accustomed”); 7836008 (“reasonable health, education, support and maintenance needs consistent with a high standard and quality of living”); 7914036 (“to maintain the standard of living to which he or she was accustomed during the lifetime of the first of us to die, at and immediately prior to the time of the death of the first of us to die”; ruling reasoned that “accustomed standard of living” alone is not sufficient, but here, the word “maintain” tied the standard to one of the four HEMS standards).

The following rulings have held that references to a standard of living did not constitute an ascertainable standard. Rev. Rul. 77-60, 1977-1 C.B. 282 (“continue an accustomed standard of living” without further restriction is not ascertainable); Ltr. Rul. 8339004 (“to provide comfortably for his wants according to the style of living which we have enjoyed”).

i. Rulings Related to “Emergency” Standard. For gift tax purposes, Regulation § 25.2511-1(g)(2) refers to a “reasonably fixed or ascertainable standard.” In an example, that Regulation states that “a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard.” Based on this language in the gift tax regulations, one would assume that an “emergency” standard would be treated as an ascertainable standard for purposes of Section 2041. Nevertheless, the IRS maintains (and has been successful in persuading some courts) that a distribution standard based on “emergency” relates to the “timeliness” of a distribution, not to need in terms of health, education, support, maintenance, or other ascertainable standards, and thus does not qualify as an ascertainable standard for purposes of Sections 2041 and 2514. E.g., Tech. Adv. Memo. 8606002 (provision for distributions for ascertainable standard, coupled with power to distribute for “emergency needs”); Tech. Adv. Memo. 8304009 (“any great emergencies which may arise in the lives and affairs ... such as extra needed medical services or hospitalization”); Ltr. Rul. 7841006 (“emergency”).

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j. **Possibility of Reformation.** If a “bad” word is included in the standard, there may be a possibility of reforming the instrument based on mistake. E.g., Ltr. Ruls. 200144018 (inclusion of reference to “welfare” was mistake; reformation to delete that word did not result in release of general power of appointment); 200024015; 199936029.

k. **Effect of Providing that Trustee Must/May Consider Outside Resources.** A provision that the trustee either should or should not or may consider the beneficiary’s outside resources in determining whether to make distributions under a standard that comes within the ascertainable standard should not have any effect on whether an ascertainable standard exists under §2041. See Treas. Reg. §§20.2041-1(c)(2)(“immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised”) &25.2514-1(c)(2); Ltr. Rul. 9036048 (“determines to be advisable, considering resources otherwise available to them . . . to provide for their health, education, support and maintenance in the manner of living to which they have become accustomed”).

It is *very important* that beneficiaries understand that requiring the trustee to consider outside resources has real economic consequences and may limit the ability to make distributions.

If the instrument directs that distributions should be made for the beneficiary’s support without considering other resources, if trust assets are not used first for the beneficiary’s support, the beneficiary may be deemed to have made an indirect contribution to the trust.

If a beneficiary of a trust with a HEMS distribution standard exercises an inter vivos limited power of appointment, the “considering other available resources” phrase may impact the amount of the gift that is made by the appointing beneficiary.

If the instrument provides that the trustee *may* consider outside resources, what is the trustee’s responsibility to exercise due diligence to ascertain what outside resources are available? Under the literal language of the instrument, the trustee is not *required* to do so. Arguably, a duty of impartiality may in some situations indicate that the trustee should inquire about outside resources if the trust instrument gives the trustee the clear authority to do so. However, the panelists generally believe that the trustee does not have a duty to investigate outside resources if the trustee merely has the authority but not the direction to consider outside resources.

If the trustee seeks information about outside resources and the beneficiary refuses to provide information, the trustee would be justified in not making distributions to that beneficiary if the instrument or state law gives the trustee the authority to consider outside resources.

Requiring the trustee to consider outside available resources may result in a frozen trust for a long period of time. For example, if a bypass trust permits distributions only to the surviving spouse during the balance of his or her lifetime and requires the trustee to consider outside resources, the trustee may not be able to make any distributions during the spouse’s lifetime (if the spouse has plenty of outside resources).
If the trust is silent about considering outside resources, state law may vary as to the result. For example, in Illinois, the trustee would not have to consider outside resources but probably would have to consider outside resources in California. As other examples, if the trust instrument is silent, the trustee is forbidden from considering outside resources in Georgia but the trustee may consider other resources in Virginia.

Texas cases have been inconsistent on the issue. Compare First National Bank of Beaumont v. Howard, 229 S.W. 2d 781, 786 (Tex. 1950) (should consider all income available to the beneficiaries from any sources in determining whether to make distributions from principal) with Penix v. First National Bank of Paris, 260 S.W. 2d 63, 67 (Tex. Civ. App.—Texarkana 1953, writ ref’d) (trustee required to consider need for distribution “without regard to the financial ability of the beneficiary’s parents”).

The Restatement (Second) of Trusts seems to suggest that the trustee should not consider outside resources available to a beneficiary if the trust instrument authorizes distributions for support but is silent on the issue of whether to consider outside resources. Restatement (Second) of Trusts §128, cmt. e (1992) (“It is a question of interpretation whether the beneficiary is entitled to support out of the trust fund even though he has other resources. The inference is that he is so entitled.”). However, the Restatement (Third) of Trusts suggests the opposite. Under the Restatement (Third) of Trusts, §50, Comment e, “the presumption is that the trustee will take the beneficiary’s other resources into account in determining whether and in what amounts distributions are to be made, except insofar as, in the trustee’s discretionary judgment, the settlor’s intended treatment of the beneficiary or the purposes of the trust will in some respect be better accomplished by not doing so.” Restatement (Third) of Trusts, §50, cmt. e (2003). The trustee generally may rely on the beneficiary’s representations and on readily available, minimally intrusive information requested of the beneficiary, unless the trustee has reason to suspect that the information thus supplied is inaccurate or incomplete. Id., at cmt. e(1). The Comments and Reporter’s Notes to Section 50 of the Restatement (Third) of Trusts summarizes the diversity of state law regarding the consideration of outside resources if the trust instrument is silent on the issue.

If the beneficiary’s other resources are to be considered, does that mean just the beneficiary’s sources of income or all of the beneficiary’s assets? The general rule seems to be to limited the consideration to sources of income and not the beneficiary’s assets in general. Restatement (Third) of Trusts, §50, cmt. e (2003).

State law regarding this issue can have an effect on decanting decisions. Decanting a trust from an Illinois trust to a California trust may mean that the trustee can no longer make discretionary distributions to the surviving spouse. Decanting the trust to California in that circumstance may subject the trustee to potential liability for breaching the duty of impartiality.

1. Small Trust Termination Provision. A provision giving the trustee the authority to terminate the trust and distribute to the current income beneficiaries (which could include the trustee individually) may create a general power of appointment. Such clauses are sometimes restricted so that they can only be exercised if the trust reaches an objective small amount. If that is the case, the general power of appointment probably would not arise until the trust diminishes to that size limit, at which time the
power could be exercised. See section III.B.1.h of this outline. The IRS has ruled that the power of a trustee-beneficiary to terminate under very limited circumstances would not create a general power of appointment. Tech. Adv. Memo. 8606002. If an objective formula is not used, the trustee-beneficiary is at risk as to whether, in the exercise of its fiduciary capacity, it would actually have the power in existence at the time of his death. See generally Pennell, Avoiding Tax Problems For Settlors and Trustees When An Individual Trustee is Chosen, EST. PL. 264, 271-72 (September 1982) (“Accordingly, when a beneficiary is acting as trustee, the provision ought to be set to a clearly specified dollar amount. In the alternative, the determination of when termination may occur should be given to some other party.”).

m. State Laws Limiting Discretionary Distributions for Self to an Ascertainable Standard.
Various states have enacted laws that automatically restrict standards for distributions from trustees to themselves individually.

New York historically has imposed an absolute prohibition against a trustee exercising a discretionary distribution power in favor of itself, except for a trust that is revocable by the beneficiary during his or her lifetime. The statute was amended, effective September 30, 2003, to allow distributions to the beneficiary-trustee within an ascertainable standard, or if the trust instrument expressly references the statute and overrides the prohibition on distributions to a trustee-beneficiary. N.Y. CLS EPTL § 10-10.1 (“for such person’s health, education, maintenance, or support within the meaning of sections 2041 and 2514 of the Internal Revenue Code, or any other ascertainable standard”).

Like the current New York rule, some states apply the prohibition only if the distribution power in the instrument is not limited by an ascertainable standard relating to the health, education, maintenance or support of the power holder. ALASKA STAT. § 13.36.153; CONN. GEN. STAT.. § 45a-487(b); FLA. STAT. § 737.402(4)(a); MINN. STAT. § 501B.14; UTAH CODE § 75-7-41-(1); W. VA. CODE § 44-5-13. The Florida statute gives the trustees and beneficiaries of existing trusts the right to opt out of the statute, for fear that the prohibition in the statute would cause a lapse of a general power of appointment by trustee-beneficiaries who formerly had unlimited discretion to make distributions to themselves. However, the IRS subsequently ruled that the Florida statute would not be treated as causing the lapse of a power of appointment. Rev. Proc. 94-44, 1994-2 C.B. 683.

Several states have statutory provisions permitting trustees to exercise discretionary distribution powers in favor of themselves, but the statutes cut back the power to one that may be exercised only to make distributions for the power holders' health, education, support or maintenance. D.C. CODE § 21-1722; MD. CODE § 14-109; N.J. STAT. § 3B:11-4.1; PA. CONS. STAT. § 7504; TEX. PROP. CODE §113.029(b)(1).

Some of the statutes also address other issues than just restricting distributions to the trustee-beneficiary. An example is the Utah Code provision. It also (1) restricts discretionary allocations of receipts and disbursement between income and principal, unless the trustee acts in a fiduciary capacity where he has no power to enlarge or shift a beneficial interest except as an incidental consequence of the discharge or his fiduciary duties; (2) restricts making or obtaining discretionary distributions to satisfy
his legal obligations; and (3) restricts any powers that indirectly permits control over
those other issues, including the right to remove and replace the trustee. The Utah
statute makes clear that it does not apply to (1) revocable trusts, (2) a settlor’s spouse as
beneficiary of a marital trust, (3) distributions within an HEMS standard, or (4)
powers “clearly intended” to be general powers. Also, it provides that if any restricted
power is held by two or more trustees, it may be exercised by the trustee who is not
disqualified. If there is no acting co-trustee, the restricted power may be exercised by a
trustee appointed under the appointment provisions of the trust instrument or by a
court.

Cases have recognized the effectiveness of such state laws in preventing a beneficiary
from acquiring a general power of appointment. E.g., Sheedy v. U.S., 691 F. Supp. 1187
(E.D. Wis. 1988).

n. Planning Issues Regarding Distribution Standards.

(1) Different Standards for Different Trustees. Distribution powers may be bifurcated.
For example, beneficiary-trustees will be limited by a health, education,
maintenance and support (or “HEMS”) standard, but other trustees may have
broader distribution standards. The client may be unwilling, however, to give a
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corporate trustee an absolute discretion standard.

(2) May vs. Shall. Planners generally believe that a HEMS standard comes within the
exception of §2041 whether the instrument directs that the trustee “may” or “shall”
make distributions for HEMS purposes. See Estate Planning and Administration
Group of Schiff Hardin LLP, What Language Should Be Used to Avoid a General

(3) “As May Be Needed.” An instrument may direct that distributions be made “as may
be needed” for various purposes. The beneficiary may then come to the trustee with
reasons that a distribution is needed and argue that the instrument requires that
the distribution be made. This language gives room to the litigator to pressure the
trustee to make distributions. However, “needed” is in the eye of the beholder and
the trustee must still make a determination of whether the distribution is actually
“needed.”

(4) Accustomed Standard of Living. If a trust authorizes distributions to maintain the
beneficiary’s “accustomed standard of living,” various uncertainties arise. For
example, what if the beneficiary is eight years old when the trust is created and has
a restricted standard of living at that time?

(5) “Station in Life.” Trust agreements sometimes authorize distributions to
beneficiaries in accordance with their “station in life.” The meaning of that phrase is
quite uncertain. For example, if a beneficiary is at the poverty level, does the trustee
determine that his station in life is that he is destitute and broke, and therefore not
make any distributions?

(6) Trustee Guidance; Example of Factors That the Trustee May Consider. Giving
guidance to the trustee about specific factors to consider will be helpful for the
trustee to know the settlor’s intentions as particular fact scenarios arise. Examples of factors that the trustee may consider include a beneficiary’s desire to begin a profession or to buy a home. The trustee may also consider whether distributions will provide a disincentive to the beneficiary to become productive. Defending a trustee’s actions is easier if the trustee has more specific guidance on which the trustee’s decisions are based. A possible concern is that listing a variety of specific factors may give rise to an implication that other factors should not justify distributions.

For various sample clauses providing guidance to trustees regarding distribution intentions, see Benjamin H. Pruett, Tales from the Dark Side: Drafting Issues from the Fiduciary Perspective (2013) (available from the author, Pruett@bessemer.com).

(7) Budgeting Issues. A beneficiary may request a higher level of distributions than can be justified. For example, a surviving spouse may tell the trustee that the deceased spouse had previously paid for a variety of things. However, the trustee may explain that if the prior level of expenditures is continued the trust run out of money during the beneficiary’s lifetime. A good trustee will discuss budgeting with the beneficiaries and address a level of distributions that will allow the trust to continue on a long-term basis. One panelist cautions that if the trustee sets a budget, it should be followed.

One panelist said that he uses a “Mercedes and Chevrolet” analogy. Even though the decedent had paid for a Mercedes in the past, that may not be affordable in the future.

A primary concern is that remainder beneficiaries may allege that the trustee violated the duty of impartiality by making excessive distributions to the current beneficiary. There is also concern that even the current beneficiary may complain after the trust has run out of money.

