2016 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of December, 2015, through August, 2016. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

INDIVIDUAL FEDERAL INCOME TAXES FOR 2017

(Adapted from Rev. Proc. 2016-55)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th colspan="4">2016 Federal Income Tax Rates for Individuals</th></tr>
<tr><th>Unmarried</th><th>Joint</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Earned Income**</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,325</td><td>$18,650</td><td>15%</td></tr>
<tr><td>$37,950</td><td>$75,900</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$91,900</td><td>$153,100</td><td>28%</td></tr>
<tr><td>$191,650</td><td>$233,350</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000***</td><td>AGI over $250,000***</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$416,700</td><td>$416,700</td><td>35%</td></tr>
<tr><td>$418,400</td><td>$470,700</td><td>39.6%</td><td>20%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

*** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

A. KEY PROVISIONS OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

Signed into law on December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") revived and made permanent dozens of provisions that had expired at the end of 2014. That these provisions are no longer subject to expiration and extension is welcome news for planners and clients. Still, the PATH Act did not make everything permanent, and some important provisions are now set to expire (again) at the end of 2016. Here is a sample of the newly-permanent benefits of interest to individual taxpayers.

1. Above-the-Line Deduction for Teachers' Classroom Expenses

PERMANENT. K through 12 teachers can deduct up to $250 of unreimbursed expenses in determining adjusted gross income. The expenses must relate to books, equipment, supplies (except for nonathletic supplies used in health or P.E. courses—read "condoms"), or computer equipment and related services or software.

2. Exclusion for Discharges of Debt on Principal Residence

THROUGH 2016. In 2007 Congress created a new exclusion for "qualified principal residence indebtedness" (QPRI), defined as up to $2 million of "acquisition debt" (any debt used to buy, build, or improve a principal residence). A taxpayer need not be insolvent to qualify for this exclusion, but the exclusion will not apply if the debt is discharged on account of services performed for the lender or for any other reason "not directly related to a decline in the value of the residence or to the financial condition of the taxpayer." The taxpayer's basis in the principal residence must be reduced (but not below zero) by the amount excluded from gross income under this rule.

3. Deduction of Mortgage Insurance Premiums

THROUGH 2016. Legislation in 2006 created an itemized deduction for premiums paid or accrued on qualified mortgage insurance. Generally, qualified mortgage insurance is mortgage insurance obtained in connection with acquisition debt on a qualified residence that is provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or certain private providers.

4. Sales Tax Deduction

PERMANENT. Individuals may still elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes may deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables to be prescribed by the Service. The chief beneficiaries of this election are taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

5. Bonus Depreciation

THROUGH 2019. Under §168(k), depreciable tangible personal property and computer software acquired and first placed in service in 2016 and 2017 is eligible for an additional up-front depreciation deduction equal to the 50% of the asset's adjusted basis after taking into account any §179 election made with respect to the property. The regular depreciation deductions would then be computed based on whatever basis remains after the §179 election and the 50% bonus. This bonus 50% allowance is also available for alternative minimum tax purposes. The 50% bonus does not apply to intangibles amortized under §197 (with the limited exception of computer software), or start-up expenses amortized under §195. The bonus also does not apply to assets with a class life in excess of 20 years. In 2018, the bonus drops to 40%, and it drops to 30% in 2019 before expiring altogether in 2020.

6. §179 Expensing Election

PERMANENT. The dollar limitation on the §179 expensing election continues at $500,000 for 2015 and forward. As before, the $500,000 maximum is not reduced until the total amount of §179 property purchased and placed in service during the taxable year exceeds $2 million.

7. Expanded Limitations for Contributions of Qualified Conservation Real Property

PERMANENT. Prior to 2006, a contribution of qualified conservation real property to a public charity was treated the same as any other contribution to public charity: to the extent the property was capital gain property in the hands of the donor, the most that could be deducted in any one year was 30% of the taxpayer's contribution base (generally, adjusted gross income) with a carryover of up to five years. Legislation in 2006 permitted the current deduction of such contributions up to 50% of the taxpayer's contribution base, and with a carryover of 15 years. Moreover, the 50% limitation was increased to 100% in the case of "qualified farmers and ranchers" (those whose gross income from farming or ranching business exceeds 50% of their total gross incomes), provided the property is restricted to remain generally available for agriculture or livestock production. This has now been made permanent.

8. Above-the-Line Deduction for College Tuition

THROUGH 2016. The above-the-line deduction for "qualified tuition and related expenses" continues through 2016. The deduction limit remains at $4,000, and the full deduction is available only to those taxpayers with adjusted gross incomes of $65,000 or less (or $130,000 for married taxpayers filing jointly). Individuals with adjusted gross incomes in excess of $65,000 but not more than $80,000 (and joint filers with adjusted gross incomes in excess of $130,000 but not more than $160,000) may claim a maximum deduction of $2,000. A taxpayer still cannot claim both the deduction and the § 25A credits.

9. Qualified Charitable Distributions from IRAs

PERMANENT. As in past years, individuals age 70½ or older can exclude from gross income up to $100,000 in “qualified charitable distributions” from either a traditional IRA or a Roth IRA. Such distributions are not deductible as charitable contributions, but the exclusion from gross income represents a better result over prior law. Under prior law, the retiree had to include a minimum distribution in gross income but could donate the amount to charity and claim a deduction under §170. The income tax deduction was subject to the overall limitation on itemized deductions, §68, as well as the other limitations applicable to all charitable contributions under §170. In many cases, therefore, the income tax deduction did not offset completely the amount included in gross income even though the entire distribution was paid to charity. The current rule should appeal to those required to take minimum distributions that have sufficient funds from other sources to meet their living needs. A qualified charitable distribution is any distribution from an IRA made by the trustee directly to a public charity (i.e., one described in §170(b)(1)(A)) to the extent such distribution would be includible in gross income if paid to the account holder. The distribution may be made on or after the date the account holder reaches age 70½.

10. 100% Exclusion on Gains from Sales of Section 1202 Stock

PERMANENT. We all know that § 1202(a)(1) generally excludes half of the gain from the sale or exchange of “qualified small business stock” (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is engaged in an active business and has aggregate gross assets of $50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent under §1(h)(1)(F). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). But for qualified small business stock acquired in 2013 or later, a 100% exclusion applies. This gives §1202 some much-needed bite.

11. Stock Basis Adjustments for Charitable Contributions by S Corporations

PERMANENT. When an S corporation contributes property to charity, the corresponding charitable deduction, like all deduction items, passes through to the shareholders. Generally, a shareholder’s basis in S corporation stock is reduced by the amount of deductions passing through, but an S corporation’s charitable contribution will only cause a shareholder’s stock basis to be reduced by the shareholder’s pro rata share of the adjusted basis of the contributed property. Thus, for example, if an S corporation with two equal shareholders donated to charity real property worth $100 in which the corporation’s basis was $40, each shareholder could be eligible to claim a $50 charitable contribution (half of the $100 value) while only reducing stock basis by $20 (half of the $40 basis). This offers a tremendous benefit to S corporation shareholders, especially where the contributed property would have triggered liability for tax under §1374 as built-in gain property. Charitable contributions of such property do not trigger

the §1374 tax, and now also have the chance to carry out a fair market value deduction to the shareholders at a cost equal only to the basis of the contributed property.

12. Five-Year Recognition Period for S Corporation Built-in Gains Tax

PERMANENT. When a C corporation makes an S election, the §1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). For 2009 and 2010, however, the recognition period was shortened to seven years. Then, the recognition period was shortened to five years in 2011. This shorter recognition period has now been made permanent. So if the corporation made its S election effective for 2011, any net recognized built-in gains in 2016 will not be subject to the tax.

B. BASIS REPORTING AND THE DUTY OF CONSISTENCY

1. Background

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (signed on July 31, 2015) created two new income tax provisions as revenue raisers. First, new §6035(a)(1) requires executors of estates required to file a federal estate tax return to provide "a statement identifying the value of each interest in" property included in the decedent's gross estate. The statement must be furnished to the Service and to "each person acquiring any interest" in such property within 30 days of the date on which the estate tax return is filed for due (including extensions), whichever is earlier. Section 6035(b) authorizes legislative regulations to enforce this new requirement, and it directs Treasury to consider, among other things, the application of this requirement to cases where no estate tax return is required to be filed. A conforming amendment to §6724(d)(1) makes the failure to furnish this statement subject to a $250 penalty.

Second, new §1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been "determined" for federal estate tax purposes. Where there has not yet been a "determination" of the property's value, the basis cannot exceed the amount provided in the §6035 statement. Basis is "determined" for federal estate tax purposes where the value is shown on the federal estate tax return and the Service does not contest it before expiration of the statute of limitations. If the Service does timely contest the value and the executor relents, the basis of the property will be "determined" as the value set by the Service. Of course, basis can also be "determined" by a court or through a settlement agreement between the Service and the estate.

The new rules, which effectively prohibit claiming property has a lower value for estate tax purposes and a higher value for income tax purposes, are applicable to property "with respect to which an estate tax return is filed" after July 31, 2015. That gave Treasury little time to implement the new regime. In *Notice 2015-57* (issued on August 21, 2015), Treasury indicated that for §6035 statements required to filed or furnished to a beneficiary before February 29, 2016, the due date

is postponed to February 29, 2016. This was supposed to give Treasury time to issue guidance implementing these new rules and, ideally, a form. Indeed, the notice told executors and others required to furnish §6035 statements not to do so "until the issuance of forms or further guidance by the Treasury."

2. Form 8971

On January 29, 2016, Treasury released the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, together with instructions. The Form asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The Form includes a Schedule A, the page to be furnished to each beneficiary of the estate. The schedule must provide a "description of property acquired from the decedent," along with an indication of where the item is reported on the estate's Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the "estate tax value (in U.S. dollars)." The Schedule A includes this notice to beneficiaries: "You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional."

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, "the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made." As Steve Akers observed in a February, 2016 report, "This [will] cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary."

In *Notice 2016-19* (issued February 11, 2016), Treasury extended the first deadline for §6035 statements (Forms 8971) from February 29, 2016, to March 31, 2016. Then, in *Notice 2016-27* (issued March 23, 2016), Treasury again extended the deadline for Form 8971 filings to June 30, 2016.

3. Proposed Regulations

On March 4, 2016, Treasury issued proposed regulations offering guidance on the application of §§1014(f) and 6035. The proposed regulations offer a number of clarifications. First, they clarify

that while §1014(f) caps the initial basis a beneficiary takes in property, subsequent adjustments to basis for improvements, depreciation, and the like will still be allowed.

Second, the clarify that §1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes; so property eligible for the marital and charitable deductions is not subject to §1014(f), nor is any tangible personal property for which an appraisal is not already required under the estate tax regulations. But all other property included in the gross estate is subject to §1014(f) if any federal estate tax liability is incurred.

Third, the proposed regulations address property discovered after the filing of the Form 706 and property omitted from the Form 706 (herein, "omitted property"). If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax, the regular rules for determining the final value of property shall apply. But if the omitted property is reported after expiration of the statute of limitations, it will have a final value of zero. Likewise, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to §1014(f) is deemed to be zero.

Fourth, the proposed regulations clarify that the §6035 reporting requirement does not apply where an estate tax return is filed solely for purposes of making a portability election or a generation-skipping transfer tax exemption allocation.

Fifth, the proposed regulations exempt the following assets from §6035 reporting: cash, income in respect of a decedent, items of tangible personal property for which an appraisal is not required under the estate tax regulations, and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction.

Sixth, the proposed regulations make clear that where the executor is also a beneficiary, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners. If the executor cannot locate a beneficiary in time, the Form 8971 is to explain the efforts taken to locate the beneficiary.

Finally, the proposed regulations provide that where the recipient of property reported on the Form 8971 transfers all or any portion of the property to a related party, the transferor must file a supplemental Form 8971 documenting the new ownership if the transferee's basis is to be determined with reference to the transferor's basis.

C. PROPOSED §2704 REGULATIONS TAKE AIM AT CERTAIN DISCOUNTS

1. Introduction and Effective Dates

On August 2, 2016, Treasury issued long-awaited (and long-feared) proposed regulations under §2704. The most important thing to understand up front is that none of these new rules (Proposed Regulation §§25.2704-1 through 25.2704-3) will take effect until the regulations are finalized (indeed, the more controversial provisions have an effective date that is 30 days after the date the regulations are finalized). The hearing on the proposed regulations has been scheduled for December 1, 2016. Most likely, then, none of these rules will apply until sometime in 2017, if at all. That gives planners and clients some time to consider how the new rules might affect current and future arrangements regarding closely-held family entities.

A short primer on §2704 (cribbed largely from the new 4th edition of FEDERAL WEALTH TRANSFER TAXATION by Kevin M. Yamamoto and Samuel A. Donaldson) will provide some context for the new regulations. Section 2704 contains two sets of rules for measuring the value of transferred interests in a corporation or partnership among family members. The first set of rules, in §2704(a), considers the effect of lapsing rights. The second set of rules, in §2704(b), relates to whether certain restrictions on liquidation of the entity will be respected for valuation purposes.

2. Section 2704(a) Background

Under §2704(a)(1), some lapses in voting, liquidation, or similar rights in a "controlled" corporation or partnership are treated as transfers of those rights by the holder. If the lapse occurs while the holder of the right is alive, the transfer is a gift. If the lapse occurs upon the death of the holder of the right, the transfer is deemed to occur at death and thus is included in the decedent's gross estate. There are thus two elements to the application of §2704(a)(1). First, there must be a lapse of voting or liquidation right in a corporation or partnership. Second, the holder of the lapsed right and members of his or her family must control the entity both before and after the lapse. Under §2704(a)(2), the amount of the transfer (or the amount included in the gross estate, as the case may be) is the excess of the value of all interests in the entity held by the holder immediately before the lapse (determined as if the lapsed rights were non-lapsing) over the value of such interests immediately after the lapse.

An example might help. Suppose George was a partner in a limited partnership. At his death, George held both a general partner interest and a limited partner interest. The general partner interest carried with it the right to liquidate the partnership; the limited partner interest had no such power. Accordingly, the value of the limited partner interest was $59 million if it was held jointly with the general partner interest but only $33 million if it was held alone. A buy-sell agreement between George and his son, William Henry, required George's estate to sell the general partner interest to William Henry for $750,000. Absent §2704(a), the value of the limited partner interest included in George's estate would be $33 million, for the right to liquidate the partnership lapsed at death due to the obligation to sell the general partner interest to William Henry. This was the holding of *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8. But now

§2704(a) applies, assuming George and members of his family (including William Henry) controlled the partnership before and after George's death. Accordingly, George is treated as having made a transfer of $26 million (the excess of the $59 million value of the limited partner interest assuming the liquidation right was non-lapsing over the $33 million value of the limited partner interest after the lapse) at death, and that extra $26 million is also included in George's gross estate.

The regulations already contain an exception to the application of §2704(a). Under this exception, the deemed gift or deemed gross estate inclusion does not occur where the liquidation rights with respect to a transferred interest are not restricted or terminated. Because of this exception, most inter-vivos transfers of a minority interest by a controlling partner or shareholder do not trigger the deemed gift rule of §2704(a).