(8) Concern of Individual Trustees Ignoring Stated Standards. Individual trustees often forget that there is a document that places limits on distributions. They think they know better than anybody else what the beneficiaries need regardless what the document says. If there are individual trustees, a large part of the professional’s role is educating them about their responsibility in the execution of trust.

(9) Tax Minimization. The higher income tax brackets that apply to trust income above a very low threshold and the 3.8% Medicare tax may impact distribution decisions. Is tax minimization factor that may be considered by the trustee? What if the stated distribution standard is simply a HEMS standard? That depends upon the purpose of the trust. If the purpose is to minimize taxes, there may be broader authority to consider income tax effects in making distribution decisions.

Creative Planning Strategy to Allow Beneficiary to Decide Whether to Retain Unfettered Control Over Trust or be Subject to Ascertainable Standard. Steve Gorin, (an attorney in St. Louis) suggests the following creative strategy if a client wants to make an outright bequest that might be sizable enough to justify a trust and does not want trustee discretion to impede the beneficiary’s access. Consider using a lifetime trust with ascertainable standards for income and principal, as well as an unlimited
withdrawal right at a specified age. (By including an age restriction, this provision could be used for children who might currently be over that age as well as for grandchildren who may be under that age.) The child then has the choice of accepting the bequest in trust with that broad withdrawal right or doing a timely disclaimer of the withdrawal right. Because the unlimited withdrawal right is a general power of appointment, it is a separate interest that can be disclaimed, with the beneficiary still receiving distributions under ascertainable standards. See Reg. §25.2518-3(a)(1)(iii).

5. Beneficiary as Trustee—Effect of Authority to Satisfy Trustee’s Support Obligations; The *Upjohn* Issue.

a. Regulations—Power to Discharge Decedent’s Obligation is Power Exercisable in Favor of Decedent. The regulations provide that a power to satisfy the decedent’s obligation is treated as a power exercisable in favor of the decedent:

“A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent ... is considered a power of appointment exercisable in favor of the decedent or his creditors.” Treas. Reg. § 20.2041-1(c)(1). See also Treas. Reg. § 25-2514-1(c)(1).

Therefore, if a trustee has the power to make a distribution that satisfies any of his obligations, the trustee is deemed by the regulations to have a power to distribute to himself. Thus, although the trustee is not a beneficiary at all under the trust, power of appointment problems for the trustee can still arise if any person that the trustee owes legal obligations to is a beneficiary.

b. The Illogical Disconnect. A trustee may have the power to distribute property to himself for his support and he does not have a general power of appointment. But the trustee may not possess the very same power to make distributions to his minor children for their support. The reason is that the power to satisfy the trustee’s obligations is treated as a power to distribute to the trustee. Therefore, that power is a general power of appointment, unless it meets the ascertainable standard exception. The ascertainable standard exception, however, requires that the power be related to the power holder’s “... support.” Because the power is related to the child’s support and not the support of the trustee, it is not limited by an ascertainable standard. The IRS concurs with this analysis. See Rev. Rul. 79-154, 1979-1 C.B. 301; Ltr. Ruls. 8924011, 8921022

c. *Upjohn*. This issue has become known by the name of a case that does not address this precise Section 2041 issue at all. *Upjohn v. U.S.*, 72-2 USTC ¶12,888 (W.D. Mich. 1972). That case involved a Section 2503(c) trust which provided that the trustee should not make any distributions that would satisfy the settlor’s legal obligation of support. The issue was whether that constituted a “substantial restriction” on the right to make distributions to the beneficiary, so that it did not qualify under Section 2503(c), in which event gifts to the trust would not qualify for the annual exclusion. The court rejected the IRS’s argument, that this restriction constituted a substantial restriction, on the theory that it was no restriction at all to say that the trustee should not make a distribution to satisfy a need of the minor that someone else would provide anyway (i.e., the parent, because of the support obligation). In this regard, the
provision really enlarged the rights of the minor child under the instrument, because it assured that the trust funds would be used to provide additional benefits that were not already provided for by the support obligation.

The Section 2041 problem exists if the surviving spouse serves as trustee of a Section 2503(c) trust. Unless the taxpayer can convince the court to rule like Upjohn that a limitation on making distributions in satisfaction of the trustee’s legal obligations is not a substantial restriction, the spouse cannot serve as trustee of a Section 2503(c) trust. Either the trust would restrict the trustee from making distributions to satisfy his legal obligation of support (in which event it is not a valid Section 2503(c) trust if a court cannot be persuaded to follow Upjohn), or else the spouse would have a general power of appointment. Hence, clauses to solve this problem have come to be known as “Upjohn clauses.”

Interestingly, no case has addressed what seems to be the real issue. If a trustee makes a distribution to a minor, and the parent uses that to provide what should be the parent’s legal obligation, has the parent violated his duty to his children, in effect converting the child’s assets for his own use? Does the parent still owe the amount of such support payment to the child? If so, a distribution from a trust to a minor does not satisfy the parent’s legal obligation of support. See section II.B.2.c.(3) of this outline. Stated differently, a distribution that satisfies the power holder’s legal obligation is in reality a distribution to the power holder. If the instrument says that no distribution may be made to the power holder other than for the power holder’s health, education, support or maintenance, the distribution would not be authorized (because it is not for the power holder’s “ … support”—but for the payment of a claim against the power holder.) See Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 (1986).

d. The Fix. To cure any possible argument, planners insert what has become known as the Upjohn clause: A clause prohibiting the trustee from making any distribution that would have the effect of discharging that trustee’s legal obligations. For an excellent discussion of the tax effects if a trust does not absolutely prohibit satisfying legal obligations of the donor or of a trustee, see Pennell & Fleming, Avoiding the Discharge of Obligation Theory, PROBATE & PROPERTY 49 (Sept./Oct. 1998). One ruling approved a clause requiring that if the trustee (a surviving spouse) had the obligation to support any other trust beneficiary, the trustee was required to appoint a special trustee of her choosing at that time to make distributions for that beneficiary. Ltr. Rul. 9036048. See Section III.D.5. of this outline.

Some of the state law statutory “savings clauses” address this issue. For example, TEX. PROP. CODE § 113.029(b)(2) provides that unless the trust provides otherwise, “a trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee personally owes another person.”
6. **Special Issues With Settlor’s Spouse as Trustee.** A very common estate plan is to name the surviving spouse as the trustee of any trusts created in the decedent’s will. A variety of tax and legal issues may arise that the planner should carefully consider.

a. **Restrict Power to Distribute to Self to Ascertainable Standard.** The trust should restrict the spouse-trustee from making any distributions to himself that are not related to health, education, maintenance and support.

b. **Restrict Incidents of Ownership.** In case the trust owns any life insurance on the spouse’s life, the trust should restrict the spouse, as trustee, from having the power to exercise any incidents of ownership over such policy.

c. **Restrict Power to Distribute to MinorChildren or Otherwise in Satisfaction of Spouse’s Legal Obligations.** In order to avoid the “Upjohn issue,” the spouse should be restricted from exercising any power to make a distribution in satisfaction of any of his legal obligations. See section III.B.5. of this outline.

d. **Spouse and Children as Discretionary Beneficiaries—Use Ascertainable Standard for Distributions to Children Also.** One possible implication of Treas. Reg. § 25.2511-1(g)(2) is that the spouse is treated as making a gift if (1) the spouse has a “beneficial interest” in the trust, and (2) the spouse makes a distribution to someone else under a standard that is not an ascertainable standard. See section III.A.4. of this outline. Accordingly, if the spouse is the trustee, it is likely that the spouse has some kind of beneficial interest in the trust. If so, to be conservative in light of the possible implication of the regulation, the trust instrument should restrict the authority of the spouse-trustee to making distributions to any other beneficiaries only under an ascertainable standard.

e. **Use Tax Savings Clause.** The author strongly urges using a tax savings clause designed to cure all of those prior problems in every trust—especially where the spouse is serving as trustee. See section IV of this outline.

f. **Fiduciary Obligations.** In some situations, spouses as trustees may face tremendous emotional pressures in responding to requests/demands from children for distributions. The spouse may face fiduciary issues in light of the conflict of having both the spouse and children as beneficiaries. The spouse may face fiduciary issues in connection with decisions that may be made innocently for independent tax reasons. (An example would be a spouse-trustee who makes distributions to himself under a HEMS standard to carry out all DNI to the spouse (and tax the income at lower rates) when the spouse had sufficient outside resources and could not justify a need for those distributions.)

g. **Income Tax.** As discussed in Section III.E. below, the spouse may potentially be treated as the owner of the trust under Section 678 if the spouse is the sole trustee and has the authority to make distributions to himself.

h. **QTIP Trusts.** The spouse may wish to make gifts of assets in a QTIP trust to take advantage of the lower effective gift tax as compared to the estate tax. To keep from including the trust directly in the spouse’s estate, the QTIP trust will probably not
give the spouse unlimited discretion to make distributions from the QTIP (which would permit large distributions to the spouse so that he could make gifts.) For that situation, having a third party as trustee could be helpful. See generally Tiernan, Creating an Amicable Estate Plan for the Decedent’s Children and the Second Spouse, 94 J.TAX’N (Feb. 2001).

i. Clayton Trusts. A QTIP trust may specify that the trust passes differently depending on whether or not the QTIP election is made. If the trust provides that the trust assets will pass outright to the surviving spouse if the QTIP is not made, to be conservative, the spouse should not serve as the executor with the authority to make that election. See Sloan, Planning and Drafting for Maximum Flexibility in Credit Shelter/Marital Deduction Planning, 38th Annual Heckerling Inst. On Est. Pl. ¶ 800 (2004). If the spouse has the authority, through making a tax election, to receive the trust property not subject to an ascertainable standard, the spouse would have a general power of appointment. If the QTIP trust assets will pass to a standard bypass trust (which would be restricted so that the spouse would not have a general power of appointment), the spouse should not have a general power of appointment if the spouse serves as the executor, but questions could arise as to whether the spouse makes a gift by not making the QTIP election if the new trust terms do not give the spouse a mandatory income right.

j. Section 2503(c) Trusts. As discussed in section II.B.6.a., neither the settlor nor the settlor’s spouse should serve as trustee of a Section 2503(c) trust. (If the spouse serves as trustee, there is a clear Upjohn problem. Either the trust might not qualify for Section 2503(c) treatment because it does not satisfy the substantial restriction requirement, or else the spouse would have a general power of appointment. See Section III.B.5. of this outline.)

7. Summary of Selection of Trustee Issues Regarding Dispositive Powers Held by a Beneficiary. The beneficiary should not have the power as trustee to make distributions to himself that are not limited by an ascertainable standard relating to his HEMS. If the beneficiary is a co-trustee (or holds a veto power), the beneficiary will be deemed to hold distributive powers of the trustee unless he is a co-trustee with the grantor (but then there would adverse tax consequences to the grantor) or an adverse party. If the beneficiary has a contingent power to become trustee in the future upon the occurrence of events outside his control, the beneficiary will not be deemed to hold the powers of the trustee until the triggering event actually occurs. Once the events have occurred entitling the beneficiary to become trustee, he will be deemed to hold any problematic powers (even before he accepts as trustee) unless he formally disclaimed the right to be trustee (generally within nine months of when the original transfer in trust was made.)

Reciprocal powers (in reciprocal trusts) may be uncrossed.

If there is a third party trustee: A third party trustee can have complete discretion over distributions. However, if there are mandated distributions, the beneficiary will be deemed to have a general power of appointment over any undistributed but “accrued” amounts (but this does not apply if the trustee just has the discretion, even within a standard, to make distributions.) A third party trustee may be used as a co-trustee with
a beneficiary, and the instrument could direct that any problematic powers (to make distributions beyond a HEMS standard to the beneficiary or to any other beneficiary or to make distributions that satisfy the beneficiary’s obligation of support) would be held solely by the third party trustee. Even if there is a third party trustee, to be safe, the instrument should prohibit any distributions in satisfaction of legal obligations of the trustee.

If the beneficiary is trustee: Use an ascertainable standard. Do not get fancy and stray from the pure HEMS standard. Even slight word deviations could potentially have disastrous effects—or at least give rise to a lawsuit. Adding “in the accustomed standard of living” is satisfactory as long as those words modify the stated standard. (In addition, as discussed in Section III.A.4., the instrument should not allow the beneficiary-trustee to make distributions to another beneficiary unless the distribution is within an ascertainable standard as to that other beneficiary.)

C. Estate Tax—Management/Administrative Powers.

1. The Issue. Overly broad administrative powers might potentially create (1) estate tax inclusion problems under Section 2041 if the powers enable the power holder to favor himself, and (2) gift tax concerns under Section 2514 if the power holder could exercise the power to favor himself, but instead exercises the power in a manner that favors others.

2. Regulations. The regulations to Sections 2041 and 2514 indicate that “mere … management {and} investment” powers will not cause the holder of the power to have a general power of appointment:

   “The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties in not a power of appointment.” Treas. Reg. § 20.2041-1(b)(1); 25.2514-1(b)(1).

3. Lack of Cases; Analogy to Section 2036-2038 Cases. There have been very few cases addressing the effects of administrative and management powers under Section 2041. Estate of Rolin v. Comm’r, 68 T.C. 919 (1977), aff’d, 588 F.2d 368 (2nd Cir. 1978) (investment power not general power of appointment because required to be exercised in fiduciary capacity). However, the cases regarding the effects of administrative and management powers under Sections 2036 and 2038 should provide guidance by analogy. The underlying principles would seem to be the same. In particular, the Supreme Court’s discussion in Byrum of the effects of management powers (in particular, in that case, the power to vote stock) in relation to the power to designate the persons who may possess or enjoy property or the income therefrom. As discussed above, the planner should be careful to make clear that any administrative owners of a beneficiary-trustee must be exercised in a fiduciary capacity. See generally section II.B.4. of this outline.
The lack of very many cases under Section 2041 regarding administrative powers, however, does raise potential concerns. Some planners may want to draft around potential arguments by the IRS in sensitive situations.