3. Proposed Regulations Restrict Scope of Regulatory Exception to §2704(a)

The proposed regulations limit the regulatory exception to inter-vivos transfers made more than three years before death. Any transfers made within three years of death would trigger gross estate inclusion under §2704(a) upon the transferor's death. The following example from the proposed regulations illustrates how this new rule would work:

> D owns 84 percent of the single class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

4. Section 2704(b) Background

Section 2704(b) relates to restrictions imposed on a power to liquidate a corporation or partnership. Under §2704(b)(1), if three requirements are met, any "applicable restrictions" are to be disregarded when valuing a transferred interest in the entity. These requirements are: (1) a transfer of an interest in a corporation or partnership (2) to or for the benefit of a member of the transferor's family (3) where the transferor and the members of the transferor's family control the entity immediately before the transfer.

An "applicable restriction" is any limitation on the entity's ability to liquidate that either lapses to any extent after the transfer or can be removed after the transfer by the transferor or any member of the transferor's family. For instance, assume Wendy and Peter, a married couple, own general partner and limited partner interests in a limited partnership. Under their partnership agreement, Wendy and Peter have agreed that the partnership can be liquidated

only with the written consent of all partners, though this restriction on liquidation may be removed by a unanimous vote of the partners. Wendy transfers her limited partner interest to her son, Michael. All of the requirements of §2704(b)(1) are met, for Wendy has transferred to her son an interest in the partnership controlled by Wendy and her husband. Thus the value of the limited partner interest transferred to Michael must be determined without regard to the restriction that the partnership may be liquidated only with the consent of all partners, because this restriction can be removed upon the vote of Wendy, Peter, and Michael, all members of the same family.

The statute provides that certain restrictions on liquidation are not to be disregarded even where the elements of §2704(b)(1) are met. Commercially reasonable restrictions on liquidation arising from a financing transaction with an unrelated party, for example, are not subject to §2704. In addition, §2704(b)(3)(B) provides that restrictions on liquidation imposed by state or federal law do not trigger §2704(b). In effect, then, only those liquidation restrictions that are more stringent than those under applicable federal and state laws or those found in commercially reasonable financing transactions will be disregarded.

5. Proposed Regulations Eliminate Comparison to State Law

The current regulations restrict the scope of §2704(b) to limits "on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The preamble to the proposed regulations observe that some states have, in response to this regulation, changed their statutes to allow liquidation only upon a unanimous vote of all owners and to eliminate existing laws that allowed limited partners the right to liquidate their interests in a partnership. That makes Treasury mad. In response, the proposed regulations remove the restriction in the current regulations that limits the definition of "applicable restrictions" to those that are more restrictive than under applicable state law. Indeed, the proposed regulations go on to state that an "applicable restriction" includes any restriction imposed under the entity's governing documents or under local law "regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise."

Lest you think that's contrary to §2704(b)(3)(B), the proposed regulations state that the statutory exception is limited to restrictions imposed or required to be imposed by federal or state law. The proposed regulations go on to explain:

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the [owners] or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be

removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

6. There's More – Proposed Regulations Create More Disregarded Restrictions

Section 2704(b)(4) authorizes regulations providing that "other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." In each of 2009, 2010, 2011, and 2012, President Obama's budget called for legislation that would have broadened the scope of §2704(b) to include as disregarded restrictions "limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations." That this idea never caught traction didn't stop Treasury in issuing the proposed regulations.

New Proposed Regulation §25.2704-3(b) lists four restrictions that will be disregarded in valuing an interest in a corporation or partnership transferred to or for the benefit of one of the transferor's family where the transferor and members of the transferor's family control the entity immediately before the transfer.

The first restriction to be disregarded is one that limits the ability of the holder of the interest to liquidate the interest. Thus, for example, when a parent transfers a limited partner interest to a child, the child's inability to liquidate the transferred interest is to be disregarded when valuing the interest.

The second restriction to be disregarded is one that limits the liquidation proceeds to an amount less than "minimum value," defined in the proposed regulations as the interest's share of the "net value" of the entity at the time of liquidation (net value, in turn, is generally defined as the net asset value of the entity). So any restriction that would pay the holder less than the liquidation value of the interest is to be disregarded under this rule.

The third restriction to be disregarded is one that defers the payment of liquidation proceeds for more than six months. The final restriction to be disregarded is one that permits payment of the liquidation proceeds in any form other than cash, property, or certain notes.

Combine the four disregarded restrictions and it appears that, for example, a limited partner interest subject to §2704(b) would be valued under the assumptions that the holder could cash it in at any time for its full liquidation value, with such amount to be paid in full in cash or other property within six months.

7. Preliminary Thoughts

For planners who worry that the proposed regulations spell the end of certain strategies related to family-owned entities, the message is clear: you have a few months remaining to implement those strategies before the regulations take effect. For those who insist the proposed regulations exceed the scope of the statute or, indeed, violate the statute, it might be best to remember the high degree of deference accorded to agency interpretation of statutes under the current common law. The burden of proof on those alleging legislative regulations to be invalid is, to put it mildly, high. While it may well come to pass that final regulations will be more diluted than the proposed regulations, planners should probably proceed under the assumption that the proposed regulations will take effect and listen for updates as the proposed regulations undergo the comment stage.

D. NONTAX REASONS FOR FAMILY LIMITED PARTNERSHIP REJECTED AS AFTER-THE-FACT JUSTIFICATIONS (*Estate of Holliday v. Commissioner,* T.C. Memo. 2016-51, March 17, 2016)

Late in 2006, Sarah Holliday (through a power of attorney held by her sons, Dr. Doug Holliday and Joe Holliday) formed a family limited partnership with $5.9 million in marketable securities. The sons owned all of the membership interests in the limited liability company that served as the general partner owning a 0.1% interest in the partnership. Sarah owned the remaining 99.9% interest as the sole limited partner. After formation, Sarah gifted a 10% limited partner interest to an irrevocable trust. At her death in January, 2009, Sarah still owned her 89.9% partnership interest. Alas, the marketable securities held by the partnership were worth only $4 million as of the alternate valuation date (July, 2009). The estate tax return reported the value of Sarah's 89.9% limited partnership interest at $2.4 million, reflecting an aggregate minority interest and marketability discount of about 33%.

The Service argued that the partnership should be ignored and that the full $4 million of partnership assets should be included in Sarah's gross estate under §2036(a). Section 2036(a) applies where the decedent made a transfer of property in which the decedent retained the right to income, possession, or enjoyment for life (or for a period not ascertainable without reference to the decedent's death or for a period that does not in fact end before the decedent's death). The Service argued that Sarah retained the right to income from the marketable securities contributed to the partnership because the partnership agreement required periodic pro-rata distributions of net cash flows. Moreover, Joe's testimony indicated that the partnership was prepared to make a distribution to Sarah if she needed it. On these facts, the Tax Court had little trouble upholding the Service's determination that Sarah had effectively retained the right to income from the partnership.

But §2036(a) does not apply in the case of a bona fide sale for a full and adequate consideration in money or money's worth. To determine whether the transfer of the securities to the partnership in exchange for the partnership interest was a bona fide sale, the Tax Court stuck to its precedent from the 2005 decision in *Estate of Bongard v. Commissioner*. Under *Bongard*, the formation of a partnership satisfies the "bona fide sale" exception to §2036(a) only where there is "a legitimate and significant nontax reason for creating the family limited partnership" and that "[a] significant purpose must be an actual motivation, not a theoretical justification." In this case, the estate proffered three nontax purposes for the partnership, but the court ultimately rejected them as theoretical justifications.

The estate first contended that the partnership was formed to protect Sarah's assets from "trial attorney extortion." Apparently there was a concern that Sarah could be sued and that a judgment creditor could attach assets that were not in the partnership. But the court observed that Sarah had never been sued and that no such suits were imminent. And if protecting assets from judgment creditors was a concern, said the court, Sarah would have transferred substantially more than just the $5.9 million in marketable securities that were actually contributed to the entity.

The estate then argued that the partnership was created to protect Sarah's assets from the undue influence of caregivers. There was evidence that Sarah's dead husband had been abused and taken advantage of by his caregivers late in life. But Sarah was never consulted about the formation of the partnership, and Dr. Holliday's weekly visits were an adequate safeguard to make sure assets were not stolen. More importantly, the court was not convinced that the formation of a partnership would protect an asset from theft. Besides, marketable securities are not exactly the type of assets in-home caregivers are apt to pilfer.

Finally, the estate argued that the partnership was formed to preserve assets for the benefit of the family. Again, however, the fact that Sarah was not consulted about the formation of the partnership belies this asserted purpose. Too, Sarah's husband had done the bulk of his planning through trusts, and there was never an issue as to whether trusts were an effective vehicle for the preservation of family assets.

That the partnership did not maintain all of the required records and never paid compensation to its general partner (both required under the partnership agreement) was not helpful to the estate in making its case. Ultimately, this is another case where the Service prevails under facts overwhelmingly in its favor. The planning lessons here are several. Among them: (1) partnership agreements probably should not contain provisions requiring periodic distributions to the partners; (2) those acting under a power of attorney should consult with their principals as to the reasons for the formation of the entity; (3) all parties should be prepared to respect the formalities of the entity and the provisions of the partnership agreement; and (4) the parties should be careful to identify and articulate the reasons for using the family partnership structure in advance of any actual transfers.

E. SETTLEMENT OF CASES INVOLVING INSTALLMENT SALE TO DEFECTIVE GRANTOR TRUST USING DEFINED VALUE CLAUSE (*Estate of Donald Woelbing v. Commissioner*, stipulated decision entered March 26, 2016; *Estate of Marion Woelbing v. Commissioner*, stipulated decision entered March 29, 2016)

In 2006, Donald sold all of his nonvoting stock in a closely-held business to an irrevocable life insurance trust in exchange for a promissory note with a face value of about $59 million with interest payable at the applicable federal rate. The purchase and sale agreement contained a defined value clause providing that what was sold was $59 million "worth" of stock and that the number of shares sold would be adjusted if the Service or a court determined that the per-share value of the stock was different from that set forth in an independent appraisal. Two of Donald and Marion's children gave personal guarantees to the trust; the combined value of the guarantees was worth 10% of the purchase price of the stock. This gave the trust "substantial financial capability" to pay the installment note to Donald. Donald and Marion filed gift tax returns for 2006 in which they elected to split gifts. He died in 2009 and she died in 2013 (two days after receiving a gift tax notice of deficiency in the amount of $32 million!).

The Service assessed both gift tax and estate tax deficiencies against Donald's estate and Marion's estate. The gift tax deficiencies resulted from the Service's position that the note has a value of zero and that the stock transferred was worth $116.8 million instead of $59 million. The zero value for the note stems from the Service's application of §2702—apparently the Service viewed the note as a retained equity interest in the stock that was sold, triggering the zero-value rule. The Service argued in the alternative that if the note was not worth zero, then Donald and Marion still made taxable gifts to the extent the value of the stock transferred exceeded the face value of the note.

On the estate tax side, the Service alleged that under both §§2036 and 2038, Donald's gross estate should include not the note but the date-of-death value of the stock sold to the trust ($162.2 million, per the Service). We don't know the exact rationale behind the application of §§2036 and 2038, but some have speculated that the trust lacked sufficient equity to be able to buy such a large amount of stock in exchange for a note bearing interest only at the applicable federal rate.

Planners worried what a Service victory in these cases could mean for installment sale transactions, gift-splitting, and the use of defined value clauses. But the Service and Donald's estate settled with no additional gift or estate tax due. A few days later, the Service and Marion's estate settled with no gift tax due, but the Service could still argue that her estate owes estate tax. That the Service walked away from a claim to over $150 million in taxes, interest, and penalties means this settlement is important, but its exact meaning going forward defies easy description. Alas, we will have stay tuned for further developments.

F. REVERSE LIKE-KIND EXCHANGES OUTSIDE THE SAFE HARBOR ARE POSSIBLE (*Estate of Bartell v. Commissioner*, 147 T.C. No. 5, August 10, 2016)

Bartell Drug Co., an S corporation owned by the decedent and his two children, owns and operates a chain of retail drugstores in western Washington. The company decided to acquire a new parcel of real estate in Lynwood, Washington, on which to construct and operate a new retail location. But it also wanted to do via a §1031 exchange where possible. Accordingly, after negotiating the purchase of the Lynwood location, the company assigned all of its rights in the purchase agreement to a third-party exchange facilitator. A subsequent agreement between the company and the facilitator provided that the facilitator would buy the property and give the company the right to buy for a set price for a stated period. Using bank financing guaranteed by the company, the facilitator acquired title to the Lynwood property in August, 2000. The company then constructed a drugstore on the property, and when construction finished in June, 2001, the company leased the store from the facilitator from that time until December, 2001, when the facilitator conveyed the property to the company after receiving full payment as provided under their agreement (and as explained more fully below).

Meanwhile, in 2001, the company entered into a contract to sell an existing parcel of property in Everett, Washington, to another, unrelated buyer. The company then entered into a different exchange agreement with a different qualified intermediary and assigned its rights under the sale agreement (along with its rights under the earlier agreement with the facilitator) to that intermediary. The intermediary then sold the Everett property, used the proceeds of that sale to buy the Lynwood property, and conveyed the Lynwood property to the company.

The company realized a $2.8 million gain on the sale of the Everett property, but it took the position that the gain was excluded under §1031 because these events essentially equated to a like-kind exchange of the Everett property for the Lynwood property. The statute, you see, covers not only "simultaneous" swaps of land for land, but also "deferred" exchanges. In the typical ("forward") exchange, the taxpayer sells a parcel of land and uses the proceeds to buy another parcel of land within a particular timeframe. But in the case, the taxpayers are seeking to qualify a "reverse" exchange, for the Lynwood property had been identified and acquired before the Everett property was sold.

While the regulations are silent about "reverse" exchanges, the Service has established a safe harbor under Revenue Procedure 2000-37 under which some reverse exchanges can work. But the safe harbor can only apply to arrangements made with an "exchange accommodation titleholder" on or after September 15, 2000, and the company's arrangement with the intermediary in this case preceded this date. Because the revenue procedure did not apply, then, the parties had to figure out whether a legitimate "exchange" took place that could qualify for nonrecognition.

The Service argued that the company already owned the Lynwood property by the time the Everett property was sold. It was thus too late to engage in a like-kind exchange of the Everett property, for an exchange requires "that the taxpayer not have owned the property purportedly

received in the exchange before the exchange occurs; if he has, he has engaged in a nonreciprocal exchange with himself." The Service claimed that the company (not the facilitator) owned the Lynwood property and thus had all the benefits and burdens of ownership in the Lynwood property by the time the Everett property was sold. The facilitator, it argued, had no equity interest in the property, made no economic outlay to acquire the property, was not at risk with respect to the property, and had no interest in the improvements made (and funded) by the company.

But the taxpayers pointed to controlling precedent establishing that the facilitator need not assume the benefits and burdens of ownership to have title to the property. That precedent said one like the facilitator could obtain title "solely for the purpose of the exchange" and thus preclude a prohibited "self-exchange." The Tax Court agreed, and while it observed that this precedent does indeed elevate form over substance, it works to qualify transactions like the one at issue in this case. The Service pointed to more recent precedent emphasizing the benefits and burdens of ownership, but the court found important distinctions: the Service's precedent involved a case where the taxpayer itself acquired the replacement property first (obviously different from the case here where the company did not have title until all aspects of the exchange were complete), and it came from a non-controlling jurisdiction.

The court observed that while this transaction spanned 17 months, a period far longer than any of those from the precedents favorable to the taxpayer, "the caselaw provides no specific time limit on the period in which a third-party exchange facilitator may hold title to the replacement property before the titles to the relinquished property and replacements properties are transferred in a reverse exchange."

G. ECONOMIC BENEFIT REGIME APPLIED TO INTERGENERATIONAL SPLIT-DOLLAR ARRANGEMENT (*Estate of Morrissette v. Commissioner*, 146 T.C. No. 11, April 13, 2016)

In 2006, Clara's revocable living trust entered into two split-dollar life insurance arrangements with three separate dynasty trusts, one for each of her three sons and their families. Each dynasty trust bought two universal life insurance policies, one on the life of each of the other brothers. To fund these policies, the dynasty trusts and Clara's revocable trust entered into a split-dollar arrangement. Under the arrangement, Clara's trust would transfer about $10 million to each dynasty trust, and the trustees of those trusts would use the funds to pay the premiums on the policies. Upon the death of a son, Clara's revocable trust would receive a portion of the death benefits from the policies on the life of the deceased son. With respect to each policy, the amount payable to Clara's revocable trust would be the greater of the cash surrender value of the policy or the total premium payments made on the policy. The dynasty trusts owning the policies would then receive the balance of the death benefits, to be used to buy stock owned by (or held in trust for the benefit of) the deceased son. If the split-dollar arrangement terminated before the death of a son, Clara's revocable trust would still be entitled to receive the "greater of" amount described above.

This is a so-called "intergenerational split-dollar arrangement." Howard Zaritsky explains:

> Intergenerational split-dollar involves using the economic benefit regime with a collateral assignment non-equity split-dollar agreement, to avoid both gift and GST taxes and to reduce estate taxes. Under this arrangement, a senior-generation member (in this case, Clara's revocable trust) pays that part of the premiums on the policies insuring the lives of one or more middle-generation members (in this case, Clara's sons). The death benefits are payable to a trust for the benefit of lower-generation members (in this case, the three dynasty trusts). Typically, the senior-generation family member pays the portion of the premium equal to the value of the present insurance coverage, determined under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower.
>
> Proponents of this concept argue that the senior generation makes no taxable gifts by paying these premiums; rather, he or she is advancing funds with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. Moreover, when the senior generation family member dies, the value of the right of recovery in his or her estate is merely a "collateralized receivable" that must be paid at the insured child's death. The economic benefit regime impairs the value of these receivables, potentially reducing their value for estate tax purposes. The receivables are mere unsecured promises to pay uncertain amounts at an uncertain time, with no current return on their value and with ongoing tax liabilities.

Consistent with this strategy, Clara filed federal gift tax returns reporting gifts to each dynasty trust using the economic benefit regime under Regulation §1.61-22. Under that approach, the gift is equal to the cost of the current life insurance protection as determined under Table 2001 minus the amount of the premium paid by the dynasty trust. That reduced the total annual gifts from 2006 to 2009 to amounts ranging from just over $64,000 a little over $206,000. Following Clara's death in 2009, the estate valued the revocable trust's right to receive future repayments from the dynasty trusts at about $7.5 million.

But the Service determined that the entire $30 million transferred to the dynasty trusts in 2006 was a gift. That sent the estate to Tax Court, where it argued that the economic benefit regime should apply in determining the amount of the gift. In a reviewed opinion, the Tax Court granted the estate's motion for partial summary judgment on this issue. Clara's trust was entitled to recover all of the premiums paid on the policies (at a minimum), and that recovery was secured by the death benefits. The transaction was thus a valid split-dollar arrangement.

The key remaining issue, then, is whether the loan regime or economic benefit regime applies to this arrangement. Because the dynasty trusts were the owners of the policies, one would think the loan regime would apply. But the regulations provide that the donor is the deemed owner of the policies where the arrangement is donative in nature and the donee receives only the current life insurance protection from the policies. The court determined this exception applied here, especially after noting that the preamble to the regulation contains an example explaining this

exception that uses facts nearly identical to those in the case at bar. Because Clara's trust retained the greater of the total premiums paid or the cash surrender value of the policies, the dynasty trusts did not have any additional economic benefit. The dynasty trusts had no access to the cash values of the policies. Thus the economic benefit regime properly applies to this arrangement.

Note that this is only a decision on a summary judgment motion. There is still the issue of the value of the right to repayment that is included in Clara's gross estate. If the estate prevails there, notice that the arrangement will have worked to remove about $22.5 million from transfer tax ($30 million transferred to the trusts less $7.5 million included in Clara's gross estate).

H. SERVICE SUPPLIES SAMPLE LANGUAGE TO AVOID THE "PROBABILITY OF EXHAUSTION" TEST FOR CHARITABLE REMAINDER ANNUITY TRUSTS (Revenue Procedure 2016-42, August 8, 2016)

Regulations governing charitable remainder trusts provide that no income, estate, or gift tax deduction is available if the charity's interest "would be defeated by the subsequent performance of some act or the happening of some event," unless the possibility of such occurrence is "so remote as to be negligible." In a 1970 revenue ruling, the Service stated that "if there is a greater than 5 percent probability that payment of the annuity will defeat the charity's interest by exhausting the trust assets by the end of the trust term, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible." This is referred to as the "probability of exhaustion test." It was specifically made applicable to charitable remainder annuity trusts (CRATs) in a 1977 ruling.

As the Service explains, in the case of a CRAT, the probability of exhaustion is calculated "first by applying the §7520 assumed rate of return on CRAT assets (§7250 rate) against the amount of the annuity payment to determine when the CRAT assets will be exhausted. Then, a mortality table (Mortality Table 2000CM, found in [Regulation] §20.2031-7(d)(7)) is used to determine the probability that the income beneficiary or beneficiaries will survive exhaustion of the CRAT assets. If the probability that the life beneficiary or beneficiaries will survive exhaustion of the CRAT assets is greater than 5 percent, then the charitable remainder interest of the CRAT does not qualify for an income, gift, or estate tax charitable deduction and the CRAT is not exempt from income tax under §664(c). If the §7520 rate at creation of the trust is equal to or greater than the percentage used to determine the annuity payment, then exhaustion will never occur under this test."

The Service has noticed that in today's environment of low interest rates, this calculation leads to weird results. "For example, in May of 2016, the §7520 rate was 1.8 percent. At this interest rate, the sole life beneficiary of a CRAT that provides for the payment of the minimum allowable annuity (equal to 5 percent of the initial FMV of the trust assets) must be at least 72 years old at the creation of the trust for the trust to satisfy the probability of exhaustion test. The §7520 rate has not exceeded the minimum 5 percent annuity payout rate since December of 2007, which has necessitated testing for the probability of exhaustion for every CRAT created since that time."

Accordingly, the Service has offered sample form language. Any trust created after August 8, 2016, containing this form language and providing for annuity payments covering one or more measuring lives will qualify to have that language treated as a "qualifying contingency," meaning it would be exempt from the probably of exhaustion test. "A CRAT that contains a substantive provision similar but not identical to [the Service's sample language] will not necessarily be disqualified, but neither will such a provision be assured of treatment as a qualified contingency."

The sample language essentially forces the early termination of a CRAT "immediately before the date on which any annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than 10 percent of the value of the initial trust corpus." The assets would then pass immediately to the charitable remainder beneficiary.

I. MORE IN THE WAR ON CONSERVATION EASEMENTS AND FAÇADE EASEMENTS

The Service continues to monitor carefully transactions involving the donation of qualified conservation real property, usually in the form of a "conservation easement" (where the taxpayer attaches a perpetual restriction on real property that precludes any change to existing use without the consent of the charitable organization that receives the easement) of a "façade easement" (where the taxpayer attaches a perpetual restriction that the exterior of any structures on real property cannot be changed absent the consent of the charity that holds the easement). As the following litany of recent cases illustrates, taxpayers must be careful about the valuation of the easement, ensuring the easement attaches to property in perpetuity, complying with substantiation requirements, and both disclosing and valuing any consideration received in exchange for the donation.

Failure to Obtain Written Subordination from Banks Doomed Deduction (*RP Golf LLC v. Commissioner*, T.C. Memo. 2016-80, April 28, 2016). The taxpayer owns two private golf courses in Kansas City. In 2003, it conveyed a conservation easement over the courses to the Platte County Land Trust, a charitable organization. On its 2003 return, the taxpayer claimed a $16.4 million deduction, pursuant to an appraisal that found the pre-contribution value of the courses to be $17.4 million and the post-contribution value to be $1 million.

Interestingly, though, the court never got to the issue of this valuation. You see, two banks were mortgagees on loans made to the taxpayer. Regulation §1.170A-14(g)(2) precludes a conservation easement deduction for encumbered property "unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Here, while the easements were conveyed on December 29, 2003, consents were not executed until April 14, 2004, nor recorded until April 15, 2004. The Service claimed that because the consents were not given contemporaneously with the donation, the taxpayer was not entitled to a deduction. The Tax Court agreed, pointing to recent case law indicating that the subordination must be in place at the time of the transfer. The taxpayer

argued that it had oral consents from both banks, but the court found that an oral consent would not be binding under applicable state (Missouri) law.

Fair Market Value of Easement is Not Always the Same as the Deduction Amount, a Distinction that Foiled a Deduction (*Carroll v. Commissioner*, 146 T.C. No. 13, April 27, 2016). On December 15, 2005, the taxpayers contributed a conservation easement on nearly 26 acres of Maryland land jointly to the Maryland Environmental Trust and the Land Preservation Trust. The taxpayers claimed the easement was worth $1.2 million, and thus claimed charitable contribution deductions for each of 2005, 2006, 2007, and 2008.

Of the many requirements for a deduction, one is that the conservation purpose must be protected in perpetuity. Regulation §1.170A-14(g)(6)(ii) provides that "when a change in conditions give rise to the extinguishment of a perpetual conservation easement restriction…, the done organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction." The conservation easement in this case, however, provided that the charities' fractional share of any extinguishment proceeds would be equal to a fraction the numerator of which is the amount allowable as a federal income tax deduction to the taxpayers and the denominator of which is the fair market value of the whole property at the time of the donation. As the Tax Court observed, that's different than the fraction required by the regulations—the numerator needs to be the value of the easement, not the deduction allowed to the taxpayers.

Sure, in many cases those two figures will be the same (the deduction amount is, generally, the value of the easement). But not always: "For example, if the…Service denies petitioners' charitable contribution deduction for Federal income tax purposes for reasons other than valuation and the easement is extinguished in a subsequent judicial proceeding, the numerator [under] the conservation easement will be zero, and [the charities] will not receive a proportionate share of extinguishment proceeds." Alas, this is fatal to the taxpayers' claim for a deduction, for case law has established that the "perpetuity" element for a conservation easement deduction must be construed strictly.

Don't Forget the Written Acknowledgment (*French v. Commissioner*, T.C. Memo. 2016-53, March 23, 2016). The taxpayer was a beneficiary of a trust that, on December 29, 2005, donated a conservation easement on four contiguous parcels to the Montana Land Reliance. The trustees obtained an appraisal indicating the easement was worth $1.1 million, and the taxpayer's share of that deduction would be almost $351,000.

The first 2005 return filed by the taxpayer did not claim any deduction for the easement. But an amended return, filed before April 15, 2006, claimed a charitable contribution deduction of nearly $57,000. The taxpayer then carried over the remaining deduction to 2006 (nearly $45,000), 2007 (just over $57,000), and 2008 (almost $32,000). The Service initially determined that the total value of the easement was $432,000, but in this case before the Tax Court it went

a step further and claimed the taxpayer gets no deduction at all for lack of receiving a contemporaneous written acknowledgement from the charitable donee.

The taxpayer argued that two documents could serve as the acknowledgement. The first was a letter from a representative of the organization dated June 6, 2006, stating no goods or services were furnished in exchange for the donation. The problem, though, is that this letter is not "contemporaneous" with the donation because it was not received by April 15, 2006. The second was the donation agreement itself, in the form of a conservation deed recorded on the day of the donation. The Tax Court observed that a conservation deed can work as an acknowledgment where the deed states whether the donee provided goods or services in exchange for the contribution. Even where such express language is missing, the court will still "look to the deed as a whole" to determine whether the donee furnished consideration for the donation.

Here, though, the deed said nothing about consideration furnished by the donee, and the court did not find an absence of consideration from the deed as a whole: "Although the conservation deed includes provisions stating that the intent of the parties is to preserve the property, those provisions do not confirm that the preservation of the property was the only consideration because the deed did not include a provision stating that it is the entire agreement of the parties. Without such a provision, the IRS could not have determined by reviewing the conservation deed whether petitioners received consideration in exchange for the contribution of the conservation easement. We conclude, therefore, that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii)."

Taxpayers Do Sometimes Prevail in These Cases (*Palmer Ranch Holdings v. Commissioner*, 11th Cir., February 5, 2016). The taxpayer, a partnership, donated a conservation easement on an 82-acre parcel of real property (home to an eagle's nest, it should be noted) to Sarasota County, Florida. The taxpayer claimed a $23.9 million deduction for the contribution, but the Service concluded that maximum deduction amount should be $7 million. The taxpayer argued that the highest and best use of the property would be the development of a 360-unit residential complex. But the Service said the best use was limited to 41 units based on the property's current zoning designation. The Service noted an extensive history of failed rezoning requests, environmental concerns, limited road access, and strong neighborhood opposition to development as proof that the taxpayer would never be able to build more than the currently allowable number of residential units on the property.

But the Tax Court rejected the Service's position, observing that several of the failed rezoning requests were close votes and that while the property contains a "wildlife corridor," the corridor does not preclude development along the lines suggested by the taxpayer. The lower court also determined there was adequate road access for a multiple-unit development as large as that suggested by the taxpayer. Ultimately, then, the Tax Court held that the contributed easement was worth $19.9 million, a figure much closer to the taxpayer's original position.

On appeal, the Eleventh Circuit affirmed the Tax Court's determination of the property's "highest and best use" but reversed the determination of the amount deductible. The court agreed that

a rezoning request would have a “reasonable probability” of approval. The Service argued that the proposed highest and best use was not likely to be needed shortly after the date of the donation, and while the appellate court agreed, it found that the Tax Court’s error in not considering this fact to be harmless. “The evidence clearly shows that, in 2006, the market for…development was bullish.” Where the lower court went wrong, said the Eleventh Circuit, was in reducing the “highest and best use” valuation offered by the taxpayer. The lower court based its valuation on its own assumptions about market activity at the time and not on comparable sales. “The tax court must at a minimum explain why it departed from the comparable-sales method” in valuing the property at its highest and best use. Thus the court remanded the case for further determination, with these instructions: “On remand, then, the tax court must either stick with the comparable-sales analysis or explain its departure. Whatever the tax court chooses to do, the court must keep its sights set strictly on the evidentiary record for purposes of selecting an appreciation rate, and ensure that it crunches the numbers correctly.” Stay tuned for further developments.