4. **Potentially Troublesome Powers.** One commentator has given an excellent summary of potentially troublesome powers that might possibly be interpreted to give the trustee the power indirectly to favor himself:

“The mere existence of [an administrative] power arguably can be a power (even a general power of appointment or a power exercisable solely by the power holder to vest income or corpus in himself). The exercise or lapse of the power in favor of other than the power holder arguably can be a taxable gift. Potentially troublesome are powers:

(1) to retain, dispose and invest property when particular types of income are allocated to particular beneficiaries;

(2) to retain or invest in unproductive or underproductive property (especially if the governing instrument waives the application of state law that otherwise would require an adjustment in favor if income);

(3) to allocate receipts and expenses between income and principal;

(4) to lend without adequate security or interest;

(5) to exchange property with the trustee;

(6) to release a trustee or accept the trustee’s account;

(7) to distribute in non-pro rata shares without regard to unrealized gain for tax purposes; and

(8) to pay (or cause payment of) death costs (i.e., debts, costs of administration and taxes) from one fund rather than another.” Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 503.36 (1986).

Mr. Horn’s article has a very thoughtful discussion of drafting steps that the planner might take to avoid potential problems in sensitive situations.

5. **Income and Principal Allocations.** If the amount that is or may be distributed to the trustee depends on income/principal allocations (such as would occur if the surviving spouse or another beneficiary is the trustee of a QTIP trust), the regulation suggests that giving the trustee the power make such allocations would not raise problems, as long as the power is “exercisable in a fiduciary capacity.” However, this is a particularly sensitive power. The potential problems of many other powers can be avoided by using a tax savings clause to limit any discretionary distributions to the trustee within an ascertainable standard. For many other issues, it may not matter how an
administrative power is exercised, as long as ultimately any discretionary distributions to the spouse must meet an ascertainable standard. However, the exercise of the income/principal power will directly cause (or prevent) the distribution of assets if there is a mandatory income interest in the trust.

Regulations under Section 2041 make clear that the power to allocate receipts and disbursements between income and principal in a fiduciary capacity is not a power of appointment. Treas. Reg. § 20.2041-1(b)(1); 25.2514-1(b)(1). Regulations under Section 2056 regarding the mandatory income interest requirement in marital trusts may also give guidance by analogy:

“If it is evident from the nature of the trust assets and the rules provided for management of the trust that the allocation to income of such receipts as rents, ordinary cash dividends, and interest will give to the spouse the substantial enjoyment during life required by the statute, provisions that such receipts as stock dividends and proceeds from the conversion of trust assets shall be treated as corpus will not disqualify the interest passing in trust. Similarly, provision for a depletion charge against income in the case of trust assets which are subject to depletion will not disqualify the interest passing in trust, unless the effect is to deprive the spouse of the requisite beneficial enjoyment. The same principle is applicable in the case of depreciation, trustees’ commissions, and other charges.” Treas. Reg. § 20.2056(b)-5(f)(3).

“Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets passing to the trust. ... Nor will such a power [i.e., to retain unproductive property] disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets.” Treas. Reg. § 20.2056(b)-5(f)(4) (emphasis added).

A very standard clause for QTIP trusts is to provide that the income/principal allocation power may not be exercised in a manner that would endanger the availability of the marital deduction. Similarly, in any trust where there is a mandatory income interest (or where distributions may only be made from income or principal, but not both) the planner should consider whether to be conservative and provide that whenever a beneficiary is serving as trustee, the income/principal allocations shall be made in accordance with applicable rules of law (or similar language). See Heisler & Butler, Trust Administration § 5.33 Illinois Inst. For Continuing Legal Ed. (1999). That might impose a rather sever administrative burden, however, by forcing the trustee to get legal opinions on a variety of issues as to how the income/principal allocation should be made under the technicalities (and uncertainties) of the appropriate state trust laws. An alternative would be to give a non-beneficiary co-trustee broad discretion in making income/principal allocations. Typically, in that situation, there is just a requirement that any such fiduciary power be exercised in a reasonable manner.
6. **Valuations; Non Pro Rata Distributions.** Some commentators have suggested that the drafter “should also avoid authorizing the trustee-beneficiary to divide or distribute trust property ‘at such valuations as the trustee considers fair’ or make ‘non pro rata distributions’ of trust property items.” Id. The concern is that these powers might be argued to permit the trustee to shift benefits to himself. However, most planners do not impose these restrictions on trustee-beneficiaries. The Jordahl case, which held that a settlor-fiduciary who had the power to substitute assets of equivalent value with a trust did not have Section 2038 or 2042 powers over the trust, because the settlor would be required to exercise the power fairly in a manner that would not deplete the corpus of the trust. (That case even suggested that holding such a power in a nonfiduciary capacity would be permissible for purposes of Section 2038 and 2042.) *Estate of Jordahl v. Comm’r*, 65 T.C. 92 (1975). See section II.B.4.g of this outline.

7. **Tax Elections.** Certain tax elections can directly benefit the trustee in an individual capacity. For example, a decision to take administration expenses as income tax deductions rather than estate tax deductions will benefit income beneficiaries over remaindermen. However, most commentators believe that the exercise (or non-exercise) of such tax elections, which have an incidental effect of benefiting certain beneficiaries, should not raise Section 2041 concerns. See Adams, *Questions & Answers, TR. & ESTS*, 53 (Sept. 1985). However, the spouse should not have the power to make a QTIP election, where the assets will pass outright to the surviving spouse if the QTIP election is not made. See Section III.B.6.i of this outline.

8. **Power to Adjust Under Section 104.** Section 104 of the new Uniform Principal and Income Act, was approved by the National Conference of Commissioners on Uniform State Laws in July 1997. It has been passed or is being considered in many states (including Texas in 2003). If a trust provides for the mandatory distribution of all income, and if a trustee makes the decision under section 104 to allocate some or all capital gains to income for a particular year, the decision directly impacts the amount to be distributed to the income beneficiary. Accordingly, section 104 of the Uniform Act and most of the states adopting the provision stipulate that the discretion may only be exercised by an independent trustee. See Section I.E of this outline. Query, what would be the tax effect if the trustee-beneficiary were authorized to make an adjustment under Section 104 only with court approval?

9. **Incidents of Ownership Over Life Insurance.** If the trust holds any life insurance on the trustee’s life, the trustee should be restricted from having any discretion regarding exercising any incidents of ownership over the policy. See section II.B.4.k.(2) of this outline.

10. **Beneficiary Consent to Trustee’s Administrative Actions.** The regulations make clear that “the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.” Treas. Reg. § 20.2041-1(c)(1). Thus, unless the IRS could establish that a beneficiary is relinquishing clear legal rights (so as to constitute a gift—see Section III.A.3 of this outline), the ability of beneficiaries to consent to administrative actions should not case gift problems.
11. **Beneficiary Power to Veto Stock Sales.** The IRS has ruled privately that a power in the beneficiary to veto proposed sales of stock by the trustee does not constitute a general power of appointment. Ltr. Rul. 9042048.

12. **Power to Borrow, Pledge Trust Property, Dispose or Property and Contract With Trust.** The IRS has ruled privately that a testamentary beneficiary-trustee’s power to borrow money, to pledge trust property as security, to renew indebtedness, to dispose of trust property, and to enter into any transaction with the executor of the decedent’s estate without the consent or approval of any interested person or court is not a general power of appointment. In that situation, the wife had a mandatory income interest in the trust, was a discretionary beneficiary of corpus within a HEMS standard, and served as co-trustee with her daughter. Ltr. Rul. 8942094.

13. **Summary of Selection of Trustee Issues Regarding Administrative Powers.** Make explicitly clear that all of the trustee powers are held in a fiduciary capacity. If any beneficiary has a mandatory income interest, require that income/principal allocations be made in a reasonable manner, and to be conservative, say that such allocations should be made by a co-trustee who is not a beneficiary or remainderman. If the trustee will be able to make a Section 104 discretionary power to allocate corpus to income, there must be a non-beneficiary trustee (or co-trustee) exercising that power. The beneficiary should not hold any incidents of ownership over life insurance on the beneficiary’s life. For the paranoid (in particularly sensitive situations), see Section III.C.4. for a listing of potentially troublesome administrative powers.

D. **Trustee Removal and Appointment Powers.**

1. **Overview: Analogy to Grantor Powers.** If the power of the trustee to make distributions to a beneficiary is limited to a HEMS standard, and if the trustee is precluded from making distributions in satisfaction of his or own obligation to support a beneficiary, there is no estate inclusion problem for the beneficiary regardless who serves as trustee (ignoring restrictions that may be present under Section 2042 if the trust owns an insurance policy on the trustee’s life.) In those circumstances, it does not matter how much control the beneficiary keeps over other trustees. However, if the distribution authority of the trustee is not so prescribed, the ability of a beneficiary to remove and replace trustees could give the beneficiary a general power of appointment. Many of the appointment/removal issues that affect grantors also affect beneficiaries. There is a detailed discussion of this issue regarding removal and appointment powers retained by grantors in section II.B.5. of this outline, and much (but not all) of that discussion is relevant for trustee appointment powers held by beneficiaries.

2. **If Beneficiary-Trustee Declines to Accept Office as Trustee.** If a beneficiary is named as trustee, and if the beneficiary would have a general power of appointment because of dispositive powers of the trustee, the beneficiary will have a general power of appointment if he is the trustee, and as discussed in section III.A.1.a. of this outline, once the general power of appointment taint is cast, it is very difficult to ever get rid of that taint without gift or estate tax consequences. What if the beneficiary declines to serve as trustee before accepting office as trustee? That procedure apparently will not prevent the creation of a general power of appointment. However, the power holder may formally disclaim the power and not be treated as having released the general
power of appointment, if the requirements of Section 2518 are satisfied. See section III.B.1.h. of this outline. The IRS ruled privately in Technical Advice Memorandum 9125002 that the mere fact that the named beneficiary-trustee died before the trust was funded and before accepting office as trustee did not prevent the beneficiary from having a general power of appointment. *But cf.* Rev. Rul. 74-492 (amount of elective share that could have been acquired if the election had been made during the statutory period is not includable under §2014; “which the widow is considered to acquire only if she exercises her right to take it. The widow must accept the benefits of the state law through exercise of the personal right of election or else the inchoate right is, in effect, renounced by operation of law.”).

3. **Power to Appoint Self as Trustee.** If a beneficiary has the power at any time to appoint himself or herself as trustee or co-trustee (unless the other co-trustee has a substantial interest in the trust that is adverse), the beneficiary will be treated as holding the powers of the trustee. The regulations provide directly that a donee’s power to remove a trustee and appoint himself may be a power of appointment. Treas. Reg. § 20.2041-1(b)(1).

4. **Power to Appoint Self as Trustee Under Limited Conditions That Have Not Yet Occurred.** “[T]he decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal.” Treas. Reg. § 20.2041-1(b)(1).

5. **Power to Appoint Co-Trustee to Exercise Tax Sensitive Powers.** Trusts often include a savings clause, to provide that the beneficiary-trustee cannot exercise various dispositive powers that would cause tax problems, but to provide that the beneficiary-trustee can appoint a co-trustee to exercise that discretion. The IRS has approved a similar arrangement in private letter ruling 9036048. In that ruling, the decedent’s will named the surviving spouse as trustee of a bypass trust for the benefit of the spouse and descendants. The trust requires the surviving spouse to choose a special trustee in the event that the surviving spouse has a legal obligation to support any beneficiary under the bypass trust. The special trustee will have the exclusive power to make all decisions involving any discretionary distribution or allocation to such a beneficiary. The surviving spouse will not have the power to remove a special trustee. The ruling acknowledged the problem that would arise if the trustee could make distributions that would satisfy her legal obligations. (See section III.B.5. of this outline.) However, the IRS ruled that the procedure requiring the spouse to appoint a Special Trustee (of her choosing at that time) served to eliminate the problem. *Cf. Matter of Shurley,* 115 F.3d 333 (5th Cir. 1997) (power of beneficiary to appoint special trustees who could terminate the trust did not invalidate the spendthrift protection of the trust).

6. **Power to Appoint Successor Trustee Other Than Self.** A non-grantor beneficiary may name a successor trustee other than himself. The beneficiary, in that case, “never moves into a position of possessing the powers of the trustee and never has a voice in the determination of whether the power in the trustee will be exercised.” 3A Casner, ESTATE PLANNING § 12.0, at 84 (5th ed. 1986).
7. **Power to Veto Appointment of Independent Trustee.** The IRS has ruled privately that the power to veto the appointment of an independent trustee and the subsequent legal right to petition the court to select an independent replacement who is not a related or subordinate to any of the beneficiaries is not a general power of appointment. Ltr. Rul. 9741009. (The facts of that ruling are rather vague, and the beneficiary served as a co-trustee, so it is not clear why any power over the appointment of a successor to another co-trustee raises any Section 2041 issues. If there are any Section 2041 issues, they presumably still exist because the beneficiary serves directly as a co-trustee.)