Don’t Forget to Attach the Qualified Appraisal! (*Gemperle v. Commissioner*, T.C. Memo. 2016-1, January 4, 2016). In 2007, the taxpayers donated a façade easement on their Chicago home to the Landmarks Preservation Council of Illinois. A contemporaneous appraisal found the easement worth $108,000 (about 12% of the unencumbered value of the home). The taxpayers deducted this amount on their 2007 and 2008 returns. They did not attach the appraisal to the return, however, and §170(h)(4)(B)(iii)(I) conditions a deduction on the attachment of a qualified appraisal with the federal income tax return. Thus the Tax Court had little trouble sustaining the Service’s adjustment disallowing the charitable contribution deduction in both years.

But it doesn’t end there. Because the taxpayers did not make their expert available for cross-examination at trial, the court did not admit the appraisal into evidence because the statements were hearsay. That left the couple with no evidence to support the value of the easement, which in turn led to the imposition of a 40% gross valuation misstatement penalty.

J. FOLLOWING ORDERS, TAX COURT IGNORES ASSETS IN VALUING A GOING CONCERN (*Estate of Giustina v. Commissioner*, T.C. Memo. 2016-114, June 13, 2016)

The decedent died in 2005 with a 41.128% limited partner interest in Giustina Land & Timber Co. Limited Partnership, an entity that owns and operates nearly 48,000 of timberland as an active business. The timberland alone was worth $143 million at the decedent’s death; the entity’s total asset value at the time was just over $150.6 million. In a 2011 decision, the Tax Court valued the decedent’s partnership interest by giving 25% weight to the entity’s asset value and 75% weight to the entity’s income stream. It based this allocation on its conclusion that there was a 25% chance the partnership would liquidate after the transfer of the decedent’s interest to a hypothetical third-party willing buyer.

In 2014, however, the Ninth Circuit reversed, concluding the Tax Court’s finding of a 25% chance of liquidation was clearly erroneous. The appellate court reasoned a third-party buyer who intended to dissolve the partnership would not be admitted by the general partners, so focusing

on the asset value of the entity was the wrong approach. The court sent the case back to the Tax Court with instructions to disregard the assets in valuing the entity as a going concern.

The Tax Court did so, adjusting the value of the decedent's limited partnership interest from about $27.4 million to about $13.9 million, a value much closer to that offered by the estate's expert (roughly $13 million) than the Service's expert ($33.5 million). The court based its final value on the present value of the entity's cashflows using a long-term growth rate of 4% and a capitalization rate of 14%.

K. POST-DEATH EVENTS, WHILE VALID, REDUCED CHARITABLE DEDUCTION AMOUNT (*Estate of Dieringer v. Commissioner*, 146 T.C. No. 8, March 30, 2016)

The decedent owned a controlling interest in a closely-held real property management corporation that managed a number of commercial and residential properties in Portland, Oregon (oh, and a Wendy's franchise in Texas). The decedent's revocable living trust provided that the closely-held stock was to pass to a private foundation the decedent had created during her lifetime. Her estate claimed a charitable contribution deduction for the value of the stock as of the date of death, with no minority or marketability discounts.

The Service reduced the amount of the deduction, however, as it concluded a series of post-death events undermined the decedent's intent to transfer control of the company to the foundation. The company elected to be taxed under subchapter S but didn't want the foundation to be subject to unrelated business income tax. So the company made arrangements to redeem all the decedent's voting stock and most of the nonvoting stock in exchange for a note. The thinking was this was good for the foundation since it converted the foundation from shareholder to creditor, giving it higher status in the liquidation food chain. To give the company cash to pay off the notes, the decedent's sons made capital contributions in exchange for more stock.

The Tax Court agreed that while these post-death events occurred for valid, non-tax business reasons, the effectively served to reduce substantially the actual amount passing to the foundation. The redemption agreements valued the foundation's stock using a 15% minority interest discount and a 35% marketability discount. Ultimately, the per-share price of the stock was much less than the value of the stock at the date of the decedent's death. One son testified the decline in value was due to the poor business climate at the time (2009). But the Tax Court held the decline was due to the son's instruction to the appraisers value the decedent's stock as a minority interest. Ultimately, said the court, the sons "thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest." So the estate tax deduction was reduced the amount used in the redemption appraisal. The instruction to value the decedent's stock as a minority interest was then used by the court as grounds for upholding the Service's assessment of a negligence penalty.

L. TERMINATION OF POLICY RESULTS IN CANCELATION OF DEBT INCOME (*Mallory v. Commissioner*, T.C. Memo. 2016-110, June 6, 2016)

In 1987, the taxpayer paid $87,500 to buy a single-premium variable life insurance policy on his life, naming his spouse as the beneficiary. Through the end of 2001, the taxpayer had taken 25 loans against the policy totaling $133,800. The taxpayer paid no interest on these loans, but luckily the cash value of the policy grew substantially over this time. By late 2011, however, the cumulative debt exceeded the cash value. The insurance company told the taxpayer to fork out over $26,000 or the policy would be terminated. The taxpayer made no payment, so the policy terminated.

The insurance company sent the taxpayer a Form 1099-R showing a gross distribution of $237,897.25, $150,397.25 of which was taxable. That income never made its way onto the taxpayer's 2011 return, but the filed return did attach the Form 1099-R along with this handwritten note: "*Paid hundreds of $. No one knows how to compute this using the 1099R from Monarch--IRS could not help when called--Pls send me a corrected 1040 explanation + how much is owed. Thank you.*"

Unsurprisingly, the Service concluded the taxpayer had $150,397.25 of gain from the cancelation of his policy debt. The taxpayer ran to Tax Court, arguing that there could be no income absent an actual payment of cash and that the various amounts received from the insurance company over the years were payments of the cash value and not loans. The court rejected these claims. Every distribution from the insurance company was accompanied by a "loan activity confirmation," and the company annually sent notices requesting payment of interest. By using the cash value to extinguish the debt amount, there was a constructive distribution of $237,897.25 to the taxpayer.

The court also upheld a 20% substantial understatement penalty. It found no reasonable basis for failing to include the distribution amount in gross income. It didn't help that the insurance company specifically flagged the includible amount both in correspondence and in the Form 1099-R. As Howard Zaritsky observes, "This issue keeps coming before the courts … because so many policy owners simply do not read or understand the notices that insurers send them regarding policy loans. Typically, there will be at least several notices before a policy is terminated. An owner who does not receive cash on the policy termination will usually assume that there cannot be income. In fact, they have received the cash on which the tax is being imposed in the form of policy loans which now never will be repaid. The taxable income merely reflects the 'day of reckoning' that ultimately must occur, unless the loans are repaid."

M. SERVICE HAS BURDEN OF PROOF IN CASES OF EXECUTOR LIABILITY FOR UNPAID ESTATE TAXES (*Singer v. Commissioner,* T.C. Memo. 2016-48, March 14, 2016)

Under the federal claims statute, 31 USC §3713(b), and the case law interpreting it, an executor is personally liable for the payment of unpaid federal estate tax where an executor with notice of the unpaid tax liability distributes assets when the estate is insolvent (or is rendered insolvent as a result of the distribution). This case involves Scott Singer, the executor of the estate of Melvin Sacks. Sacks was an attorney who at his death left behind a spouse, two girlfriends, and a $4

million income tax deficiency. During the course of administration, Singer secured the release of some $750,000 from brokerage accounts that were subject to a restraining order imposed by the local court when it appeared the estate would lack sufficient assets to pay off all creditors. A portion of the amount was earmarked to be paid to the Service in satisfaction of the decedent's tax liabilities, but the rest (about $422,000) was paid to other creditors (the spouse and the State of New York). But the Service invoked the federal claims statute to claim that Singer was now on the hook for the $422,000 paid to others.

The issue is whether the estate was insolvent at the time of the payment to the others. If it was, Singer would be personally liable for paying the $422,000 to the federal government. If not, there would be no personal liability. On this issue, the Tax Court held that the Service has the burden of proof. Further, in determining the estate's solvency, the court held that countable assets include the probate estate, nonprobate assets, and contribution rights the estate has against any beneficiaries. On these facts, the court held that the Service did not establish the estate's insolvency at the time of the distribution. Accordingly, Singer was not personally liable for the payment of estate taxes.

N. NO SPOUSAL ROLLOVER OF COMMUNITY PROPERTY INTEREST FROM INHERITED IRAs (Private Letter Ruling 201623001, June 3, 2016)

The decedent and the decedent's spouse resided in a community property state. The decedent named a child (not the spouse) as the beneficiary of the decedent's three individual retirement accounts. The spouse filed a claim against the decedent's estate for the spouse's share of the community property in the decedent's name, which included the IRAs. A state court approved a settlement agreement under which a fixed dollar amount was to be transferred to the spouse "as a spousal rollover IRA."

One of these parties (likely the spouse or the child) sought a ruling that the spouse be treated as the payee of the decedent's IRAs so that the spousal rollover would work. But the Service concluded that because the child was the beneficiary regardless of the operation of any state community property laws, there could be no spousal rollover. Consequently, any amounts placed into an IRA by the spouse will be subject to the IRA contribution limits and any assignment of the inherited IRAs to the spouse will be treated as a taxable distribution to the child. Oops.

O. LATE TRANSFER OF BUSINESS INTEREST BETWEEN EXES WAS STILL "INCIDENT TO THE DIVORCE" (*Belot v. Commissioner*, T.C. Memo. 2016-113, June 13, 2016)

The taxpayer and his ex-wife operated three businesses during their marriage: dance studios, retail sale of dancewear, and real estate holding. The couple divorced, and their January, 2007, settlement agreement provided they would continue to operate the businesses as equal partners. But in September, 2007, the ex filed suit seeking to force the taxpayer to sell his interests to her. That litigation resulted in an April, 2008, settlement agreement pursuant to which the ex agreed to buy out the taxpayer's interests in the businesses for $1.58 million, $900,000 payable at closing and $680,000 payable under a ten-year, 5% note. But since this

transfer was more than one year after the divorce, the taxpayer's gain from the sale will qualify for nonrecognition under §1041 only if the transfer is "related to the cessation of the marriage."

The Service said it did not, since the sale transfer was not pursuant to the original divorce instrument but instead pursuant to separate litigation. But the Tax Court rejected this reasoning. Yes, the regulations contain a presumption that §1041 does not apply to transfers "not pursuant to a divorce or separation instrument," but that same regulation states the presumption can be rebutted by "showing the transfer was made to effect the division of property owned by the former spouses at the time" of their divorce. On the record, the court determined that the sale of the interests was made to "effect the division of property owned by former spouses" and were thus "related to the cessation of the marriage."

P. POSNER HAS A FIELD DAY WITH THE HOBBY LOSS REGULATIONS (*Roberts v. Commissioner*, 7th Cir., April 15, 2016).

The taxpayer built a fortune through restaurants and bars in Indianapolis. In the late 1990s he developed an interest in horse racing. In 2005, he spent a good chunk of change on a horse training facility and then $1 million on a 180-acre tract of land for his horse operation. He then spent another half-million making improvements on the property. He worked eight hours a day on the activity, and up to 12 hours per day on race days. The Service alleged that the activity was a hobby in 2005 and 2006, and thus disallowed the expenses he deducted on his personal income tax return. Interestingly, the Service never challenged the activity as a business from 2007 on. The Tax Court applied the nine-factor test in Regulation §1.183-2 to conclude the horse racing activity was a hobby, so it upheld the deficiency.

But the Seventh Circuit, in an opinion by Judge Richard Posner, reversed. "We musn't be too hard on the Tax Court," he observed. "It felt itself imprisoned by a goofy regulation." Judge Posner noted the regulation lists nine non-exclusive factors to consider in determining whether an activity is merely a hobby instead of a trade or business. Ironically, perhaps, "the test is open-ended—which means the Tax Court was not actually required to apply all of those factors to Roberts' horse-racing enterprise." Nonetheless, the Seventh Circuit applied the factors itself and reached the opposite conclusion. The court concluded with some advice:

> Considering that most commercial enterprises are not hobbies, the Tax Court would be better off if rather than wading through the nine factors it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or other conventional sources of income, is a presumptively a hobby, though before deciding for sure the court must listed to the owner's protestations of business motive.

Q. INNOCENT SPOUSE RELIEF CASES

Equitable Relief from Penalties and Interest Possible Even Where Underpayment is Attributable to Requesting Spouse's Income (*Boyle v. Commissioner*, T.C. Memo. 2016-87, May 2, 2016). Joe had a business selling new and refurbished printer cartridges. His wife, Pat, handled all the finances for the business and for the couple's personal matters. She even arranged for their 2003 joint return to be prepared. She had Joe sign the return but she never filed it. It was only after Pat's death in 2006 that Joe first discovered no return had been filed, and he promptly filed one. The Service assessed deficiencies, penalties, and interest with respect to the late return. Joe wants equitable relief from the penalties and interest, saying the failure to file was Pat's fault.

The Service would not grant the relief because the underpayment at issue was related to Joe's income, not to Pat's (she had no income for 2003). But the Tax Court observed that Joe wasn't asking for forgiveness from the underpayment—he just wants relief from the penalties and interest. To deny Joe relief just because the underlying deficiency relates to his income "runs counter to our mandate…'to determine the appropriate relief available'." The court went on to find that Joe had been deceived by Pat in signing the dummy 2003 return that was never filed. On the whole, it was convinced that equitable relief from the penalties and interest was appropriate.

Not Questioning Returns and Enjoying the Good Life Preclude Innocent Spouse Relief (*Arobo v. Commissioner*, T.C. Memo. 2016-66, April 14, 2016). Larry and Sletta were married for the taxable years in question (2004 – 2007). Larry ran a mortgage origination company while Sletta worked in education. While Sletta paid the couple's bills, Larry kept their financial records and presented Sletta with joint returns for her to sign, which she did without question. It's just that Larry never filed them until after the Service started investigating the couple. The returns contained unsubstantiated business expenses and failed to include about $1.5 million in gross receipts from Larry's business.

Sletta wanted innocent spouse relief, but the Service did not grant her petition. The Tax Court agreed, finding she had reason to know of the understatements of income on each return. She "should have suspected that something might be amiss" when the 2004 return showed a $58,000 loss from Larry's business. "Even a cursory review of each year's tax return would have revealed that [Larry]'s mortgage origination business had reported (on line 12 of the first page of each return) substantial losses for 2004 and 2005 and that no business income or loss was reported for 2006 and 2007." Given Sletta paid the couple's bills, she knew first-hand that these "losses" were not impacting their standard of living.

The Tax Court also refused to extend equitable relief to Sletta. Sletta did not show how making her jointly and severally liable would cause her to suffer economic hardship. She had reason to know of the understatements and has not claimed to be a victim of abuse. She has not alleged Larry restricted her access to financial information. Perhaps most importantly, there was no change in the couple's standard of living, so she "received the benefit of paying no tax on hundreds of thousands of dollars."