8. **Power to Remove and Appoint Successor Other than Self.** If a trustee holds powers that would be treated as a general power of appointment if held by a beneficiary, will a beneficiary’s power to remove and replace the trustee with someone other than himself cause the beneficiary to have a general power of appointment?

   a. **Power to Remove For Cause.** If a beneficiary has the power to remove a trustee for cause and replace the trustee, the beneficiary does not have a general power of appointment. A power to remove a trustee only for cause is a power that is subject to a contingency that is beyond the control of the power holder. Therefore, such a power can be given to a beneficiary without concern that it will result in the trustee’s powers being imputed to the beneficiary. **See** Treas. Reg. § 20.2041-3(b), discussed in section III.B.1.h. of this outline. Cf. Ltr. Rul. 9832039 (right to remove and replace trustee for cause did not trigger Section 2042). (However, if a grantor holds the power to remove and replace a trustee for cause, there may be at least theoretical concerns, because even contingent powers can still be taxable powers under Section 2036. Treas. Reg. § 20.2036-1(b)(3); see generally Moore & Powell, Millennium Schmimium: Is Your Tax Drafting Y2K Compliant? 34 ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. Fundamentals Program Materials (2000).)

   b. **Power to Remove Without Cause.** If the beneficiary holds the power to remove and replace the trustee without cause, there may be situations when the beneficiary would be power holder would be deemed to hold the powers of the trustee. If so, this would give the beneficiary a general power of appointment if the trustee can make distributions to the beneficiary that are not limited to HEMS or if the trustee can make distributions to a beneficiary who the trustee is obligated to support. Following the issuance of Rev. Rul. 79-353, 1979-2 C.B. 325, the IRS extended that analysis to removal powers held by beneficiaries. Ltr. Rul. 8916032. In Rev. Rul. 95-58, 1995-2 C.B. 191, the IRS ruled that Sections 2036 and 2038 are not triggered if a grantor holds a removal and appointment power as long as the grantor must appoint someone other than the grantor who is not related or subordinate to the grantor under Section 672(c). The IRS, in private rulings, has extended the same principle to Section 2041 with respect to powers of removal held by beneficiaries. E.g., Ltr. Ruls. 201432005, 200551020, 200210013, 200031019, 9735025, 9735023 & 9746007. The IRS granted a ruling in 2000 that is more liberal than Rev. 95-58, in that a beneficiary could remove and appoint a successor (including individuals who are beneficiaries). Ltr. Rul. 200024007. The ruling relied on a restriction in the trust agreement that prohibited any trustee from participating in any decision to pay or apply trust assets to himself or his issue, and provided that any such decision would be made by the other then acting trustees.
In effect, the beneficiary could appoint anyone else, who could make distributions back to the beneficiary. One wonders if the IRS realized the impact of its ruling. Reliance on the ruling at the planning stage would seem unwarranted.

c. Power to Remove and Replace Trustee—Section 2042. The principles of Rev. Rul. 95-58 would appear to extend to the power of an insured to remove and replace a trustee who holds incidents of ownership over a policy on the insured’s life. See a detailed discussion of this issue in section II.B.5.h. of this outline.

9. Summary of Selection of Trustee Issues Regarding Removal and Appointment Powers. The beneficiary will have the powers of the trustee if the conditions have occurred giving the beneficiary the power to accept office as trustee or to appoint himself as co-trustee (unless the beneficiary formally disclaimed the right to become trustee within the required time.) If the conditions allowing appointment of the beneficiary as trustee have not yet occurred, he does not yet hold a general power of appointment.

A beneficiary-trustee can have the power to appoint a co-trustee who would exercise tax sensitive powers. (To be very cautious, the instrument could stipulate that any such co-trustee would have to be an “independent trustee”—with some definition of that term. However, that should not be required—unless there is an extreme case of a beneficiary having an explicit prearrangement with whomever he appoints directing how the co-trustee’s powers will be exercised, and even there, the taxpayer could make arguments that the fiduciary responsibility of the appointed co-trustee should override any such informal “agreements.”)

If a beneficiary has the right to remove the trustee and appoint himself, that beneficiary will be deemed to hold the powers of the trustee. If a beneficiary has the power to remove and appoint someone else—the IRS appears to recognize a safe harbor if the beneficiary must appoint someone who is not a related or subordinate party. If the power is retained to appoint a replacement who is a related or subordinate party, the taxpayer would argue, based on the Vak and Wall cases (see Section II.B.5.g. of this outline) that the fiduciary responsibility of any such successor would preclude the beneficiary from being deemed to hold any powers such appointee would have as trustee.

E. Income Tax Issues.

1. Section 678—Income Taxed to Beneficiary As Owner Under Grantor Trust Rule.

a. Issue. If a beneficiary of a trust serves as the sole trustee and has the authority to make distributions to himself, there is the possibility (perhaps remote if the distribution power is limited by anascertainable standard) that the income of the trust will be taxed to the beneficiary under a grantor trust rule, regardless of whether distributions are actually made to that beneficiary. Whether there is anascertainable standard exception is not clear. If the beneficiary serves as co-trustee and does not make discretionary distribution decisions by himself, Section 678 clearly does not apply.
b. **Statute.** Section 678(a)(1) provides that an individual shall be treated as the owner of any portion of a trust with respect to which the individual has a power, exercisable solely by himself, to vest the corpus or income from the trust in himself. See Ltr. Rul. 8211057 (trustee-beneficiary with mandatory income/discretionary principal interest with $100,000 annual distribution cap taxable on income to that extent).

c. **Ascertainable Standard Exception Is Uncertain.** There is no ascertainable standard in the statutory language of Section 678. Many planners, however, take the position that the trustee will not be taxed on trust income under Section 678 if the trustee’s discretion is subject to an ascertainable standard. The theory is that the statutory language requires that the trustee be able to vest the corpus or income in himself “solely by himself,” and the trustee is not making a determination “solely by himself” if he is making a distribution decision based on whether ascertainable standards are satisfied. The legislative history states that Section 678 would treat a person as an owner of the trust “if he has an *unrestricted power* to take the trust principal or income.” S. Rep. No.1622, 83d Cong., 2d Sess. 87 (1954) (emphasis added).

The reference to an unrestricted power is consistent with case law under a predecessor provision to Section 678. See *Funk v. Comm’r*, 185 F.2d 127 (3d Cir. 1950) (trustee’s power to distribute income to herself for her “needs” did not cause trust income to be taxed to trustee as owner); *Smither v. U.S.*, 108 F. Supp 772 (S.D. Tex 1952), aff’d, 205 F.2d 518 (5th Cir. 1953) (power to distribute income for support, maintenance, comfort and enjoyment; trustee not taxed on trust income as owner).

In addition, there is one reported case that has addressed this issue after the adoption of Section 678, and it adopts an ascertainable exception approach. *U.S. v. DeBonchamps*, 278 F.2d 127, 130 (9th Cir. 1960) (held that grantor trust rules applied to determine tax effects of holder of life estate; life tenant did not have unrestricted power under state law to distribute corpus to self, but only for “needs, maintenance and comfort”; held that undistributed capital gains not taxed to life tenant).

Private rulings from the IRS have been inconsistent. Compare Ltr. Rul. 8211057 (trustee-beneficiary with discretionary principal interest for “support, welfare and maintenance” taxable on income under Section 678) with Ltr. Rul. 9227037 (trustee-beneficiary with discretionary principal interest for “health, support and maintenance” held not taxable under Section 678). See also Ltr. Rul. 8939012 (trustee-beneficiary not taxable as owner of trust under Section 678; however exact distribution standard not clearly set forth in ruling).

d. **Effect if Beneficiary-Sole Trustee Appoints Co-Trustee.** If a beneficiary initially serves as sole trustee and appoints a co-trustee, the beneficiary who was initially the sole trustee will still likely be taxed on the trust income under Section 678(a)(2).

e. **Distributions to Satisfy Trustee’s Support Obligation.** The authority of a sole trustee to make distributions that would satisfy such person’s legal obligation of
support will be taxed as income to the person only to the extent that such
distributions are actually made. I.R.C. § 678(c). See Ltr. Rul. 8939012 (sole
trustee not taxable under Section 678 where beneficiaries were trustee’s adult
children and descendants to whom he owed no legal obligation of support). (If any
such support distributions are actually made, the power holder is taxed under
Sections 661-662—based on an allocation of DNI—rather than being treated as the
owner of a portion of the trust. I.R.C. § 678(c).)

f. Effect of Disclaimer. Section 678 does not apply if the power holder renounces or
disclaims the power within a reasonable time after the holder first became aware of
its existence. I.R.C. § 678(d). See section III.B.1.h. of this outline for a discussion
of the Section 2041 effects of a disclaimer.

g. Treating Crummey Beneficiary as “Owner” of Trust Under §678. In order to avoid
gain recognition on a sale to a grantor trust, the grantor must be treated as wholly
owning the assets of the trust. Theoretically, this may be endangered if the trust
contains a Crummey withdrawal clause. However, recent private letter rulings
reconfirm the IRS’s position that using a Crummey clause does not endanger the
grantor trust status as to the original grantor.

The Potential Problem. The IRS generally treats the holder of a Crummey power as
the owner of the portion of the trust represented by the withdrawal power under
Section 678(a)(1) while the power exists and under Section 678(a)(2) after the
power lapses if the power holder is also a beneficiary of the trust. See Ltr. Ruls.
200011058, 200011054-056, 199942037 & 199935046.

The IRS’s position under Section 678(a)(2) as to lapsed powers may be questioned
because that section confers grantor trust status following the “release or
modification” of a withdrawal power. This arguably is not the same as the mere
lapse of a withdrawal power. A “release” requires an affirmative act whereas a
“lapse” is a result of a passive nonexercise of a power. Furthermore, the gift and
estate tax statutes make a distinction between lapses and releases. (Sections
2041b)(2) and the 2514(e) provide that “the lapse of a power … shall be considered
a release of a power.”) Despite this argument, the IRS clearly treats the beneficiary
as an owner of the trust with respect to lapsed withdrawal rights.

Observe that treating Crummey powerholders as owners under §678 can cause a
complex reporting nightmare. There may be 20 Crummey powerholders, each of
whom is treated as owning a portion of the trust. (There are no reported cases
where the IRS has pursued Crummey powerholders for not reporting trust income.)

h. IRS Has Reconfirmed Informal Rulings That Using Crummey Trust Does Not
Invalidate “Wholly Owned” Status of Grantor. Section 678(b) generally provides
that if grantor trust status is conferred on the grantor under Section’s 673-677 and
on a beneficiary under Section 678, the grantor trust status on the original grantor
will prevail. However, Section 678(b) literally applies only as to “a power over
income” and a withdrawal power is typically a power to withdraw corpus. However,
the 1954 Committee Reports make apparent that the language of section 678(b)
contains a drafting error and that it was intended to apply to a power over income
and corpus, similar to Section 678(a)(1). The committee reports relating to Sections 671 through 678 include the following statement:

A person other than the grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income ... unless the grantor himself is deemed taxable because of such a power.


Despite arguments from the literal statutory language (the exception in section 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will “trump” a section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. (See also PLR 9141027, but in that ruling the spouse also had an inter vivos power of appointment of principal.) This issue was raised in a PLR request that was discussed by Jonathan Blattmachr at the 2005 Heckerling Institute and the IRS said (during discussions in 2004) that this issue was “in a state of flux.” A recent PLR held that where a Crummey withdrawal power was held by the grantor’s spouse, the trust was still a grantor trust as to the grantor “notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under §678.” PLR 200603040 & 200606006. Jonathan Blattmachr indicates that the IRS has informally confirmed that this issue is no longer “in a state of flux” with the IRS.

This has been confirmed by a number of recently issued private letter rulings, which all concluded that the original grantor continued to be treated as the “owner” of the all of the trust under the grantor trust rules despite the existence of a Crummey clause in the trust. Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, 200730011.

In any event, the IRS can change its position from that taken in prior PLRs. If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power. A message dated February 17, 2007 has been published that was sent from David Handler to Catherine Hughes (U.S. Department of Treasury) describing the problem of using a Crummey provision in a grantor trust and concluding that the issuance of private letter rulings does not solve the problem:

“However, we cannot rely on private letter rulings, as you know. This uncertainty has caused great headaches or inconvenience for many practitioners and their clients. Guidance confirming what the letter rulings have concluded would be most helpful.”

Unfortunately, the IRS and Treasury Department has not acted on that request. The 2007-2008 IRS Priority Guidance Plan does not list this issue as one of the projects for the upcoming year.
Even if the trust does continue as a grantor trust as to the original grantor, it is not clear what happens at the grantor’s death. Does the trust then become a grantor trust as to the Crummey beneficiaries under §678(a)? Just reading the statute says the lapsed powers come roaring back to life — and the trust is treated as owned by the Crummey power holders. There have been only two private rulings (and they arose out of one ruling: 9321050, revoking 9026036 on the §678 issue). The IRS initially ruled that the beneficiary would be treated as the owner. Several years later, the IRS revoked that position and said the beneficiary would not be treated as the owner—with no further discussion.) Perhaps the IRS was saying that no one could figure this out. Practically, the IRS apparently does not want to treat all of the Crummey powerholders as the owners, but cannot justify that position under its general interpretation of the statute.

i. “Beneficiary Controlled Trust”. If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under §678. As discussed above, the IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder has interests or powers that would cause §§671-677 to apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust). See Ltr. Ruls. 201216034, 200949012, 200011058, 200011054 through 200011056, 199942037, & 199935046.

An advantage of the “beneficiary controlled trust” approach is that after the trust has been funded, the beneficiary might sell additional assets to the trust in return for a note. If the beneficiary is treated as the owner of all of the trust under §678 for income tax purposes, there would be no gain recognition on the sale. The trust would not be included in the beneficiary’s estate and future appreciation in the assets sold to the trust in excess of the low interest charge on the note would be removed from the beneficiary’s estate. The decision to transfer value to the trust would be an easy decision because the beneficiary is a discretionary beneficiary of the trust (and could hold a power of appointment with respect to the trust.)

For example, a client’s parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The beneficiary would be treated as the owner of the entire trust for income tax purposes under §678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary’s estate, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary’s creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment.