R. SURVIVING SPOUSE CANNOT USE DECEASED SPOUSE'S AMT CREDIT CARRYFORWARD (*Vichich v. Commissioner*, 146 T.C. No. 12, April 21, 2016).

Nadine married Bill in 2002. It was his second marriage—his divorce from Marla was final just eight months before he tied the knot with Nadine. On their 1998 joint return, Bill and Marla paid alternative minimum tax of over $708,000 in connection with the exercise of Bill's incentive stock options. That tax payment resulted in an AMT credit carryforward.

On their 2003 joint return, Bill and Nadine claimed over $304,000 of the carryforward. Bill died in 2004, and on the 2004 joint return filed by Nadine none of the carryforward was used. Things were quite for a while, until Nadine started claiming the remaining carryforward on her own individual returns starting in 2007. It worked for a while until the Service caught on, at which point it stopped issuing refunds and started sending deficiency notices with respect to the prior years.

The Tax Court agreed with the Service that Nadine could not use Bill's AMT carryforward as his surviving spouse. Although this was a case of first impression, the court looked to decisions holding that deductions do not pass to surviving spouses at death. "Marriage affords its entrants certain benefits, among them the option of filing joint returns. The Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but 'does not create a new tax personality.'" In effect, then, the carryover died with Bill.

S. THIS IS WHY YOU DON'T LOAN MONEY TO FRIENDS (*Riley v. Commissioner*, T.C. Memo. 2016-46, March 10, 2016)

A few years before her divorce, Kaylan worked at a Blockbuster video rental store (remember those?). There she met Frank, a fellow from the same neighborhood whose kids attended the same school as Kaylan's kids. "Their relationship blossomed." In 2002, Kaylan divorced her husband. As part of the divorce decree she received a pension plan and an IRA, each worth about $1 million, along with monthly alimony payments of $4,300. Soon thereafter, Frank told Kaylan he had invented a device that allowed cell phones to act as remote controls for television sets—just point your phone at the TV and you're surfing channels in no time. If only he could find an investor, he lamented. Over the next five years, then, Kaylan wrote checks totaling over $1.3 million, usually payable to Frank and once to his business, and sometimes in exchange for a note and sometimes not.

Kaylan noticed that Frank started dressing better and that he drove a nicer car. Her friend, Wendy, went to work at Frank's company in 2010 and soon reported to Kaylan that things weren't right with the company. Kaylan started to realize that maybe she had been duped. She hired an attorney to write a demand letter to Frank, but that did no good. She found another law firm willing to take her case on a contingency but she didn't hire them because they asked for a $10,000 retainer. On her 2010 federal income tax return, Kaylan claimed a $1.33 million theft loss deduction that created a large net operating loss carryback. She them amended her 2008

return to claim the carryback, but the Service denied her requested refund on the grounds that she did not sustain a theft.

The Tax Court considered whether the facts gave rise to a theft loss, a bad debt deduction, or a worthless securities deduction. In each scenario the court found no basis for a deduction. She did not establish a theft because the only proof of misleading statements was her conversations with Frank and Wendy, neither of whom testified at trial. That rendered those statements inadmissible as hearsay (the court admitted them only to prove Kaylan's state of mind). So without any proof as to Frank's statements or his own state of mind, Kaylan can't prove a false representation was made with intent to defraud her.

As for the bad debt deduction, the court reasoned that even if Kaylan could make a case for a bad debt, it would be a nonbusiness bad debt since the advances to Frank were not part of any business activity of Kaylan. Nonbusiness bad debts are deductible as capital losses, and there is no carryback for capital losses. So that argument would not work for her 2008 return. The same goes for the worthless securities deduction, for it too would generate a capital loss that cannot be carried back. On top of that, said the court, Kaylan has not shown she lacks a reasonable chance of recovery. Heck, she found a law firm that would take her case on contingency. Frank is still around, and Kaylan still keeps in contact with him. She might have a bad debt or worthless security at some point, but not yet.

T. STATUTE OF LIMITATIONS CAN'T BE USED TO AVOID REPORTING INCOME (*Squeri v. Commissioner,* T.C. Memo. 2016-116, June 15, 2016)

The taxpayers own an S corporation that operates a "full-service janitorial business." The company reported its gross receipts based on deposits made into its bank accounts during the calendar year, regardless of when the checks were received. The Service recalculated the company's gross receipts based on when checks were received instead of when they were deposited, and this resulted in deficiencies for each of 2009, 2010, and 2011. In computing the tax due for 2009, however, the Service did not exclude checks that had been received in 2008 and deposited in 2009. The taxpayers claimed the Service needed to do this, because those amounts were actually received in 2008 and the statute of limitation precluded the Service from making adjustments related to 2008.

But the Tax Court agreed with the Service that if the taxpayers were right, they would never pay tax on the income originally reported in 2009 but properly allocable to 2008, a now-time-barred year. The common law "duty of consistency" precludes taxpayers "from benefiting in a later year from an error or omission in an earlier year which cannot be corrected because the limitations period for the earlier year has expired." The court found that allowing the taxpayers to recharacterize the income as attributable to 2008 "would harm the Commissioner; it would allow petitioners to avoid tax on $1,634,720."

U. FORFEITURE OF INSIDER TRADING PROFITS IS A NONDEDUCTIBLE PENALTY (*Nacchio v. United States*, Fed. Cir., June 13, 2016)

The taxpayer was CEO of Qwest Communications International when, in 2001, he sold a large block of stock in the company for a $44.6 million gain. He paid almost $18 million in tax on the gain. In 2007 the taxpayer was convicted of insider trading. After several appeals, in 2010 the taxpayer was forced to forfeit his $44.6 million gain from the 2001 sale. So now the taxpayer wants credit for the $18 million in tax paid on this sum. 2001 is a closed year, of course, but the taxpayer wants to use §1341 for relief. That section allows a taxpayer either a current deduction for the repayment of an amount previously included in income or a current credit equal to the extra tax paid from the prior inclusion.

To qualify for §1341, however, the taxpayer must be able to claim a deduction for the repaid amount. That's where the taxpayer's claim gets tricky. The Service disallowed the taxpayer's §1341 claim on the grounds that his forfeiture was a nondeductible fine or penalty. It also contended that the taxpayer was estopped from using §1341 because of his criminal conviction. The Court of Federal Claims rejected these contentions, finding the taxpayer could deduct his forfeiture payment as a loss under §165 (but not as a business expense under §162(a) because of §162(f)) and that he was not collaterally estopped from using §1341 just because he was convicted of a criminal offense. It thus granted the taxpayer's summary judgment motion on these points.

On appeal, though, the Federal Circuit reversed the lower court's grant of summary judgment. The appellate court held that §165 is subject to a public policy exception, citing a line of cases affirming that this exception applies both to §165 losses and to §162(a) business expenses. Moreover, the forfeiture was clearly in the nature of a fine or penalty. "We further understand [the taxpayer's] argument that not being allowed to deduct his forfeited income from his taxes would result in a sort of "double sting": both giving up his ill-gotten gains and paying taxes on them. But in this case, the relevant statutes, regulations, and body of relevant case law lead us to conclude that [his] criminal forfeiture must be paid with after-tax dollars, just as fines are paid with after-tax dollars." Since there is no income tax deduction for the forfeiture, §1341 cannot apply. The court thus did not reach the argument as to whether the taxpayer was estopped from using §1341 because of his conviction.

V. DEDUCTING LAW SCHOOL TUITION

German Lawyer Working as Apartment Manager Cannot Deduct Tuition to Attend United States Law School (*O'Connor and Tracy v. Commissioner*, 10th Cir., June 28, 2016). The taxpayer had been admitted to practice law in Germany in 2007. In 2009, after two years of working as an apartment building manager, the taxpayer started the J.D. program at San Diego. His 2010 and 2011 returns claimed deductions for his law school expenses. The Service disallowed the deductions because the course of study was not required to maintain or improve his job skills. The Tax Court agreed, finding the taxpayer was not established in the legal profession in the United States and thus the law school degree qualified him for a new trade or business. On appeal, the Tenth Circuit affirmed. The taxpayer argued that he was using his skills as a lawyer in his work, but that didn't cut the mustard. "For purposes of deductibility, courts

have held that a person who is admitted to practice law in one jurisdiction, but then incurs expenses to become qualified to practice in another jurisdiction, is considered to be entering a new trade or business."

The Tax Court also upheld the imposition of 20% negligence penalty, which the Tenth Circuit also affirmed. "Appellants' failure to heed relevant precedent regarding [the regulations and case law], without any indication that such precedent has been superseded or overruled, supports the imposition of accuracy-related penalties."

Accountant Can't Deduct Law School Tuition (Nor Read Precedent, It Seems) (*Santos v. Commissioner*, T.C. Memo. 2016-100, May 17, 2016). The taxpayer worked as an accountant for 20 years before enrolling in law school. The taxpayer paid $20,275 in tuition for the 2010 taxable year and deducted that amount as a business expense on his Schedule C. There's just one problem: Regulation §1.162-5(b)(3)(ii), Example (1) expressly provides that law school costs for "a self-employed individual practicing a profession other than law" are not deductible "because this course of study qualifies him for a new trade or business."

Before the Tax Court, the taxpayer argued the regulation was invalid. But the Tax Court had already upheld the validity of the regulation in a 1971 case, and the underlying law on which the regulation was based has not changed in the interim. In fact, there is a long line of cases applying the regulation and denying a deduction in similar circumstances. This decision is yet another.

W. DISCRIMINATION AWARD TAXABLE SINCE NOT ATTRIBUTABLE TO PHYSICAL INJURY OR SICKNESS (*Barbato v. Commissioner*, T.C. Memo. 2016-23, February 16, 2016)

The taxpayer worked as a letter carrier when, in 1991, she sustained back and neck injuries in a work-related automobile accident. The injuries forced her to accept a new at the Post Office answering telephones and helping customers. In 2004, her branch got a new manager. The new manager assigned the taxpayer to resume work as a letter carrier. The taxpayer tried to comply, but the pain was too much. She noticed the new manager and other supervisors retaliated against her when she requested medical accommodations, thus creating a hostile work environment. Eventually the taxpayer filed a complaint with the Equal Employment Opportunity Commission.

An EEOC administrative judge ruled that the taxpayer was "entitled to non-pecuniary damages in the amount of $70,000, for the emotional distress which she established was proximately caused by the discrimination" she suffered. The judge found the taxpayer suffered from depression, anxiety, sleep problems, and post-traumatic stress disorder, all conditions caused or exacerbated by the discriminatory actions. But the judge also found that the taxpayer's physical pain was not the result of discrimination. The United States Postal Service paid the $70,000 damage award to the taxpayer in 2011, but she did not include this amount on her 2011 tax return.

The Service concluded that the award was taxable, and the Tax Court agreed. The court concluded the damages paid to the taxpayer were for emotional distress attributable to discrimination and not to physical injury or physical sickness. Yes, the discrimination exacerbated her distress and pain, but it did not cause them.

X. CAPITAL GAINS STILL REQUIRE THE SALE OR EXCHANGE OF A CAPITAL ASSET (*Duffy v. United States*, Fed. Cir., January 8, 2016)

The taxpayer worked for United Commercial Bank as Tax Director and First Vice President. In that job, he was supposed to make sure the bank complied with the financial disclosure requirements of the Sarbanes-Oxley Act. In 2006, the taxpayer informed bank management of instances of noncompliance. His reward? The bank placed him on administrative leave and then terminated his employment. So the taxpayer filed a claim with the Department of Labor alleging that the bank fired him for whistleblowing and refusing to participate in the bank's illegal conduct. The taxpayer and the bank settled when the bank agreed to pay him $50,000 and pay $25,000 to his attorneys on his behalf. In exchange, the taxpayer agreed to accept his termination and withdraw his claim with the Department of Labor. The settlement agreement expressly provided it was "for the exclusive purpose of avoiding the expense and inconvenience of further litigation."

The taxpayer's original return included the $50,000 as "other taxable income," but he then amended the return and excluded it on the grounds it was either excludable under §104(a)(2) as compensation for physical injury or subject to tax at a reduced rate as a capital gain from the loss of goodwill to his separate financial consulting business.

The Service disallowed the refund, which sent the taxpayer to the Court of Federal Claims. That court found no capital gain income because there was no sale or exchange of a capital asset. Moreover, §104(a)(2) did not apply because there was no physical injury. So it upheld the Service's denial of the taxpayer's refund claim.

The taxpayer didn't stop there, appealing the capital gain ruling to the Federal Circuit. But the appellate court affirmed. Even if the taxpayer could show that the goodwill in his separate consulting business was a capital asset, there was no sale or exchange of that asset. No property was transferred to the bank and any goodwill in the business remained with the taxpayer. The settlement agreement made no mention of the goodwill either.

Y. RALPH LAUREN SALESMAN CANNOT DEDUCT COST OF CLOTHING REQUIRED FOR HIS JOB (*Barnes v. Commissioner*, T.C. Memo. 2016-79, April 27, 2016).

In 2010 the taxpayer took a sales job with Ralph Lauren. The employer required sales staff to wear Ralph Lauren clothing while representing the company. The taxpayer tried to deduct the cost of the Ralph Lauren clothes he purchased as an unreimbursed employee expense, but the Service tore the deduction to shreds, citing the long line of precedent that clothing suitable for ordinary wear away from the job is not a deductible business expense. The Tax Court agreed, and even upheld the imposition of a 20% negligence penalty.

The more interesting issue in the case relates to the contribution of used clothing and household items to the Salvation Army in that same year. The taxpayer got receipts, all describing the various contributions (e.g., "4 box of clothes," "1 printer"). But the receipts did not reflect the value of the donated goods. When the Service disallowed the deductions, the taxpayer produced "summary sheets" listing the values at the time of donation. Most of these amounts were calculated with reference to the Salvation Army's "Donation Value Guide." But the summary sheets list assets not reflected on any of the receipts. The Tax Court held these sheets, together with the receipts, did not constitute adequate substantiation for the $5,030 in claimed charitable donations. It thus upheld the assessed deficiency but waived the application of the 20% negligence penalty as to the charitable contribution deduction, for while the documentation submitted did not provide adequate substantiation, it offered proof of the taxpayer's good faith attempt to comply with the law.

Z. RELATIONSHIP ISSUES

Payments for Sex are Gross Income (*United States v. Fairchild*, 8th Cir., March 17, 2016). The taxpayer was sentenced to 33 months in prison for making a false tax return. This is an appeal of her conviction, in which she claims there was insufficient evidence that she willfully underreported her gross income. For the years at issue, the taxpayer reported gross income ranging from $120,000 to just over $150,000 from her work as a professional adult entertainer. But bank records suggest the taxpayer received 37 checks from one man (not her husband or any other related party) totaling over $1 million, plus six checks from another guy totaling $50,000. None of these payments made their way onto any tax returns. The taxpayer said she gave private dances to the men making the payments but insisted they were all gifts. The free private dances were her way of thanking the men for their payments. Interestingly, there was one year in which some of the payments were reported as income. That, according to the taxpayer, was to relieve the man of having to pay gift tax on the transfers. The men told a different story, both of them testifying that the payments were in exchange for sex.

The Eighth Circuit found that there was sufficient evidence to support the jury's finding that the taxpayer willfully filed false tax returns by not including all of the payments in gross income. Although the taxpayer testified she truly believed she accurately reported the portions of the payments that were compensation, "they jury was free to disregard [her] statements as not credible." The court also rejected claims that the jury instructions were improper and that the sentence is unreasonably long.

Using the 1099-MISC as a Post-Breakup Weapon (*Blagaich v. Commissioner*, T.C. Memo. 2016-2, January 4, 2016). Lewis (age 72) and Diane (age 54) dated for about 18 months. During that time, Lewis provided Diane with cash and property (including a Corvette) worth over $743,000. Late in the relationship they entered into an agreement whereby Lewis agreed to provide financial accommodation to Diane and whereby both parties agreed to remain monogamous. When Diane moved out after the termination of their relationship, Lewis sent her

a notice of termination of their agreement. Some time later, Lewis came to believe Diane was dating another man.

In 2011, Lewis sued Diane seeking repayment of the cash and property transferred to her. He also filed a 1099-MISC reporting that he had paid over $743,000 to Diane. The lawsuit ended in 2013 when the court found Diane liable for fraudulent inducement. It ordered her to pay $400,000 to Lewis's estate; the rest of the payments made to Diane (including the car) were "clearly gifts" that she was entitled to keep. So Lewis's estate filed a revised 1099-MISC for 2010 reporting $400,000 as compensation paid to Diane.

The Service increased Diane's 2010 gross income by the $743,000 reported on the original 1099-MISC. That led to the deficiency and accuracy-related penalty that was the subject of this case before the Tax Court. At this point we are at the summary judgment phase, and Diane has Diane argued that the modified 1099-MISC should be controlling such that only $400,000 is at issue, and she further claimed the state court's determination that the $400,000 was a gift should be binding here. But the Tax Court noted that the Service was not a party to the state court action, so it is not estopped by the state court's determination as to how much, if any, of the amount paid to Diane was a gift.

Diane then argued that although she received the $743,000 in 2010, she should not have income because of the repayment obligation. But the court noted that the obligation to repay any portion of the $743,000 did not arise until 2013, so the doctrine of rescission could not apply to supplant application of the claim of right doctrine.

AA. DAMAGE RESULTING FROM GRADUAL DETERIORATION NOT A CASUALTY (*Alphonso v. Commissioner*, T.C. Memo. 2016-130, July 14, 2016).

The taxpayer owned stock in a cooperative housing corporation that owned properties in upper Manhattan. She leased an apartment in a building owned by the co-op. In 2005, a retaining wall owned by the co-op collapsed, causing substantial damage. The co-op levied an assessment against each of its shareholder-tenants for repairs. The taxpayer paid her portion of the assessment ($26,390) and then deducted this amount on her 2005 income tax return as a casualty loss. After applying the $100 floor and the 10%-of-AGI limit, her net deduction was $23,188.

The Service disallowed the deduction, concluding that the collapse of the retaining wall was a result of gradual weakening, and therefore was not a casualty. The Service then maintained that any casualty loss deduction would be claimed by the co-op and not by its shareholders. It was on this latter point that the Tax Court denied the deduction in a 2011 case. The taxpayer did not have a property interest in the co-op's grounds (she didn't lease the retaining wall, she didn't have an easement over that wall, she didn't have any kind of property interest in the wall or any of the co-op's grounds) so she could not claim the payment as a casualty loss deduction. The taxpayer argued she should be able to deduct the payment under §216(a), which allows shareholder-tenants of co-ops to deduct their shares of the co-op's taxes and interest expenses.

The Tax Court rejected this argument, noting that §216(a) is simply designed to put co-op shareholder-tenants on an even keel with homeowners as regards taxes and interest expenses. It does not cover casualty losses or expenses of the kind incurred here.

On appeal, however, the Second Circuit reversed. It held that under applicable state law (New York), the taxpayer had a property interest, namely the right to use the grounds, though shared with other residents of the cooperative. It thus remanded the case back to the Tax Court for a determination as to whether the damage was the result of a sudden "casualty" or just gradual weakening.

The taxpayer said the damage was the result of five consecutive months of excessive rainfall, but the Tax Court was unimpressed with the taxpayer's expert. It found the Service's expert more persuasive, thus adopting his conclusion that the cause was more likely due to "tension cracks" formed at and shortly after construction. Thus, the damage resulted from progressive deterioration and not from a casualty.

Department of Labor Fiduciary Rule

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Agenda

- Overview of the rule
- Key areas of change
- Exemptions

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Key Highlights of the DOL Fiduciary Rule

Treatment of Tax Qualified Dollars Saved for Retirement

On April 6, 2016, the U.S. Department of Labor (DOL) released its final regulations redefining ERISA's "investment advice fiduciary' definition and related exemptions (the "Rule").

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Overview of the Rule

Qualified Dollars + Advice for Compensation = ERISA Fiduciary

ERISA Fiduciary = Best interest standard + Disclosures + Eliminate conflicts of interest

Exemptions = Allow ERISA Fiduciaries to receive compensation for selling qualified products to retirement investors

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Overview of the Rule

The Rule seeks to protect retirement plans, plan participants and IRA owners (“retirement investors”) from financial harm that may be caused as a result of conflicted investment advice by:

- Significantly expanding the types of communications that constitute fiduciary investment advice;
- Making financial representatives ERISA fiduciaries whenever they are providing investment-related advice to, or engaged in a sales transaction with, a retirement investors;

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Overview of the Rule (cont.)

The Rule seeks to protect retirement plans, plan participants and IRA owners ("retirement investors") from financial harm that may be caused as a result of conflicted investment advice by:

- Subjecting fiduciaries to ERISA's duty to act prudently and with undivided loyalty (i.e., in the best interest) to retirement investors;
- Prohibiting fiduciaries from having an interest that conflicts with the interests of the plan, plan participant or IRA owner, unless an exemption applies.

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The Rule's Broad Scope

The Rule generally covers any recommendations related to product sales involving qualified dollars, including:

- 401(k) Rollovers;
- Movement to managed accounts involving Registered Investment Advisors ("RIA"); and
  - Once assets are transferred into the RIA Managed Account, advisor will received fixed advisor management fees, which are considered to be unconflicted
  - However, the advice to transfer assets into the RIA account is conflicted advice, and must be in the best interests of client
- Strategies that use distributions from a qualified account that are used to purchase life insurance.

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COVERED PRODUCTS

In general, covered products include:

- Annuities (fixed, fixed index, variable and group)
- Mutual funds
- Assets in brokerage accounts
- Advisory programs (CRIA)
- Referrals to other managers (referral programs)

In general, impacted account registrations are retirement accounts such as:

- 401(k)s
- 403(b)s subject to ERISA
- IRAs
- Pension plans
- Defined benefit plans
- Money purchase plans

In addition, the Rule impacts recommendations to:

Distribute assets from a retirement account (e.g., IRA roll-overs); and
Move IRA assets from a commission-based account to a fee-based account.

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EFFECTIVE:
JUNE 7, 2016

APPLICABLE:
APRIL 10, 2017

TRANSITION PERIOD:
APRIL 10, 2017-JAN. 1, 2018

FULL APPLICABILITY:
JAN. 1, 2018

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Best Interest Standard

In general, the Best Interest Standard will apply to all interactions with retirement investors.

The Best Interest Standard requires that advice:

- Reflects the care, skill, prudence and diligence that a prudent person would use,
- Based on the investment objectives, risk tolerance, financial circumstances and needs of client,
- Without regard to the financial interests of the representative, firm, affiliate or other party.

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What Does Best Interest Actually Mean?

- Know your client;
- Analyze all available options;
- Eliminate conflicts and provide necessary disclosures;
- Make prudent recommendations; and
- Complete quality documentation
  - Most Financial Service Firms are implementing more robust standards for:
    - Data gathering,
    - Customer needs analysis,
    - Recommendations and
    - Documentation

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Exemptions

There are two main exemptions under the Rule that allows Financial Service Advisors to continue selling financial products to retirement investors:

- Best Interest Contract (BIC) exemption, and
- Prohibited Transaction Exemption 84-24 (PTE 84-24)

Both exemptions require that financial advisors act in the retirement investor's best interest and that all other requirements of the exemption be complied with

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Exemptions under the DOL Rule

- Best Interest Contract (BIC) exemption
  - Proprietary Variable Annuities and Fixed Income Annuities
  - Non-proprietary Variable Annuities, brokerage and mutual funds
  - Recommendations to open and invest in managed Registered Investment Account (RIA) arrangements or platforms
- Prohibited Transaction Exemption 84-24 (PTE 84-24)
  - Qualified fixed annuities
  - Life insurance inside qualified plans
  - Recommendations in which distributions from qualified accounts are used to purchase life insurance
- Funds managed within advisory accounts can be in an un-conflicted model which does not require the use of the exemption. In that case, the addition or transfer of new funds will require the exemption.

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Eliminating Conflicts of Interest

- Eliminating conflicts of Interest will entail:
  - Levelizing compensation within product lines;
  - Eliminating incentives to sell one product over another, or to earn extra compensation for additional qualified sales; and
  - Evaluating “neutral factors” to assess whether differential compensation across certain products could be appropriate.
    - Such neutral factors would include time involved in explaining product, expertise and knowledge needed, licensing requirements and complexity of product

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BICE Specifics

Best Interest Contract Exemption

- Acknowledgement of Fiduciary Status
- Compliance with Standards of Impartial Conduct
  - Best Interest – Investment advice will be in best interest of Retirement Investor
  - Reasonable Compensation
  - No Misleading Statements
- Provision of Warranties

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BICE Specifics

Warranties

- Adoption of Policies and Procedures by Financial Institution
  - Reasonably designed to mitigate impact of "material conflicts of interest" that could affect exercise of judgment of fiduciary
- Compensation Structure
  - Financial Institution will not use incentives that encourage recommendations not in Investor's best interest ("conflicted interest compensation")
    - Avoid compensation thresholds that enable advisor to increase earnings through increased sales
    - Eliminate all forms of trips, clubs, bonuses or recognition on qualified sales
    - Monitor recommendations
    - Develop metrics for good and bad behavior
    - Compliance with applicable laws

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BICE Specifics – Warranties (cont.)

- Contractual Disclosures
  - Disclose all material conflicts of interest
  - Investors right to obtain complete information on all fees and compensation
- Prohibited Provisions
  - No exculpatory provisions disclaiming or limiting liability
- Disclosures
  - Per transaction
  - Annual
- Web page with compensation and other required information
- Notice to Department of Labor of intended BICE reliance
- Data Retention and Recordkeeping

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PTE 84-24 Specifics

- Transaction in ordinary course of business
- At least as favorable as an arms-length transaction with unrelated party
- Reasonable compensation
- Impartial Conduct Standards complied with:
  - Act in "best interest" of client at time of transaction
  - Statements are not materially misleading
    - Failure to disclose relevant material conflict of interest is a misleading statement
- Disclosure materials:
  - If the agent, broker or consultant is an affiliate of the insurance company whose contract is being recommended
  - Commission in first and subsequent years in connection with purchase
  - Any charges, fees, discounts or adjustments which may be imposed under the contract in connection with purchase, holding, exchange or termination or sale

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Grandfathering

The Rule includes an expanded "grandfathering" provision for retirement accounts in existence as of the Applicability Date (April 10, 2017). This will permit financial advisors to continue to receive trail and renewal compensation on existing business, even if certain advice (e.g., hold recommendation) is provided.

Advice must be in the retirement investor's best interest. The grandfather does not cover advice relating to new or additional investments in a grandfathered account, but does apply to systematic deposits and automatic rebalancing if they were in place prior to the Applicability Date.

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Education Carve Out

The Rule reaffirms an advisor's ability to provide education to plan participants. It does not change how financial advisors should be interacting with plan participants.

The Rule recognizes four categories of investment education that financial advisors can provide to clients without providing fiduciary advice:

- Plan information;
- General financial and investment information;
- Asset allocation models; and
- Interactive investment materials.

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Education Carve Out

What does education mean?

- Includes guidance tools and asset allocation models in the employer-sponsored plan space as they are still deemed education, subject to specific requirements
- Specific investment menus and information can be provided in Request for Proposal responses.

The DOL clarified that education/asset allocation models may include specific references to a retirement plan's investment options (however, such specific recommendations are still not permitted for IRAs).

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Sellers Exception for Sales to Large 401(k)s

The DOL retained but significantly modified the Seller's Carve-out providing that sales to retirement plans with at least $50 million in assets under management do not cause the financial advisor to become a fiduciary as long as he or she complies with the requirements of the carve-out.

The Seller's Carve-out based upon the number of participants was eliminated from the final rule.