In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for
example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client’s estate for estate tax purposes and cannot be reached by the client’s creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) “seeding” of the trust to support the note given by the trust, persons other than the grantor (such as the grantor’s spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor’s spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client’s estate (that otherwise result from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. (The trustee could then divide the trust into “exempt” and “non-exempt” portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client’s estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.)

The trust can deplete the client’s other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has “burned” as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating “a freeze, a squeeze, and a burn.” The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client’s other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client’s parents or other relatives, the planner may decide to use guarantees to support a large sale to the trust for a note and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, The Beneficiary Defective Inheritor’s Trust (“BDIT”) (2008).

(1) Recent Letter Ruling. A recent private letter ruling was consistent with the prior rulings that have ruled that the trust is treated as owned by the Crummey power holder/beneficiary under §678. Ltr. Rul. 201216034. In that ruling the beneficiary had a non-fiduciary substitution power, and the ruling reasoned that the existence of the non-fiduciary substitution power constituted the requisite retained interest or power that would cause §675 to apply if the power were held by the grantor. That ruling, like many of the other rulings issued by the IRS acknowledging that §678 applies to the trust, involved a trust that held S corporation stock, and the ruling held that the trust was a qualified shareholder of the S corporation, because it is a grantor trust.
The ruling appears to be wrong — because the existence of the beneficiary's non-fiduciary substitution power causes the trust to be a grantor trust as to the original grantor (and §678(b) makes clear that the trust is not treated as owned by the power holder under §678(a) if the original grantor is treated as the owner). The IRS has made clear that third-party substitution powers (held by someone other than the grantor) cause the grantor trust rules to apply as to the grantor. Rev. Proc. 2007-45. (Letter Ruling 9311021 similarly concluded (apparently inadvertently and incorrectly) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power.)

(2) IRS No-Ruling Position. There have been informal indications from the IRS that the IRS is likely to continue to give favorable §678 rulings for a trust that receives or purchases S corporation stock. The IRS will no longer issue §678 “comfort” rulings in other situations to trusts about to engage in leveraged transactions.

The IRS formally announced in Rev. Proc. 2013-3 that it will no longer issue private rulings that the trust assets in this type of situation will be excluded from the beneficiary’s estate under §§2035, 2036, 2037, 2038 or 2042, that the sale will not be treated as a taxable gift under §2501, or that §2702 will not apply. This no-ruling position applies in situations in which the beneficiary meets the requirements of §678 to be treated as the owner of the trust and sells property to the trust for a note, and “the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property that is purchased.” Rev. Proc. 2013-3, §§4.01(48)-(52), (55), 2013-1 IRB 113 (Jan. 2, 2013).

(3) Summary of Tax Risks. (i) There is a risk of estate tax inclusion under §§2036 and 2038 if the sale is not deemed to be a “bona fide sale for an adequate and full consideration.” Reporting the sale on a gift tax return that meets the adequate disclosure requirements may assist in providing cover as to this issue. (ii) If the seed gift is insufficient to support the note, having another trust guarantee the note in exchange for fees may be necessary. (iii) If such guarantees are unreasonably high compared to the net value of the trust, courts may view that as an indication that the sale is not a “bona fide” transaction for purposes of §§2038 and 2038. (iv) If the beneficiary is deemed to be the “transferor” of the property that is sold to the trust, the beneficiary’s creditors may be able to reach the trust assets. Therefore, creating the trust in a self-settled trust state may be advisable.

(4) Selected Technical Issues. The IRS's position under §678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the “release or modification” of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A “release” requires an affirmative act whereas a “lapse” is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041(b)(2) and 2514(c) provide that “the lapse of a power ... shall be considered a release of a power.”] Despite this argument, the
IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

A further complication is that under §678(a), grantor trust treatment applies to “any portion” of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§671-677 to apply if such person were the grantor of the trust. The regulations discuss the “portion” issue in Treas. Reg. §1.671-2(e)(6) Ex. 4. In that example, the beneficiary holds an unrestricted power to withdraw “certain amounts contributed to the trust.” The example concludes that the beneficiary is treated as an owner of “the portion of the trust that is subject to the withdrawal power.” Some planners believe that the “portion” refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under §678. However, the term “portion” might refer to the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey power holder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust that is attributable to the power holder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

j. Sale of S Corporation Stock by Beneficiary to QSST. If a beneficiary consents to a qualified subchapter S trust (QSST) election, the beneficiary “is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election is made.” Reg. §1.1361-1(j)(8), referring to §1361(d)(1). Accordingly, the beneficiary is taxed on the K-1 income of the trust from the S corporation. Could the beneficiary also sell additional S stock in that same corporation to the trust and avoid having the sale treated as a taxable transaction? Presumably that is allowed because the beneficiary is treated as the owner of the portion of the trust holding the S stock — both before the sale and after the sale of additional S stock to the trust. (Rev. Rul. 85-13 said that a sale by the grantor to a trust that was not a grantor trust in return for a note without adequate security caused the trust to become a grantor trust and shielded that very sale from being a taxable sale. This seems to be an easier situation because the trust indeed is a grantor trust as to the S stock both before and after the sale.) However, note that the QSST regulations do not explicitly address whether a sale to the trust of additional S stock in the same company by the consenting beneficiary will be taxed as a sale by the beneficiary to the beneficiary’s grantor trust — and therefore non-taxable.
The strategy has advantages over the sale to §678 trust described above because there is no $5,000 limit that might otherwise apply to contributions to “seed” the trust, there are no technical issues regarding the “lapse” or “partial release” of a power of withdrawal. Being able to have considerably more value in the trust prior to the sale assists in defending against potential §§2036/2038 arguments about the bona fides of the sale.

If the beneficiary sells S corporation stock to the QSST in return for a note, it is imperative that the stock serve as collateral for the note. A QSST must distribute all net accounting income as determined under state law to the beneficiary, §1361(d)(3)(B), referring to §643(b). A sale of S stock to a QSST raises the question of whether distributions from the S corporation to the trust must be entirely distributed to the beneficiary or whether some portion could be used to make principal and interest payments on the note. The interest payments should be fine — because they reduce net accounting income that must be distributed to the beneficiary. Some portion of the payment may also be used to make principal payments, as summarized by Stacy Eastland at the 2013 Heckerling Institute on Estate Planning:

“The distributions on the purchased Subchapter S stock can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor. Compare the interaction of Secs. 502(b) and 504(b) of the Uniform Principal and Income Act. There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased Subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase, depending upon the interaction of Secs. 502(b) and 504(b)(4) of the Uniform Principal and Income Act. The fact that Subchapter S distributions are part of the security for the debt, and are used to retire the principal of the debt, does not disqualify the trust from being a QSST [citing Ltr. Ruls. 914005 and 200140046].”

2. State Income Tax Issues. State income tax considerations are important in the selection of trustee analysis, because a determination of what state has jurisdiction to impose its state income tax on the trust will, in some states, depend on the residency of the trustee or where the administration of the trust occurs. The one thing that is consistent across the board regarding the state income taxation of trusts is inconsistency. There is a complex labyrinth of separate rules throughout the 50 states and the District of Columbia. (Texas planners generally have been spoiled by practicing in a state that does not tax trusts, and Texas planners typically have little experience in the complex world of state income taxation of trusts.) See generally ACTEC Study 6, State Taxation on Income of Trusts With Multi-State Contacts (2001); Michaels & Twomey, How, Why, and When to Transfer the Situs of a Trust, 31 Est. Pl. 28 (Jan. 2004); Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, 57-58 (March/April 2002); Gutierrez, The State Income Taxation of Multi-Jurisdictional Trusts – The New Playing Field, 36th Annual Univ of Miami Philip E. Heckerling Inst. on Est. Pl., ch 13 (2002); Coleman, State Fiduciary Income Tax Issues, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES vol. 1, at 101-134 (Nov. 2007).
a. **Brief Overview of State Taxation Approach.** Grantor trusts are typically taxed to the grantor in his state of domicile. For non-grantor trusts, most states allow a deduction for distributions, and the distributed amounts are taxed to beneficiaries in their states of domicile. The undistributed income of trusts is taxed under the complex scheme of varying rules.

Almost all states will impose their taxes on undistributed income of trusts that is from real estate or businesses located in the state. (That can be a difficult determination for businesses which produce income in a variety of states.) Therefore, no matter whether a trust is a “resident trust” or a “nonresident trust,” undistributed trust income from real estate and businesses in the state will be taxed by that state.

The remaining income is generally taxed based on where the trust is deemed to be a resident—and a wide pattern of residency rules have developed over the years in determining whether a trust is a resident trust or nonresident trust as to a particular state.

After going through the steps described above, if two different states impose income tax on the same trust, most states allow some form of credit to the extent that other states impose an income tax on the same trust income (but the form of the credit varies dramatically).

b. **Resident vs. Nonresident Trusts.** Most of the states typically follow one of several patterns to determine whether a trust is a resident trust for that state. Ten states do not specifically define a resident trust. Some states look at various factors in determining whether a trust is a resident trust or nonresident trust.

(1) **Residency of Grantor.** Almost half of the states treat testamentary trusts of resident-decedents of that state as resident trusts. (Therefore, if a decedent dies in one of those states, any testamentary trusts created by that decedent are forever after taxed by that state.) The same states also tax inter vivos trusts created by a resident grantor. Courts in various states have reached varying results as to the constitutionality of these statutes. See e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (recognized constitutionality of use tax on foreign mail order company for goods purchased within the state; relied on by courts in Connecticut and the District of Columbia to uphold constitutionality of grantor-resident statutes); *Swift v. Director of Revenue*, 727 S.W.2d 880 (Mo. Sup. Ct. 1987) (domicile of testator alone was not sufficient basis to tax testamentary trusts; subsequent decision of same court held that testamentary trust owning Missouri real estate [also having a Missouri charity as a remote beneficiary and a Missouri bank as successor trustee] could be taxed in Missouri). Laws taxing inter vivos trusts based on residency of the grantor have particularly come under constitutional attack. E.g., *Mercantile-Safe Deposit & Trust Company v. Murphy*, 19 A.D. 765, 242 N.Y.S.2d 26 (1963), aff’d, 15 N.Y.2d 579, 203 N.E. 490, 255 N.Y.S.2d 96 (New York could not constitutionally tax undistributed income of inter vivos trust created by New
York resident where the trustee and place of administration were both out of state).

Although New York has a grantor-resident statute for taxing trusts, following the Mercantile-Safe Deposit case, the New York Tax Commissioner issued regulations making clear that New York will not tax a trust that has no New York trustees, no New York assets, and no New York source income. N.Y. Comp. Codes R. & Regs. Tit. 20 § 105.23(c). Accordingly, the selection of trustee for a trust created by a New York resident is a critical factor for determining if the New York income tax will apply to undistributed income from the trust. For example, if a Delaware bank is named as trustee and trust assets are located in Delaware, the undistributed trust income would not be taxed in New York or Delaware. (If the grantor wants a New York resident to control investments, consider creating a partnership and naming the New York resident as the general partner of the partnership and contribute the partnership interest to the trust with the Delaware trustee.) A grantor may be able to create a non-grantor trust that includes the grantor as a discretionary beneficiary and that would avoid state income taxes on undistributed income. See Section II.C.3.j of this outline.

For residents of the states that base their taxation of trusts on the residency of the grantor, state income taxation is still an important issue in the selection of trustee process. If the instrument appoints a trustee from a state that taxes based on administration or trustee residency, issues of dual taxation and multi-state credits arise.

(2) Administration in the State. Approximately seven states impose tax on the basis of administration in the state. Accordingly, appointing a trustee who would be conducting a significant part of the administration in one of those states would subject the trust to income taxation in that state.

(3) Residency of Trustee. Approximately eight states impose tax on the basis of the domicile of the trustee. (If there are co-trustees located in multiple states, the income may be pro-rated. For example, this is the approach in California. Cal. Rev. & Tax Code § 17743.) Obviously, this is a very important fact to consider before appointing a trustee who is a resident of one of these states.

(4) Residency of Beneficiary. Only a handful of states impose tax on this basis. An example is California. For example, if no trustee is a resident of California, the trust is taxed on California source income and that portion of non-source income that is to be distributed to resident noncontingent beneficiaries. Cal. Rev. & Tax Code § 17744.) Various other states have a similar provision. E.g., Del. Code Ann. Tit. 30, § 1636; Ga. Code Ann. § 48-7-22(a)(1)(C); Mass. Gen. Laws Ann. Ch. 62, § 10. Pennsylvania has a similar rule.

IV. SAVINGS CLAUSES TO AVOID ADVERSE TAX EFFECTS FOR GRANTORS, BENEFICIARIES AND TRUSTEES
A. Significance of Savings Clauses Regarding Tax Effects For Grantors, Beneficiaries and Trustees.

To avoid inadvertent adverse tax effects, consider using a “savings clause” to limit automatically any retained powers of the grantor, or of the beneficiary. While a primary dispositive provision may come within accepted ascertainable standard language, other provisions of the will may inadvertently change the result. For example in Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985), one paragraph of the will authorized distributions “for her own proper maintenance,” which would have been an ascertainable standard. However, it was nullified by more expansive powers in the next paragraph to use the assets “for whatever purpose she desires.” 761 F.2d at 442, 443, and 444. An excellent discussion of the various provisions that could be included in savings clauses to avoid adverse tax consequences with respect to powers that trustees may have is in Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 506 at p. 5-70 (1986).

A number of states have statutes that automatically restrict standards for distributions from trustees to themselves as beneficiaries to a “health, education, support and maintenance” standard, so that the power if not a general power of appointment. E.g., TEX. PROP. CODE § 113.029 (2009). See Section III.B.4.m of this outline. Such laws have been recognized as effective to prevent a beneficiary from acquiring a general power of appointment. E.g., Sheedy v. U.S., 691 F. Supp. 1187 (E.D. Wis. 1988).

B. IRS Recognizes Savings Clauses For Section 2041 Purposes.

The IRS has recognized the effectiveness of savings clauses to avoid adverse tax results for grantors and beneficiaries. For example, one letter ruling concluded that the beneficiary-trustee did not have a general power of appointment because of this clause in the instrument:

“Restriction on exercise of power for fiduciary’s benefit. (a) Except as provided in subsection (b), a power conferred upon a person in his capacity as a fiduciary to make discretionary distributions of principal or income to himself or to make discretionary allocations in his own favor or receipts or expenses as between income and principal cannot be exercised by him. If the power is conferred on two or more fiduciaries, it may be exercised by the fiduciaries who are not so disqualified. If there is no fiduciary qualified to exercise the power, it may be exercised by a special fiduciary appointed by the court.” Ltr. Rul. 7935015.

C. Miscellaneous Examples of Savings Clauses and Other Clauses Important to Achieve Tax Effects of Irrevocable Trusts.

1. Irrevocability.

Any Trust created hereunder shall be irrevocable and shall not be altered, amended or revoked by the Settlor or by any other person. Any Trust created hereunder shall only be terminated in accordance with the provisions of this Agreement.

2. Fiduciary Powers Only.
All powers given to the Trustee by this Agreement are exercisable by the Trustee only in a fiduciary capacity and no power given to the Trustee hereunder shall be construed to enable the Settlor or the Trustee or any person to purchase, exchange, or otherwise deal with or dispose of the principal or income therefrom for less than an adequate and full consideration in money or money's worth.

3. **Settlor Prohibited From Serving as Trustee.**

   At no time shall the Settlor be appointed Trustee (Co-Trustee or otherwise) of any Trust created under this agreement.

   Observe: Using this clause is not necessary if the trust has been carefully planned to avoid adverse tax consequences, as discussed in Section II of this outline.

4. **Prohibit Distributions Satisfying Support Obligations of Settlor Or Trustee.**

   Notwithstanding any other provision of this Agreement, no person serving as Trustee shall have the power or authority to distribute income or principal of a Trust in a manner that would (i) discharge such person’s legal obligation to support a beneficiary of the Trust, or (ii) discharge the Settlor’s (or the Settlor’s spouse’s) contractual, support or other legal obligation.

5. **Limitations on Beneficiary-Trustee as to Distributions, Termination, Estimated Taxes, and Life Insurance.**

   **Beneficiary Serving As Trustee and Independent Trustee.** If an individual serving as Trustee of any trust created under this Agreement is a beneficiary of such trust, such individual shall be authorized to make distributions to himself or herself pursuant to the terms of such trust, but such individual shall not possess or exercise any powers with respect to, nor authorize or participate in any decision as to: (i) any discretionary distribution or any loan to or for the benefit of himself or herself or any other beneficiary, except to the extent that such distributions are limited to amounts necessary for the person's health, maintenance, support and education; (ii) any discretionary distribution to any other beneficiary, if such distribution would discharge any of his or her legal obligations; (iii) the termination of such trust because of its small size, if such termination would result in a distribution to himself or herself or if the distribution would discharge any of his or her legal obligations; (iv) the treatment of any estimated income tax payment as a payment by such individual except to the extent that the payment is limited to an amount necessary for his or her health, maintenance, support and education; or (v) any action to be taken regarding an insurance policy held in such trust insuring the life of such individual unless such action is expressly authorized by other provisions of this Agreement. These decisions shall be made solely by the other then serving Trustee or Trustees of such trust (“Independent Trustee”). If such individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving for such trust, the currently acting
Trustee may appoint the individual or entity next designated to act as Trustee as an Independent Co-Trustee of such trust; otherwise, upon written request of the currently acting Trustee, an Independent Co-Trustee of the trust shall be appointed by the Trustee Appointer. However, if an Independent Co-Trustee is appointed under these circumstances, the sole power and responsibility of the Independent Co-Trustee shall be to make decisions reserved to the Independent Co-Trustee.

Insurance On Life Of Beneficiary Serving As Trustee. This Section shall apply whenever any trust created under this Agreement owns any interest in an insurance policy on the life of an individual serving as sole Trustee of such trust. Such Trustee must: (i) designate the Trustee of such trust as the beneficiary of the policy to the extent of such trust’s interest in the policy; (ii) continue to pay the premiums on such policy without using policy loans; and (iii) allow any policy dividends to reduce premiums. Upon termination of such trust, such Trustee must distribute the policy to the beneficiaries of such trust. Such Trustee shall not possess or exercise any other powers with respect to, or authorize or participate in any other decision as to, such policy. All other actions with respect to the policy shall be made solely by the other then serving Trustee or Trustees of the trust (“Insurance Trustee”). If such an individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving, then the currently acting Trustee may appoint the individual or entity next designated to act as Insurance Co-Trustee; but if no successor Trustee is designated, upon written request of the currently acting Trustee, an Insurance Trustee shall be appointed by the Trustee Appointer. If an Insurance Trustee is appointed, the only authority of the Insurance Trustee shall be to exercise the exclusive authority to make discretionary decisions as to the policy, including decisions to surrender or cancel the policy, borrow against the policy, and distribute the policy during the term of such trust. The intent of Settlor is that no Trustee will have any “incidents of ownership” over an insurance policy on the Trustee’s life within the meaning of Section 2042 of the Code.

Observations regarding the Beneficiary Serving As Trustee and Independent Trustee clause:

Clause (i) restricts distributions to the trustee except for HEMS to avoid inadvertent violations of Section 2041 generally and restricts any distributions to any other beneficiary of the trust except for HEMS to avoid Regulation § 25.2511-1(g)(2), as discussed in section III.A.4 of this outline.

Clause (ii) restricts making any distributions that satisfies the trustee’s legal obligations to avoid the Upjohn issue, as discussed in Section III.B.5 of this outline.

Clauses (iii) (small trust terminations) and (iv) (estimated tax payments) are included to avoid Section 2041—in case those powers might be held to constitute Section 2041 powers.

Clause (v) is included to avoid having incidents of ownership in a policy on the trustee’s life, as discussed in section II.B.4.k.(2) of this outline.
Observations regarding the Insurance On Life Of Beneficiary Serving As Trustee clause: This clause is also intended to avoid having incidents of ownership in a policy on the trustee's life. It mandates certain actions with respect to the policy (such as naming the trust as the beneficiary and paying premiums), so that the trustee could take extremely routine actions with respect to the policy without having to appoint another co-trustee to take those actions. With respect to discretionary decisions, a co-trustee must be appointed to take those actions.

6. Jerry Horn’s “Short-Form” Savings Clause.

(1) No particular Trustee shall possess, or participate in the exercise of, any power given the Trustee by this instrument or by law to make any determination with respect to

(a) any payment or application which would discharge any legal obligation of such particular Trustee personally, or

(b) any payment to, or expenditure for the benefit of, such particular Trustee personally (neither the preceding portion of this paragraph (1) nor any otherwise-applicable rule of law shall limit such particular Trustee’s possession or participation in the exercise of any power (or severable portion thereof) granted in this instrument to such Trustee to consume, invade or appropriate property for the benefit of such Trustee personally which is limited by an ascertainable standard relating to the health, education, support or maintenance of such Trustee personally.)

Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 at p. 5-14 (1986).

7. Broad Comprehensive Catch-All Savings Clauses for Settlor and Beneficiary to Avoid Estate Inclusion and Grantor Trust Treatment. For a broad extremely comprehensive set of savings clauses to avoid estate inclusion and grantor trust treatment for grantors and to avoid estate inclusion for beneficiaries, see Appendix A for form clauses developed by Don Malouf and Alex Nakos, of Malouf Lynch Jackson Swinson, in Dallas, Texas.

V. CREDITOR ISSUES

A. Self-Settled Trusts. Self-settled trusts for the benefit of the settlor generally may be reached by the settlor’s creditors. For example, under the Texas spendthrift statute for self-settled trusts, the settlor’s creditors may reach “his interest in the trust estate.” TEX. PROP. CODE 112.035(d); Matter of Shurley, 115 F.3d 337 (5th Cir. 1997). A few jurisdictions have changed their statutes to allow creditor protection for the settlor if certain requirements are met. Under those statues, the settlor must merely be a discretionary beneficiary of the trust, and the trustee must be someone other than the settlor. In addition, to come within the protection of those statues, there must be a resident trustee from that state.
B. Spendthrift Protection for Trust Beneficiaries. Texas and many other states recognize that
an individual may establish a trust for a beneficiary that prevents the beneficiary from
voluntarily or involuntarily assigning his interest. TEX. PROP. CODE § 112.035(a); First
While there is a strong policy recognizing spendthrift trusts, there are limitations. The
assets can still be reached by claims for federal taxes (U.S. v. Dallas Nat'l Bank, 152 F.2d
582 (5th Cir. 1945)), and by claims for reimbursement for expenses incurred for the legal
support and maintenance of a beneficiary's dependents, (TEX. FAM. CODE § 154.005,
Torres, 829 S.W.2d 913 (Tex. App.—Corpus Christi 1992, writ denied)). Some courts allow
creditors of a beneficiary to reach trust assets that are distributable to the beneficiary for
trustee could reach assets of spendthrift trust for bankrupt beneficiary's necessities). The
effectiveness of spendthrift trusts against claims of a beneficiary's creditors may depend on
various structural provisions for the trust.

A trust that is recognized as a valid spendthrift trust under state law will also be recognized
in bankruptcy. 11 U.S.C. § 541(c)(2).

1. Discretionary Trust. The strongest protection can be obtained by giving the trustee
total discretion in making distributions to the beneficiary. Courts have held that
spendthrift trusts which require distributions to be made for the support of the
beneficiary may be reached by creditors for support-related debts, but creditors
generally cannot seize assets of a spendthrift trust that allows the trustee to distribute
property based solely on the trustee's discretion. See Hildebrand, Asset Protection For
Estate Planners, STATE BAR OF TEX. ADV. EST. PL & PROB COURSE (1995). The
beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for
his use any part of the trust property, nor can a creditor of the beneficiary reach any
part of the trust property until it is distributed to the beneficiary. G. Bogert, The Law of
Trusts and Trustees § 228 (2d ed. 1979). See e.g., Kolpack v. Torres, 829 S.W.2d 913,
915 (Tex. App.—Corpus Christi 1992, writ denied) (statute authorized court to award
trust assets to pay beneficiary's obligation to pay child support from spendthrift trust,
but court could not direct such payment until legal obligation of beneficiary had been
established).

An IRS Internal Memorandum addresses how the federal tax lien applies to a trust
that authorizes distributions to the taxpayers in the discretion of the trustee under
ascertainable standards. ILM 200036045. The memorandum takes the position that a
federal tax lien should attach to the right to receive payments necessary for the
taxpayer's proper health, maintenance, support and education, as determined by the
trustee, and that an appropriate collection device would be a suit to foreclose the federal
tax lien.

A hybrid between a mandatory and discretionary trust is one that gives the trustee
discretion, but provides that the trustee “shall consider that the primary purpose of the
trust is to provide for the health, support, care, and maintenance of the beneficiary.” Id.

A broad discretionary trust cannot be used, however, if the beneficiary is the trustee.
The beneficiary-trustee would hold a general power of appointment under Section
(if there is a broad discretionary standard not including detailed standards such as health, education, support and maintenance.) Furthermore, the creditor may be in a position to argue that the beneficiary has control over the trust and that the creditor should be able to reach it.

Despite the traditional spendthrift protection that has been afforded to beneficiaries under a discretionary trust with an independent trustee, some commentators believe that there may be a trend in the law limiting the spendthrift protection to beneficiaries of even discretionary trusts:

“The best way to protect a beneficial interest is to give an independent trustee the ability to make discretionary distributions to the beneficiary. The Second Restatement takes the position that a beneficial interest cannot be attached by a creditor if the beneficial interest is discretionary [citing Restatement (Second) of Trusts § 155(1) (1959)]. Nor can the interest of a discretionary beneficiary be reached by a spouse or child for alimony or support by a creditor who provides necessary supplies or services to the beneficiary or by a governmental unit that may have a claim against the beneficiary [Id. § 157]. The nature of the interest provides the protection; a creditor cannot compel payment because the beneficiary cannot compel payment [Id. § 155 Comment b]. However, what is gained in creditor protection is lost in beneficiary control.

The draft of the Third Restatement takes a dramatically different position with respect to the creditor protection available to a beneficiary of a discretionary trust. The Third Restatement provides that regardless of how the discretionary trust is worded, if the settlor's purpose is to provide for the beneficiary's needs, and if it is acceptable social policy that the beneficiary not be left without support, then the trustee would be subject to a general standard of reasonableness in determining whether a distribution should be made to a beneficiary [citing Restatement (Third) of Trusts § 60 Comment a (Tentative Draft No. 2, 1999)]. A beneficiary's need for support usually includes the needs of those who might be dependent on the beneficiary [Id.]. Thus, children, spouses and ex-spouses would be able to compel the trustee to make distributions to them in such an amount as would be considered equitable under the circumstances [Id.].

It is evident that a loss of creditor protection would occur in a discretionary trust if a dynasty jurisdiction adopts the new position of the Third Restatement. It is also important to note the Uniform Trust Code, as passed by the National Conference of Commissioners on Uniform State Laws on August 3, 2000, takes the same position as the Third Restatement regarding discretionary trusts. In fact, the Uniform Trust Code adopts nearly every position taken in the Third Restatement with respect to the manner in which trust assets can be protected from claims brought by a creditor against the beneficiary of a trust [citing Uniform Trust Code §§ 502-503 (2000), and observing that section 505(b) of the Uniform Trust Code differs from the position taken in the Third Restatement with respect to the creditor effects of

2. **Sprinkling Trust May Afford More Protection.** “Ideally, the trust should give the trustee the power to ‘sprinkle’ trust property among more than one beneficiary (perhaps, the beneficiary and the beneficiary’s descendants), rather than limiting the trustee’s discretion to a single beneficiary.” Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.3 (2001).