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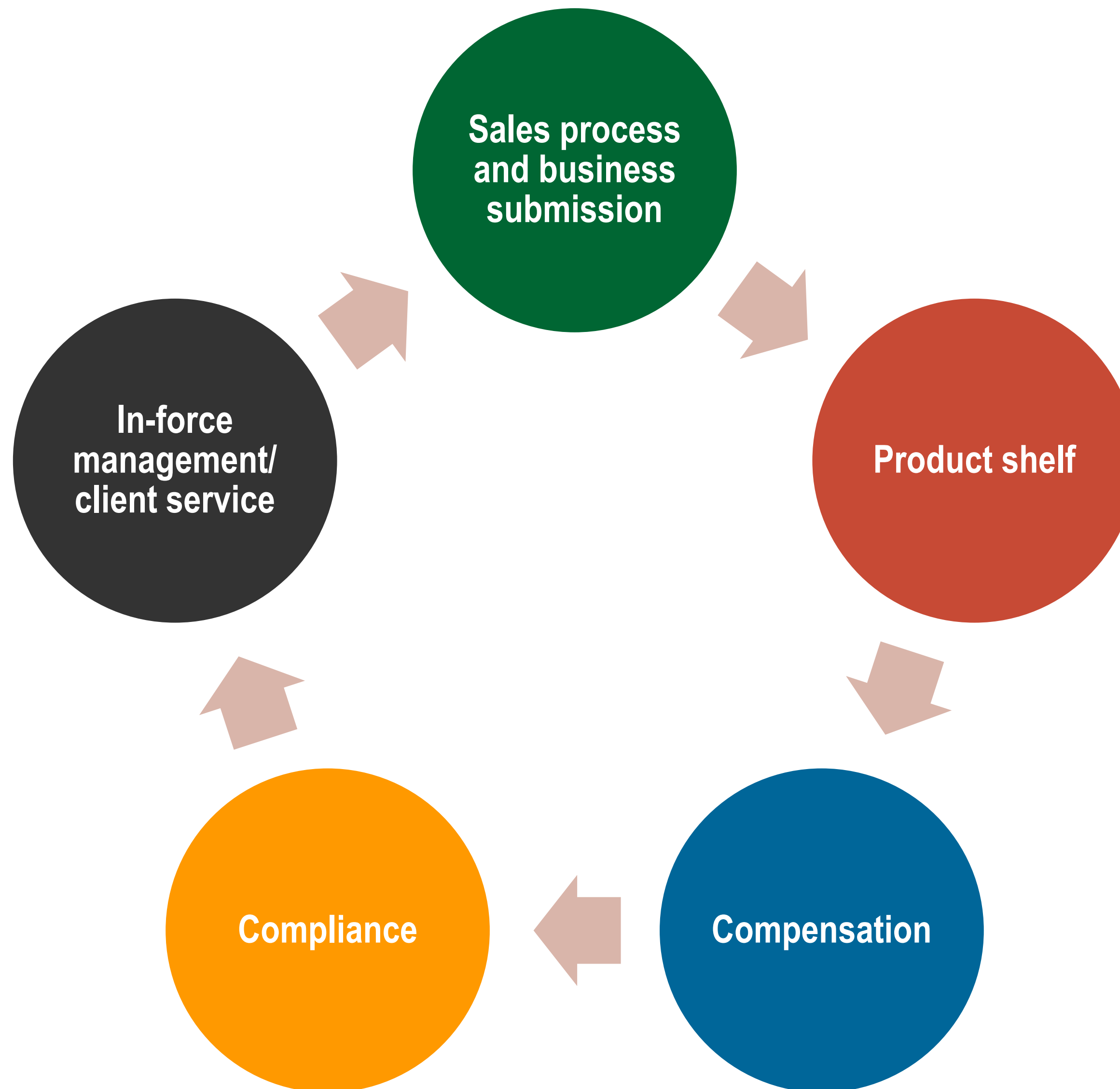
Key areas of change



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Sales process and business submission

- New Sales processes will be required to meet DOL Rule's new Best Interest Standard
- Financial service firms are currently working with their representatives to define new process requirements and develop tools and training
- Training
  - Fiduciary
  - Compensation
  - New sales process

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Product shelf

- Financial Service Firms are revising and limiting their product shelf in order to gain greater control over the process and options that are available to their representatives

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Benefits

- DOL Rule allows for benefits—an industry win
- At certain insurance companies “Career Agents” are statutory employees to the extent of their sales of their sponsoring company’s proprietary products
- Qualified proprietary sales will count toward:
  - Qualifying for benefits threshold (i.e. health insurance); and
  - Receiving retirement benefit credits.

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Life insurance in Qualified Plans

- Life insurance in qualified plans is in scope and falls under PTE 84-24
  - This includes whole life, variable life (VL), variable universal life (VUL)
- Many Insurance companies are still evaluating the risk and impact to non-qualified life sales resulting from distributions from qualified plans as the source of funds (i.e., required minimum distributions)
- Under PTE 84-24:
  - Compensation does not have to be levelized, but must be reasonable
  - Insurers are required to eliminate secondary compensation and recognition on qualified sales
  - In addition to the compensation changes, PTE 84-24 also requires new disclosures and that recommendations made are in the best interest of the client

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In-force management/client service

- Financial Service Firms are still working on:
  - Strategies to minimize change disruption with in-force business
  - Evaluating strategies that would incorporate grandfathering for certain relationships
  - Rate levelization and impact

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Marketplace Reaction/Issues

- Mutual Funds do not pay uniform sales loads
  - Some firms are establishing their own “breakpoint” for sales loads and only offering mutual funds that comply with their breakpoint schedule
    - SEC issues with ability to amend registration statement to disclose and create new sales load options
    - SEC released guidance on December 19th, 2016 to make it easier to comply with registration requirements
  - A January 6, 2017 Morningstar article (“Lower-Cost T Shares Coming to a Fund Near You”) discusses a new class of mutual funds – “T Shares” – being promoted with a 2.5% sales load and annual .25% 12b-1 fees. All other dealer allowances are not permitted.

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Tax Planning & Compliance Issues for Asset Protection Trusts

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A. Incomplete Gift Trusts.

1. Generally, gratuitous transfers to wealth protection trusts are structured to qualify as incomplete gifts for Federal gift tax purposes because most individuals who establish and fund such trusts plan to transfer assets to the trust in excess of the $5,000,0000 (as indexed from the base amount) lifetime gift tax exemption amount under §2505 of the Code.[1] A number of techniques can be used to design a trust to cause gifts to the trust to be deemed as incomplete gifts for gift tax purposes, however, not incomplete for property law purposes.

2. Section 2501 imposes a tax "on the transfer of property by gift." The gift tax imposed under § 2501 applies whether the transfer is in trust or otherwise, whether the transfer is direct or indirect, and regardless of the property transferred. § 2511(a). Nonetheless, the gift tax under § 2501 is imposed only if a donor parts with such dominion and control over the property to render the gift complete. Regs. § 25.2511-2.[2] If upon a transfer of property the donor reserves any power over its disposition, the gift may be wholly incomplete, or it may be partially complete and partially incomplete depending upon all the facts in the particular case. Regs. § 25.2511-2(b). Accordingly, in every case of a transfer of property subject to a retained power, the terms of the power must be examined and its scope determined. Regs. § 25.2511-2(b). Regulation § 25.2511-2(b) provides in part:

> if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift.

a. A gift is incomplete if and to the extent that a donor reserves the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Regs. § 25.2511-2(c). See also *e.g.*, PLR 201507008. A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment of the gift, *i.e.*, change the timing of a beneficiary's enjoyment. Regs. § 25.2511(d).

b. In *Sanford's Estate v. Com'r.*, 308 U.S. 39 (1939), a donor transferred property to a trust reserving the power to modify and revoke the trust and revest the title to all of the trust assets in himself. Five years later the donor released the power to revoke the trust, however, he reserved the power to continue to modify it. In the grantor's written

[1]All references to the "**Code**" found herein are to the Internal Revenue Code of 1986 as amended and all references to sections ("**§**") are to sections of the Code unless otherwise provided herein.
[2]All references to the "**Regulations**" or the "**Regs.**" are to the Treasury Regulations promulgated under the Code.

release and reservation of his power to revoke and modify, he specifically provided that his continuing power to modify the trust should not include the power to withdraw principal or income. The issue under consideration was whether an *inter vivos* transfer of property to the trust by the donor reserving to himself the power to designate new beneficiaries (other than himself) constituted a completed gift. The court noted that:

> 'taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed' [citations omitted] *and that the retention of control over the disposition of the trust property, whether for the benefit of the donor or others, renders the gift incomplete until the power is relinquished whether in life or at death*. The rule was thus established, and has ever since been consistently followed by the Court, that a transfer of property upon trust, with power reserved to the donor either to revoke it and recapture the trust property *or to modify its terms so as to designate new beneficiaries other than himself is incomplete*, and becomes complete so as to subject the transfer to death taxes only on relinquishment of the power at death. [Emphasis added.] *Id*. at 43.

See also Regs. § 25.2511-2(f).

Where a donor retains the power to change or modify the beneficial interests in a trust such a power will cause the gratuitous transfer of property by the donor to the trust to be incomplete for gift tax purposes, even if the exercise of such power can be defeated by the actions of other parties. See *Goldstein v. Com'r.*, 37 T.C. 897 (1962) and *Estate of Goelet v. Com'r.*, 51 T.C. 352 (1968).

c. i. Under the foregoing rules, if the donor-settlor is the sole current beneficiary of a trust and retains a testamentary special power of appointment over trust property, any gratuitous transfers by the donor to the trust will constitute incomplete gifts for Federal gift tax purposes.

ii. It should also be possible for a donor-settlor to retain a testamentary special power of appointment over the trust to avoid a taxable gift even though the settlor may be one of a class of permissible beneficiaries to whom an independent trustee may at any time make distributions of income and principal in such trustee's sole, absolute and uncontrolled discretion (that is, a "**pot trust**"). See *e.g.*, Regs. § 25.2511-2(b); PLRs 9030005, 200148028, 200247013, 200502014, 200612002, 200647001, 200715005, 200729025, 200731019 and 200731019. See also Wells, "Domestic Asset Protection Trusts-A Viable Estate and Wealth Preservation Alternative," LXXVVII The Florida Bar Journal 44 (May 2003); and Fox & Huft, "Asset Protection and Dynasty Trusts," Vol. 37 No. 2 Real Property Probate and Trust Journal 287 (Summer 2002). The foregoing concept is similar to the gift tax rule set forth in Regs. § 25.2511-1(h)(4) which provides:

> ***If A creates a joint bank account for himself and B (or a similar type of ownership by which A can regain the entire fund without B's consent) there is a gift to B when B draws upon the account for his own benefit, to the extent of the amount drawn without any obligation to account for a part of the proceeds to A.*** Similarly, if A purchases a United States savings bond, registered as

payable to "A or B," there is a gift to B when B surrenders the bond for cash without any obligation to account for a part of the proceeds to A. [Emphasis added.]

See also PLRs 201410001, 201410002, 201410003, 201410004, 201410005, 201410006, 201410007, 201410008, 201410009 and 201410010 all providing:

> Further, Grantor retained Grantor's Testamentary Power to appoint the property in Trust to any person or persons or entity or entities, other than Grantor's estate, Grantor's creditors, or the creditors of Grantor's estate. Under §25.2511-2(b) the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of this power causes the transfer of property to Trust to be incomplete with respect to the remainder in Trust for federal gift tax purposes.

Nevertheless, use of a testamentary special power of appointment as the sole mechanism to cause a gift to be incomplete for Federal gift tax purposes has been called into question after the release of Chief Counsel Memorandum 201208026. In IRM 201208026, two settlors created an irrevocable trust and gratuitously transferred property to it. The trustee of the trust was a child of the settlors who was also a current beneficiary (that is, an adverse party for tax purposes), and the beneficiaries during the lifetime of the settlors were the settlors' children, other descendants, and their spouses. The only power the settlors retained was a testamentary limited power of appointment. The trust was to terminate when both settlors died. The ruling held that transfers to the trust were completed gifts because during the term of the trust the settlors retained no dominion or control over trust assets. The fact that the settlors retained a limited testamentary power of appointment was insufficient to treat the transfers as incomplete gifts. Perhaps a critical difference between the terms of the trust in IRM 201208026 to the terms of the trust in all of the other authority discussed above is that neither settlor was a current beneficiary of the trust, that is, the trustee could not make any distribution of trust property to either settlor. For an additional discussion of some of the practical issues created by this memorandum and some revisions to the trust agreement which may have allowed the settlors to achieve their goals in establishing the trust, see "Gift Taxes: Chief Counsel Memorandum Switches IRS Position on Completed Gifts," 54 DTR G-6 (March 20, 2012) and Zaritsky, Gans & Blattmachr, "Chief Counsel Advisory 201208026," LISI Estate Planning Newsletter #1936 (March 6, 2012) at http://www.leimbergservices.com. See also Rubin, "CCM 201208026: Using Testamentary Powers of Appointment to Create Incomplete Gifts-The IRS Throws Down the Gauntlet," LISI Estate Planning Newsletter #1959 (May 8, 2012), at http://www.leimbergservices.com; Aucutt, "Ron Aucutt's Top Ten Estate Planning and Estate Tax Developments of 2012," LISI Estate Planning Newsletter #2043 (December 31, 2012) at http://www.leimbergservices.com; and Gassman, *et. al*, "Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get?," LISI Asset Protection Planning Newsletter #207 (September 11, 2012) at http://www.leimbergservices.com.

a. Under Regulation § 25.2511-2(e) a donor is considered as possessing a power if the power is exercisable by the donor in conjunction with any person who does not have a substantial adverse interest in the disposition of the transferred property or the income from such property. A person who serves as a trustee is not considered as possessing an

adverse interest in the disposition of such property or its income merely by reason of such person's position as a trustee. Regs. § 25.2511-2(e). (See *e.g.*, PLR 201507008 providing, "Trustor also retained a Lifetime Limited Power of Appointment to appoint income and principal to the issue of Trustor's father or Foundation. Trustor's Lifetime Limited Power of Appointment can only be exercised in conjunction with the Trust Protector. Under §§ 25.2511-2(e) and 25.2514-3(b)(2), Trustor is considered to solely possess the power to exercise Trustor's Lifetime Limited Power of Appointment because the Trust Protector (who is merely a coholder of Trustor's Lifetime Limited Power of Appointment) has no substantial adverse interest in the disposition of the assets transferred by the Trustor to Trust because (i) the Trust Protector may not have any beneficial interest in any trust (whether before or after the Trustor's death), (ii) the Trust Protector is not a permissible appointee of the Trustor's Lifetime Limited Power of Appointment, and (iii) the Trust Protector is not a taker in default of the exercise of the Trustor's Lifetime Limited Power of Appointment.") See also PLR 201525002 and PLR 201525003 both providing:

> because the CDA, either Spouse or the LLC, or in default, the Trust Protector, does not have a substantial adverse interest to Grantor's Consent Veto Power, under § 25.2511-2(e), Grantor is considered as having himself the power to veto any Charitable Quarterly Distribution to Grantor's Charities for any reason and for no reason. Accordingly, based upon the facts submitted and representations made, we conclude that the Proposed Transfer of property to Trust will be an incomplete gift, assuming Grantor retains Grantor's Consent Veto Power, Grantor's Sole Discretionary Veto Power, and Grantor's Testamentary Power.

See also, *Camp v. Com'r.*, 195 F.2d 999, 1004 (1st Cir. 1952). In *Camp*, the grantor reserved a power to revoke a trust in conjunction with half-brother ("**B**") or mother ("**M**"). The terms of the trust provided for income to be paid to the grantor's spouse during her life and at her death, principal would be paid to M for her life, and at M's death, to B. The court held that M and B had no interest in the life estate given to the grantor's spouse. Therefore, neither the interests of M nor B were adverse to the termination of the life estate for grantor's spouse. The court held that the Treasury Regulation (a predecessor to Regs. § 25.2511-2(e)) provides that where a grantor reserves the power to terminate a beneficiary's interests even with the concurrence of a third party who has no interest in the trust adverse to such termination, it is in reality the same as if the grantor retained such power himself. See also *Paxton v. Com'r.*, 57 T.C. 627 (1972); and *Joseloff v. Com'r*., 8 T.C. 213 (1947).

B. Completed Gift Trusts.

1. In Revenue Ruling 76-103, 1976-1 C.B. 293, a settlor established an *inter vivos* trust. The terms of the trust provided that the trustee could distribute income or principal to the settlor in the trustee's "absolute discretion." Upon the death of the settlor any remaining principal was payable to the descendants of the settlor. The circumstances surrounding the creation of the trust indicated that it had not been created primarily for the settlor's benefit. The trustee was given the absolute discretion to change the situs of the trust to another state. The trust was considered a "**discretionary trust**" in the state where it was established and administered. Furthermore, under the law of the state where the trust was created and

administered all of the property in a discretionary trust "**may be subjected to the claims of the grantor's creditors, whenever such claims may arise**."