3. **Allow Trustee to Change Beneficiary or “Hold-Back” Distributions to Maximize Protection.** To be as conservative as possible where the settlor knows that a beneficiary has potential creditor’s claim that may be pursued against the trust, the trust may authorize an independent trustee or Trust Protector to change the beneficiaries of the trust at the trustee’s discretion. Alternatively, if the settlor wants to provide for mandatory distributions but also afford creditor protection to the beneficiary, the trust might use a “hold-back” provision, authorizing an independent trustee to withhold otherwise mandatory distributions if the trustee, in the exercise of its sole and absolute discretion should deem the distribution to be adverse to the beneficiary’s interest. Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.16 (2001). In either of those situations, a third party trustee would be required.

4. **Beneficiary as Trustee.**
   a. **Same Person as Sole Trustee and Sole Beneficiary.** A restraint on alienation generally is ineffective where the same person is given both the entire legal and beneficial interest (i.e., sole trustee and sole beneficiary) under the doctrine of merger of the legal and equitable title. See 2A Scott & Fratcher, The Law of Trusts § 99. Therefore, if the sole trustee is also the sole beneficiary, the beneficiary’s creditors may be able to reach the property. However, some state merger statutes specifically address that this rule will not invalidate a spendthrift trust. Under the Texas statute, if the sole trustee-sole beneficiary is not the settlor and if the trust is a spendthrift trust, the trust shall continue to be valid and the court shall appoint a new trustee or co-trustee. TEX. PROP. CODE § 112.034(c).

   Typically, the merger doctrine does not apply, because there are remainder beneficiaries in most trusts that are different from the current beneficiary. In the unusual situation where a trust is created for one beneficiary that will pass to that beneficiary or his estate, the trust must not appoint the beneficiary as the sole trustee.

   b. **A Beneficiary is Also Trustee.** “Black-letter” trust law would suggest that the beneficiary-trustee’s creditors cannot reach the trust assets where the trustee is not the sole beneficiary. “If A holds upon a spendthrift trust for A and B, A’s interest, being an interest under the trust and not a legal interest merely, cannot be assigned by him or reached by his creditors.” 2A SCOTT & FRATCHER, THE LAW OF TRUSTS § 99.3. The Restatement 2d of the Law of Trusts clearly takes the position that a beneficiary’s creditors cannot reach trusts with an ascertainable standard for
“education and support” of the beneficiary. Restatement of the Law of Trusts, 2d §154. (However, that section does not specifically deal with a support trust of which the beneficiary is the trustee.)

Some states have adopted the position, by statute or by case law, that creditors of beneficiary-trustees cannot reach trust assets that are subject to an ascertainable standard. See, e.g., N.C. GEN. STAT. §36A-115(b)(1); TEX. PROP. CODE §112.035(f)(1)(A)(ii); Athorne v. Athorne, 128 A.2d 910 (N.H. 1957). One commentator, citing those authorities, has concluded that “[t]he present law of most states, whether statutory or judicially created, does not allow a creditor of a beneficiary who is also a trustee to force a distribution which would then be attachable by the creditor.” Oshins & Riser, Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection, TRUSTS & ESTATES (Oct. 2001).

Despite the existing “black-letter law,” there is little in the way of strong authority saying that a trust beneficiary may also serve as trustee, and still be assured absolutely of relying on strong spendthrift protection. The Restatement (Third) of the Law of Trusts, takes the position in §60, Comment g that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument. The Restatement gives the following illustrations:

1. S’s will leaves his residuary estate to his daughter D, as trustee, “to pay income or principal to or for the benefit of anyone or more of D, her children, and their issue in such amounts, if any, as the trustee deems appropriate and desirable for the particular beneficiary’s support, education, and care, taking account of the beneficiary’s other resources if and to whatever extent the trustee deems appropriate.” D’s creditors may reach the maximum amount of trust funds that she may, without abuse of her discretion, distribute to herself for the authorized purposes (see generally § 50), without reduction for other resources available to her for those purposes, but subject to a possible reservation the court may make for D’s actual support needs.

10. The facts are the same as in Illustration 9, except that T serves as co-trustee with D, and they together hold the discretionary power to determine trust distributions. The special rule of this Comment does not apply. The creditors may still attach D’s interest, absent a spendthrift restraint, but under the general rule of this Section.” Restatement (Third) of the Law of Trusts, §60, Comment g (2003).

Some of the cases that are sometimes cited as support for the position in the Restatement (Third) of Trusts have actually been decided based on the principle that a beneficiary’s creditors can reach assets of a trust that the beneficiary has complete control to withdraw. Despite the existence of distribution standards, courts in those cases have determined, under local law, that the beneficiary had the unfettered right to withdraw assets from the trust. For example, in Estate of Marcia Flood, N.Y. Law Journal (March 11, 1998). the decedent’s husband was co-trustee with decedent’s two children of a By-Pass Trust and Residuary Trusts created under Marcia Flood’s will. The will directed the trustees to make payments to the husband from the By-Pass Trust of “so much of the principal of such trust as he shall request for his support and maintenance and the education of our children.” The will also directed the trustees to make payments from the Residuary
Trust to the husband of all the net income “together with so much or all of the principal as my husband may deem necessary for his health, support and welfare.” The court determined that under state law, a beneficiary’s right to invade corpus as he deems necessary for support and maintenance is absolute if the extent of the invasion is to be determined solely in the beneficiary’s own judgment. Also, a gift for support and maintenance at the beneficiary’s request or for health, support and welfare as the beneficiary deems necessary likewise confers on the beneficiary the right to demand distribution of the entire corpus. The court concluded:

“The spouse is entitled to distribution of the principal on demand and the creditors can reach his interest [Restatement of Trusts [Second], sec 161, illustration [2]]. The will confers upon the spouse a general power of appointment which subjects the property to the claims of creditors.” Id.

In Florida, the courts have stated that a creditor can reach the debtor’s interest in a spendthrift trust (even where the trust is created by a third party) if the debtor-beneficiary can exercise dominion over the trust property. See In re May, 83 B.R. 812, 814 (Bankr. M.D. Fla. 1988) (“A trust fails, under Florida law, where the beneficiary exercises absolute dominion over trust property. ... Similarly, where the beneficiary has the right to require the trustee to convey trust property to him or her, the beneficiary has dominion and control over the trust res and the trust will fail as a spendthrift trust.”).

Some bankruptcy cases have allowed creditors to reach a spendthrift trust because the beneficiary had control to obtain the trust assets. In re George McCoy, 274 B.R. 751 (N.D. Ill. 2002). In that case, the surviving husband was the trustee and primary beneficiary of a testamentary trust created under his wife’s will. The trust authorized the trustee, in its discretion, to pay so much of the assets as the trustee determines “to be required or desirable for his health, maintenance and support. The trustee need not consider the interests of any other beneficiary in making distributions to my spouse.” The court cited the Restatement (Second) of Trusts, for the proposition that “if the beneficiary can call for the principal or can take it as needed, the restraint on alienation is invalid.” The court reasoned that the use of the term “desirable” and the fact that the trustee did not have to consider the interests of other beneficiaries meant that the husband-trustee did not have “a sufficient restraint to prevent the beneficiary to receive the corpus.” The court interpreted the settlor’s intent as giving the surviving spouse complete dominion and control. (Interestingly, the court said it would have recognized spendthrift protection if the trust had omitted the word “desirable” in the standard for distribution.)

Another case arose under Arizona law. In re Pugh, 274 B.R. 883 (2002). In that case, a mother created two separate trusts, one for the benefit of each of her son and daughter. Each child was named as sole trustee of his or her trust, but before any distributions could be made, the child had to appoint a co-trustee, and could not participate in any distribution decisions. The son appointed the daughter as the co-trustee of his trust, but the evidence showed that the trust bank account was exclusively controlled by the son (who became the debtor in the bankruptcy case.)
The court determined that the daughter did not, in fact, act as trustee. The Arizona spendthrift statute provides that a spendthrift trust is invalid if the sole beneficiary is also the trustee, and the court allowed the son’s creditors to reach the trust assets.

The Restatement position is raising significant concern among planners as to whether beneficiary-sole trustee trusts can be afforded protection from claims of the beneficiary-trustee’s creditors. Harris & Klooster, TRUSTS & ESTATES 37 (Dec. 2006).

Despite the fact that some of the cases supporting the position of the Restatement (Third) of Trusts have actually been decided based on factors other than a beneficiary’s right as trustee to make distributions under an ascertainable standard, some commentators have raised questions about the result when a beneficiary-debtor is also the trustee. See Crowell, Asset Protection vs. Asset Collection, STATE BAR OF TEXAS ADV. EST. PL & PROB COURSE ¶ I.C.2 (1993) (“Query: what happens to a creditor’s claim when the debtor is both the beneficiary and the trustee?”). In reviewing the Pugh case (discussed above), Mr. Gideon Rothschild, of New York, draws the conclusion: “Always appoint a co-trustee who participates in discretionary decisions!” Steve Leimberg’s Asset Protection Planning Newsletter (May 1, 2002).

Some commentators maintain that the beneficiary definitely should not serve as trustee if asset protection is important.

“Practitioners should generally avoid making the individual subject of asset protection planning a trustee of a trust, regardless of whether the individual created the trust or whether the trust was created for such individual by another party. Notwithstanding the fact that the trustee must govern himself or herself in accordance with fiduciary obligations, this situation raises the appearance of impropriety and may hinder the ability of a court to impartially consider the facts.” Nelson, Asset Protection & Estate Planning Why Not Have Both? POWER OF ASSET PROTECTION ANNUAL WEALTH PROTECTION. CONF. (2002).

“It is still advisable to provide for the appointment of an independent trustee in an effort to foreclose any suggestion by the trustee/beneficiary’s creditors that the law should be otherwise or that the trust is, in fact, somehow a ‘sham’”. Rothschild, Protecting the Estate from In-laws and Other Predators, 35th ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.4 (2001).

Mr. Rothschild suggests that a bank or trust company should be used as trustee in particularly sensitive situations: “Even where the trust is not self-settled, where maximum asset protection is needed, a bank or trust company can be named as trustee in lieu of an individual.” Id.

The potential creditor concerns with having a beneficiary serve as trustee are particularly troublesome in a jurisdiction that has adopted the position taken in the Third Restatement of Trusts:

“At the other end of the continuum regarding beneficiary control, the beneficiary could serve as his own trustee, and he could be entitled to discretionary distributions limited
to an ascertainable standard relating to the beneficiary’s health, education, maintenance and support. This type of trust is sometimes referred to as a "beneficiary-controlled" dynasty trust. Care must be taken that the limitation (that distributions can be made only for the beneficiary's health, education, maintenance and support in the beneficiary's accustomed manner of living) is not interpreted as setting forth a standard that requires the trustee to make distributions to the beneficiary. In other words, the limitation should set forth only a ceiling, and not a floor, in which the range of discretion may be employed. The Second Restatement does not give the creditor more rights if a beneficiary has been named as the sole trustee of his trust [citing Restatement (Second) of Trusts § 152 Comment m (1959)], presumably because he would be subject to the same fiduciary standards (particularly those that might be owed to remaindermen) as would be applicable to an independent trustee. As previously mentioned, under the Second Restatement, only special claimants such as children, spouses and ex-spouses, providers of necessaries and governmental units would have a right to reach the interest of the beneficiary in satisfaction of their claims.

The position taken in the Third Restatement differs markedly with regard to the rights of creditors against a beneficiary who is a trustee of his own trust. The Third Restatement's position is that spendthrift provisions are disregarded when the beneficiary is also the trustee. The result is that not only do the special claimants referred to above have a right to reach the beneficial interest, but any claimant can reach the maximum amount that the beneficiary could distribute to himself without the distribution being considered an abuse of discretion. The Third Restatement states any fiduciary position that the beneficiary occupies can be disregarded, and it describes the beneficiary's fiduciary rights as a limited form of ownership analogous to certain general powers. These rather harsh results do not apply if an independent co-trustee is appointed [citing Restatement (Third) of Trusts § 60 Comment g (Tentative Draft No. 2 1999)]. In jurisdictions where a current beneficiary cannot serve as sole trustee without leaving the trust vulnerable to creditor claims, it would be desirable to name an independent co-trustee who would be solely responsible for distributions.” Greer, The Alaska Dynasty Trust, 18 ALASKA L. REV. 253, 272 (2001).

A strategy suggested by various commentators would be to name two trustees—the primary beneficiary as the investment trustee, and another person (perhaps a friend of the beneficiary) as a distribution trustee. The primary beneficiary might even be given the power to remove and replace the distribution trustee. Oshins & Riser, Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection, TRUSTS & ESTATES (Oct. 2001). Mr. Greer indicates that “[t]he right to remove and replace the independent trustee could continue to be given to the beneficiary, provided the beneficial interest is not wholly discretionary but is limited to an ascertainable standard. However, it is preferable for both tax and creditor protection purposes to give the beneficiary the power to remove the independent trustee only ‘for reasonable cause,’ as defined in the trust document.” Greer, The Alaska Dynasty Trust, 18 ALASKA L. REV. 253, 274 (2001).

The Uniform Trust Code originally did not address this issue. Section 504 was revised to provide that if the trustee’s discretion to make distributions for the trustee’s own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor’s claim were the beneficiary not acting as trustee. The Comment to the revised section 504 observes that trusts are commonly drafted to give the trustee the power to make discretionary distributions of income and or principal to the trustee, limited by an ascertainable standard to prevent
estate tax inclusion. The drafting committee’s position was that “adoption of the Restatement rule would unduly disrupt standard estate planning and should be limited.” See generally Kenneth Kingma, *A Beneficiary Serving as Trustee May Affect Asset Protection*, 38 Est. Pl. 22 (April 2011) (discussion and chart of states’ treatment of UTC §504(c)).

Some states are amending their spendthrift trust laws, in light of concerns raised by Comment g to §60 of the Restatement Third of Trusts to provide that a beneficiary is not considered a settlor for spendthrift trust purposes merely because the beneficiary has the right to distribute trust assets to himself under an ascertainable standard. E.g., TEX. PROP. CODE §112.035(f); Illinois 735 ILCS 5/2-1403. A variety of states have adopted their own versions of revised section 504 of the Uniform Trust Code. E.g., FL. TRUST CODE § 736.504(2).

Some states are adopting statutes that negate the ability of a creditor to attach trust assets due to a discretionary income tax reimbursement clause. E.g., NY EPTL 7-3.1(d).

C. **Summary of Selection of Trustee Issues With Respect to Creditors Rights.** If the settlor wishes to create a self-settled spendthrift trust, he will need to create the trust under the laws of one of the few states that have statutes recognizing spendthrift protection for self-settled trusts. Those statutes require using a trustee who resides in that state. (Even then, it is not clear that courts in the settlor’s state of residence will recognize the spendthrift protection of the other state with respect to claims brought in the courts of the state of residence.)

To create spendthrift protection for beneficiaries other than the settlor, the law is unclear as to whether the beneficiary can be assured of spendthrift protection if he serves as the trustee with the ability to control distributions to himself. A creditor would be able to force the trustee to make distributions that the beneficiary, in his individual capacity, could compel. Whether creditors could compel distributions where the trustee is authorized to make distributions under an ascertainable standard is not clear. If creditor protection is important, to be conservative, a trustee other than the beneficiary should control distribution decisions to the beneficiary. However, it is certainly possible that a court would recognize spendthrift protection where the beneficiary is the trustee with an ascertainable distribution standard. In situations where creditor protection is not an immediate concern, the planner may, in weighing the issues, decide to name a beneficiary as trustee or co-trustee, but impress upon the beneficiary that he or she should resign as trustee as soon as possible when the beneficiary realizes that there may potentially be creditor issues in the future. (The beneficiary cannot wait too long in resigning, or else the creditor may raise arguments that the act of resigning is effectively a transfer in fraud of creditors rights under the Fraudulent Transfer Act, and that the creditor should still be able to reach the trust assets.) An alternate approach, to be conservative, would be to provide for the beneficiary to serve as the “investment co-trustee” and to name a third party as the “distribution co-trustee” (and perhaps even give the beneficiary the power to remove and replace the “distribution co-trustee,” which some commentators would include only if distributions were subject to an ascertainable standard.)
APPENDIX A

Broad Comprehensive Catch-All Savings Clauses for Settlor and Beneficiary to Avoid Estate Inclusion and Grantor Trust Treatment

The author expresses appreciation to Don Malouf and Alex Nakos, of Malouf Lynch Jackson Swinson, in Dallas, Texas for permission to include these comprehensive savings clauses:

Restrictions on Trustees. Notwithstanding any other provision of this Agreement (including, but without limitation, any power specifically conferred upon a Trustee hereunder), no Trustee shall ever participate as a Trustee of any Trust hereunder in (i) the exercise, or decision not to exercise, any discretion over payments, distributions, applications, uses or accumulations of income or principal to or for the benefit of a beneficiary or for such Trustee personally (including, but not limited to a payment, distribution, application or use of Trust property in discharge of such Trustee's legal obligations), unless the exercise or nonexercise of such discretion is limited by an ascertainable standard relating to the beneficiary or Trustee's health, education, support, or maintenance, (ii) the exercise or decision not to exercise any power conferred on the Trustees under Section ______ (dealing with merger of trusts), and Section ______ (dealing with change of situs) or (iii) the exercise of any general power of appointment described in Section 2041 of the Code. If any Trustee (in his individual capacity) is under a duty to support a beneficiary or is acting as a guardian, conservator or committee of any individual who is a beneficiary, such Trustee shall not participate in the exercise, or the decision not to exercise, any discretion over payments, distributions, applications or uses of Trust property to or for the benefit of a beneficiary in discharge of any obligation of support of such Trustee (in his individual capacity). The preceding sentence shall not restrict the Trustee from being able to make distributions to himself as a beneficiary for his health, education, support or maintenance. No Trustee shall participate in the exercise of any discretion (including, but without limitation, any discretion which would constitute an “incident of ownership” within the meaning of Section 2042(2) of the Code) with respect to any insurance policy on his or her life held hereunder. In each case, the determination of the remaining Trustees or Trustee shall be final and binding upon the beneficiaries of such trust. No individual shall serve as Trustee of any Trust which holds property with respect to which such individual has made a qualified disclaimer within the meaning of Section 2518 of the Code. In addition, notwithstanding any other provision of this Agreement (including, but without limitation, any power specifically conferred upon a Trustee hereunder), no Trustee shall possess any power that would cause the Grantor to be treated as owner of any portion of the Trust under Sections 671-677 of the Code or that would cause any portion of the Trust assets to be includible in the gross estate, for federal estate or state death tax purposes, of the Grantor or the Primary Beneficiary, or of any Trustee. No powers of any Trustee enumerated in this Agreement, or now or hereafter conferred upon Trustees generally, shall be construed to enable the Grantor or any other Person to purchase, exchange, or otherwise deal with or dispose of all
or any part of the principal or income of any Trust for less than an adequate consideration in money or money's worth, or to enable the Grantor to borrow all of any part of the principal or income of any Trust, directly or indirectly, without adequate interest or without adequate security, or to allow any Person to exercise a power of administration (as described in Section 675(4) of the Code) over this Trust in a nonfiduciary capacity without the approval or consent of any Person in a fiduciary capacity.

Powers of Independent Trustee. Except to the extent specifically provided otherwise in this Agreement, the Independent Trustee shall have (i) the powers enumerated in this Section ___ and (ii) any power not expressly granted to one or more Trustees and/or an Investment Manager in this Agreement to the extent such power is substantially similar to the types of powers expressly enumerated in this Section ____.

(1) Apportionment of Income and Expenses. Where not otherwise clearly provided by law or otherwise set forth herein, the Independent Trustee shall have the power to determine with finality, as to each sum of money or other thing of value held or received by any Trustee, whether and to what extent the same shall be deemed to be principal or to be income, and as to each charge or expense paid by any Trustee, whether and to what extent the same shall be charged against principal or against income, including, without hereby limiting the generality of the foregoing language, power to apportion any receipt or disbursement between principal and income and to determine what part, if any, of income is available for distribution according to the terms hereof, and what part, if any, of the actual income received upon a wasting investment, or upon any security purchased or acquired at a premium, shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to set up such reserves out of principal or income as the Independent Trustee shall think fit.

(2) Management of or Division into Shares or Separate Trusts. To hold, manage, invest, and account for the several shares or separate Trusts which may be held in trust, either as separate funds or as a single fund, as the Independent Trustee shall think fit; if as a single fund, to make division thereof only upon the books of account, to allocate to each share or Trust its proportionate part of the principal and income of the single fund, and to charge against each share or Trust its proportionate part of the common expenses. In addition, the Independent Trustee shall have the power to divide any Trust established by this Agreement into separate identical shares or Trusts if the Independent Trustee determines that doing so may be advantageous for tax or other reasons.

(3) Method of Distribution or Division. In dividing the Trust estate into separate shares or trusts, or in distributing the same, to divide or distribute in cash, in kind, or partly in cash and partly in kind, using different properties according to their fair market values or undivided interests in the same property, as the Independent Trustee shall think fit for any purpose. The reasonable and good faith determination of the fair market value of the
Trust estate or any part thereof shall be conclusive and binding on all parties.

(4) **Use or Occupancy of Trust Property.** To allow any of the following Persons to use or occupy any Trust property without payment of rent or other remuneration:

(a) Any beneficiary;

(b) With regard to any residential property occupied by a beneficiary, the spouse or significant other of the beneficiary and any descendants of the beneficiary;

(c) With regard to any residential property occupied by a beneficiary, any individual appointed by a court of competent jurisdiction and qualified to serve as the guardian of the person of such beneficiary; and

(d) With regard to any residential property occupied by a beneficiary, the spouse or significant other of the individual appointed by a court of competent jurisdiction and qualified to serve as guardian of the person of such beneficiary.

(5) **Termination of Small Trust.** Notwithstanding any provision of this Agreement, to terminate any separate Trust established by this Agreement whenever in the Independent Trustee’s opinion such Trust is so small in value that the administration thereof is no longer economically advisable. In making this determination, the Independent Trustee is requested to take into consideration the financial and special advantages to the beneficiary or beneficiaries of continuing the Trust estate. In the event of a termination, the Independent Trustee shall distribute the remaining Trust assets to the then income beneficiary or beneficiaries, per stirpes. The Independent Trustee’s judgment shall be final and binding upon all interested parties, and distribution of Trust assets in any manner provided in this Agreement shall relieve the Trustee of any further responsibility with respect to such assets.

(6) **Generation-Skipping Transfer Taxes and Payment.** If the Independent Trustee considers any distribution or termination of any interest hereunder as a distribution or termination subject to a generation-skipping transfer tax, the Independent Trustee is authorized:

(a) To augment any taxable distribution by an amount which the Independent Trustee estimates to be sufficient to pay that tax and to charge the same to the particular Trust or share to which the tax relates without adjustment of the relative interests of the beneficiaries;

(b) In the case of a taxable termination, to pay the tax from the particular Trust or share to which the tax relates, without adjustment of the relative interests of the beneficiaries. If the tax is imposed in part by reason of the
Trust property hereunder and in part by reason of other property, the Independent Trustee shall pay only the portion of the tax which the Independent Trustee determines in good faith to be attributable to the taxable termination hereunder, taking into consideration deductions, exemptions, credits and other factors which the Trustee deems advisable; and

(c) Subject to the limitations of the rule against perpetuities to postpone final termination of any particular Trust and to withhold all or any portion of the Trust property until the Independent Trustee is satisfied the Trustee and the Trust no longer have any liability to pay any generation-skipping transfer tax with reference to the Trust or its termination.

(7) Assistance to Certain Estates. The Independent Trustee may, in its sole discretion, utilize the principal of any Trust as set forth in this paragraph, and any payment made in the bona fide belief that it is pursuant to this paragraph shall be binding upon all beneficiaries:

(a) Investments. To purchase and to retain as investments any property, real or personal, belonging to the estate of the Primary Beneficiary.

(b) Loans. To make loans to the Executor of the Primary Beneficiary’s estate on such terms as the Trustee deems advisable.

Renunciation of Interest by Grantor. Notwithstanding any other provision in this Agreement, no part of the principal or income of any Trust established herein shall ever revert to or be used for the satisfaction of legal obligations of the Grantor, and no income of any Trust established herein shall be applied to the payment of premiums of insurance on the life of the Grantor (or the Grantor’s spouse, if any) without the prior written approval of all of the then income beneficiaries of such Trust. The Grantor renounces for himself and his estate any interest, either vested or contingent, including any reversionary right or possibility of reverter, in the principal and income of the Trusts, and any power to determine or control, by alteration, amendment, revocation, termination, or otherwise, the beneficial enjoyment of the principal or income of the Trusts.

Independent Trustee. Any original or successor Independent Trustee appointed pursuant to this Section shall be either (i) any Person other than (x) the Grantor, (y) any beneficiary, or (z) any Person who is “related or subordinate” (within the meaning of Section 672(c) of the Code) to either the Grantor or any beneficiary or (ii) any corporate fiduciary.
APPENDIX B

Twenty Things You Have to Know About Selecting Trustees and Structuring the Powers of Trustees

Steve R. Akers
Mark R. Parthemer
Bessemer Trust

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PROBING NON-TAX ISSUES

1. Probe the appropriate selection of trustee for non-tax factors in our role as counselor.

DONOR ISSUES

GIFT TAX

2. Plan whether or not the transfer to the trust should be a completed gift.

ESTATE TAX

3. If the goal is to keep the asset out of the donor’s estate, do not allow the donor to be a beneficiary, unless the trust is in a “self-settled trust” jurisdiction.

4. Be careful with having the donor serve as trustee if the donor has powers over distributions.

5. If the trustee’s powers over distributions are not limited by a fixed determinable standard, prohibit any possibility of the donor becoming trustee or co-trustee.

6. The donor can serve as trustee if there is a determinable external standard on distributions.

7. The donor can have administrative powers as trustee as long as the powers are subject to court control and fiduciary duties.

8. Do not give the donor-trustee either of two prohibited powers.

9. The donor can have broad trustee appointment and removal powers.

INCOME TAX

10. Avoid having foreign persons as $\frac{1}{2}$ or more of the trustees.

11. Avoid or trigger the grantor trust rules, as desired.
BENEFICIARY ISSUES

GIFT TAX

12. If the beneficiary is trustee, use an ascertainable standard on distributions to OTHER beneficiaries.

ESTATE TAX

13. Limit the beneficiary from serving as trustee if distributions to the beneficiary are not limited by an ascertainable standard.

14. The beneficiary can be given the authority as trustee to make distributions to himself or herself if there is an ascertainable standard on distributions.

15. Restrict the trustee from making distributions that would satisfy the trustee’s legal support obligations.

16. The beneficiary may have broad powers to appoint and remove trustees (like the donor).

INCOME TAX

17. Having a beneficiary as sole trustee MAY result in grantor trust treatment as to the beneficiary.

18. Determine if the appointment of a trustee in another state will avoid or cause state income taxation on undistributed trust income and gains.

MISCELLANEOUS ISSUES

19. Use a Savings Clause

20. Be wary of having a beneficiary as trustee with the authority to make distributions if there are any creditor concerns for the beneficiary.