The issue addressed in the ruling was whether the transfer to the trust was an incomplete gift for federal gift tax purposes because all of the assets transferred to the trust were subject to the claims of the grantor's creditors. The ruling held that the gift was incomplete because both "prior and subsequent creditors" of the settlor could reach the maximum amount of trust property the trustees could in their discretion distribute to the settlor. Thus, the ruling noted that the settlor could enjoy all trust property "by relegating [his] creditors to the trust for settlement of their claims." Case law supports the holding in Revenue Ruling 76-103. See *e.g.*, *Outwin v. Com'r*, 76 T.C. 153 (1981); *Paolozzi v. Com'r*, 23 T.C. 182 (1954). See also *Estate of Paxton v. Com'r*, 86 T.C. 785 (1986) (Estate tax inclusion based on creditor's rights doctrine).

2. The opposite result was reached in Revenue Ruling 77-378, 1977-2 C.B. 347, where the settlor's creditors could not compel distributions under state law. In this ruling a settlor contributed one-half of his "income-producing property" to a trust with a corporate trustee. The trustee was given the power to distribute trust income and principal to the settlor in its "absolute and uncontrolled discretion." Upon the settlor's death, the trust was directed to terminate and the assets distributed to the settlor's spouse and children. Unlike the facts in Revenue Ruling 76-103, "under applicable state law the trustee's decision whether to distribute trust assets to the grantor [was] entirely voluntary." The settlor could not require any trust property be distributed to him. Additionally, the settlor's creditors could not reach any of the assets in the trust. The ruling stated:

> Even though a trustee may have an unrestricted power to return all of the trust's assets to the grantor, if the grantor's interest in the trust is not enforceable either by the grantor or on the grantor's behalf, then the grantor has parted with dominion and control over the property transferred into the trust. See section 25.2511-2(b) of the regulations. Furthermore, if the grantor retains such a mere expectancy that the trustee will distribute trust assets to the grantor rather than an enforceable interest in the trust, the expectancy does not prevent the completion or reduce the value of the gift. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d. Cir. 1941).

The holding in Revenue Ruling 77-378 is also supported by case law. See *e.g.*, *Wells v. Com'r*, T.C. Memo 1981-574 (no estate tax inclusion because transfer constituted complete *inter vivos* gift); *Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957); *Estate of German v. United States*, 85-1 U.S.T.C. 13,610 (Ct. Cl. 1985) (same). The IRS continues to adhere to this result in its publicly released but nonbinding documents. See *e.g.*, PLR 200944002; PLR 9837007, PLR 9332006; PLR 8829030; PLR 8037116; PLR 7833062; TAM 8213004.

Taxpayers and Internal Revenue Service personnel are permitted to rely on revenue rulings to determine the tax effect of a transaction. See Rev. Proc. 89-14, 1989-1 CB 814, §§ 7.01(4), 7.01(5). According to §§ 7.01(5) and 7.01(6) Revenue Procedure 89-14:

> Taxpayers generally may rely upon revenue rulings, and revenue procedures published in the Bulletin in determining the tax treatment of their own

> transactions and need not request specific rulings applying the principles of a published revenue ruling or revenue procedure to the facts of their particular cases. However, taxpayers, Service personnel and others concerned are also cautioned to determine whether a revenue ruling or revenue procedure on which they seek to rely has been revoked, modified, declared obsolete, distinguished, clarified or otherwise affected by subsequent legislation, treaties, regulations, revenue rulings, revenue procedures or court decisions.

Thus, taxpayers are entitled to rely on the holding in Revenue Ruling 77-378 in structuring gifts to a trust settled in a jurisdiction that does not apply the self-settled trust doctrine to certain types of irrevocable trusts. Unless presented with substantially different facts, it is unlikely that the Internal Revenue Service would take a litigation position inconsistent with its position set forth in a published revenue ruling.

3. **PLR 200944002**. In PLR 200944002, the grantor wanted to establish an irrevocable trust for the benefit himself and his wife and descendants. Initially, he proposed to fund the trust with a cash gift and have an independent trust company serve as the sole trustee. Under the terms of the trust the trustee would be granted the authority to distribute the income and principal in such amounts and proportions as it determines in its sole and absolute discretion for the benefit of one or more members of the class consisting of the grantor, his wife and his descendants. Any income not so distributed would be accumulated and added to principal.

Also to be included under the terms of the trust, upon its termination no part of the income or principal could be distributed to the grantor, his estate, his creditors or the creditors of his estate. Upon the death of the survivor of the grantor and his wife, the remaining principal and accrued income of the trust would be directed to be allocated to any descendant of the grantor then living to be held in separate trusts. If no such descendant was then living, the remaining principal and accrued income would be distributed to one or more charitable organizations.

The trust agreement would also provide that neither the grantor, his wife, a former wife of the grantor; any beneficiary of a trust under the agreement, the spouse or former spouse of any beneficiary of any trust under the agreement nor any person related or subordinate to the grantor within the meaning of § 672(c) of the Code, could serve as a trustee.

The grantor would also retain the right, exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire trust property by substituting other property of equivalent value. According to the terms of the proposed trust agreement the grantor could exercise this authority by certifying in writing that the property that was transferred in exchange for the trust property is the same value. The trustee would also have a fiduciary duty to ensure the grantor's compliance with the terms of this substitution power. Before the substitution of property is completed, the trustee would need to be satisfied that the properties acquired and substituted are of equal value. Additionally, the substitution power cannot be exercised in a way that could change the beneficial interests of the beneficiaries of the trust.

The trust would also provide that the grantor could not serve as a trustee or remove any trustee of the trust. The trust agreement will also prohibit the trustee from paying the grantor (or his executor) any income or principal to discharge the grantor's income tax liability.

The grantor in this ruling was a resident of Alaska and it was proposed that the trust would also have a situs in Alaska. Under its trust code Alaska permits a settlor to create a self-settled trust and if drafted and implemented properly, the grantor's creditors cannot reach the assets held in the trust to satisfy a judgment against the grantor.

The taxpayer requested the Service rule on the following issues:

(1) Whether the taxpayer would make a completed taxable gift when making a gratuitous transfer to the trust.

(2) Whether any portion of assets in the trust would be includible in the taxpayer's estate at his death.

Completed Gift Issue:

Section 2501 provides that the gift tax applies to the transfer of property by gift during any calendar year by any individual, resident or nonresident.

Section 2511(a) provides that the gift tax applies regardless of whether the gift is made in trust or in another manner, whether the gift is direct or indirect, and whether the property gifted is real or personal or tangible or intangible property.

Section 25.2511-2(b) provides that as to any property or portion of such property where the donor has relinquished such *dominion and control* as to leave the donor with no authority to change its disposition, whether for the donor's benefit or for the benefit of another, the gift is complete.

Section 25.2511-2(c) provides that a gift is not complete in every case where the donor reserves the authority to revest the beneficial title to the property. Additionally, a gift is not complete when a reserved power gives the donor the right to designate new beneficiaries or alter the interests of the beneficiaries between themselves.

In this ruling the Service recognized that the grantor retained no authority to revest beneficial title and he did not reserve any right to designate new beneficiaries or alter the interests of the beneficiaries. As a result, the ruling held that the grantor's gifts to this trust would be treated as completed gifts.

Estate Tax Issue:

The gross estate of a decedent ("**D**") includes the value of all property to the extent of any interest therein in which D made a transfer (except in the case of a *bona fide* sale for adequate and full consideration in money or money's worth), in trust or otherwise, where D retained for life or a period which cannot be ascertained without reference to D's death or does not end prior

to D's death, the possession or enjoyment of, or the right to the income from, the property. § 2036(a)(1).

The use, possession, right to income, or other enjoyment of property that is transferred is treated as being retained to the extent that it is to be applied to the discharge of a legal obligation of D. Regs. § 20.2036-1(b)(2).

The ruling held that the substitution power on its own would not cause the trust to be includible in grantor's gross estate. See Rev. Rul. 2008-16, 2008 I.R.B. 796.

The ruling noted that the trustee was prohibited from reimbursing grantor for income taxes paid by the grantor attributable to income from the trust. Thus, it held that the grantor did not retain a reimbursement right that could cause the Trust to be includible in grantor's gross estate under § 2036. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

Finally, in the most important part of the ruling, the Service held that the trustee's discretionary authority to distribute income and principal to grantor would not by itself be sufficient to cause the assets of the Trust to be includible in grantor's gross estate under § 2036. Prior to this ruling and the advent of the state asset protection trust acts that have been enacted since 1997 the Service was unwilling to rule on the estate tax inclusion issue in cases involving completed gift self-settled trusts. See *e.g.*, 9837007 (holding, "We are expressly not ruling on whether the assets held under the Trust agreement at the time of Donor's death will be includible in Donor's gross estate for federal estate tax purposes"). It should also be noted that the Service was willing to rule on this same issue in regards to a discretionary tax reimbursement provision in PLR 200822008 (discussed *infra*). Thus, the Service was backing off its prior position even before it released PLR 200944002.

PLR 200944002 closed with a warning that it was not ruling in regards to whether the Trustee's authority to make distributions to the grantor combined with other facts (such as a pre-existing arrangement or understanding between the grantor and the trustee regarding such distributions) would cause inclusion of the assets of the Trust in the grantor's estate under § 2036.

The Blackletter law appears to be that a gift is incomplete when a trustee has an unrestricted power to distribute income or principal to a settlor, if the settlor's creditors can reach the trust assets under the self-settled trust doctrine. *Com'r. v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958); *Outwin v. Com'r*, 76 T.C. 153 (1981), *acq*., 1981-1 C.B. 2; *Hambleton v. Com'r.*, 60 T.C. 558 (1973), *acq*. in result, 1974-1 C.B. 1; *Paolozzi v. Com'r.*, 23 T.C. 182 (1954), *acq*. 1962-1 C.B. 4. However, if the settlor's creditors cannot reach the trust assets because the self-settled trust doctrine is not applicable, a gratuitous transfer to such a trust should be a completed gift for purposes of the Federal gift tax provided the settlor has not otherwise retained a power over the trust that would cause gifts to be incomplete or includible in the settlor's estate. See *e.g.*, PLR 200944002; PLR 9837007; PLR 9332006. Thus, it is important to determine the settlor's retained rights. If it is not possible to ensure that anything of value would pass to the other beneficiaries of the trust, the settlor's transfers to the trust will constitute incomplete gifts. Importantly, in a string of private letter rulings, it is apparent that the IRS will respect the situs issues related to the settlement of self-settled trusts for tax planning purposes. See *e.g.*, PLR

201653001; PLR 201653002; PLR 201653003; PLR 201653004; PLR 201653005; PLR 201653006; PLR 201653007; PLR 201653008; PLR 201653009; PLR 201650005; PLR 201636027; PLR 201636028; 201636029; 201636030; 201636031; PLR 201636032; PLR 201628010 (Service deferred ruling on income tax status of trust); PLR 201614008; PLR 201614007; PLR 201614006; PLR 201613009; PLR 201550005 PLR 201550006; PLR 201550007; PLR 201550008; PLR 201550009; PLR 201550010; PLR 201550011; PLR 201550012; PLR 201550005 PLR 201550006; PLR 201550007; PLR 201550008; PLR 201550009; PLR 201550010; PLR 201550011; PLR 201550012; PLR 201510008; PLR 201510007; PLR 201510006; PLR 201510005; PLR 201510004; PLR 201510003; PLR 201510002; PLR 201510001; PLR 201440012; PLR 201440011; PLR 201440010; PLR 201440009; PLR 201440008; PLR 201436032; PLR 201436031; PLR 201436030; PLR 201436029; PLR 201436028; PLR 201436027; PLR 201436026; PLR 201436025; PLR 201436024; PLR 201436023; PLR 201436022; PLR 201436021; PLR 201436020; PLR 201436019; PLR 201436018; PLR 201436017; PLR 201436016; PLR 201436015; PLR 201436014; PLR 201436013; PLR 201436012; PLR 201436011; PLR 201436010; PLR 201436009; PLR 201436008; PLR 201430007; PLR 201430006; PLR 201430005; PLR 201430004; PLR 201430003; PLR 201426014; PLR 201410001, PLR 201410002, PLR 201410003, PLR 201410004, PLR 201410005, PLR 201410006, PLR 201410007, PLR 201410008, PLR 201410009, PLR 201410010, PLR 200148028, PLR 200247013, PLR 200502014, PLR 200612002, PLR 200647001, PLR 200715005, PLR 200729025, PLR 200731019, PLR 200731019, PLR 201310002, PLR 201310003, PLR 201310004, PLR 201310005 and PLR 201310006. Thus, although a grantor is resident in a jurisdiction that recognizes the self-settled trust doctrine, the grantor can establish and transfer assets to a trust in another jurisdiction that does not recognize the doctrine. If the trust is drafted properly, gifts to such a trust will be treated as completed gifts for federal gift tax purposes. By way of example illustrating this point, the taxpayer in PLR 201510001 requested rulings under §§ 671, 2041, 2501, and 2514 of the Code. In PLR 201510001, a grantor (the "**Grantor**") created an irrevocable trust (the "**Trust**"), for the benefit of the Grantor, his issue, his spouse ("**Spouse**"), Individual 1, Individual 2, and Individual 3 (collectively, the "**Beneficiaries**"). The Trust provides that, during the Grantor's lifetime, the trustees shall distribute such amounts of net income and principal as directed by a Power of Appointment Committee (the "**Committee**") and/or the Grantor as follows:

> (1) At any time, the Co-Trustees, pursuant to the direction of the majority of the Committee members, with the written consent of the Grantor, shall distribute to the Grantor or the Beneficiaries such amounts of the net income or principal as directed by the Committee (the "**Grantor's Consent Power**");
>
> (2) At any time, the Co-Trustees, at the direction of all of the Committee members other than the Grantor, shall distribute to the Grantor or the Beneficiaries such amounts of the net income or principal as directed by the Committee (the "**Unanimous Consent Power**"); and
>
> (3) The Grantor shall have the power in a nonfiduciary capacity, at any time, to appoint to any one or more of the Beneficiaries such amounts of the principal as the Grantor deems advisable to provide for such Beneficiary's health maintenance, support and education (the "**Grantor's Sole Power**").

Upon the Grantor's death, the balance of the Trust may be distributed to such persons or entities (other than Grantor, his estate, his creditors, or the creditors of his estate) as the Grantor appoints by his will. In default of the exercise of the Grantor's limited power of appointment, the balance of Trust will be divided into shares and distributed to the Grantor's issue, to Individual 1, to Individual 2, and to Individual 3.

The Trust provides that the Committee may direct distributions from the Trust to or for the benefit of any one or more of Beneficiaries equally, or unequally, and to the exclusion of others. The members of the Committee serve in a non-fiduciary capacity. The Committee is composed of the Grantor, Child 1, Child 2, Individual 1, Individual 2, Guardian 1, and Guardian 2. If the Committee at any time consists of at least three or more members other than Grantor, all the members of the Committee, including the Grantor, may by unanimous vote add one or more members to the Committee provided that such members are beneficiaries of the Trust. If at any time Committee does not include at least one member other than Grantor, the Committee will cease to exist. In any event, the Committee will cease to exist upon Grantor's death.

The taxpayer requested the following rulings:

1. That so long as the Power of Appointment Committee is serving, no portion of the items of income, deductions, and credits against tax of the Trust would be included in computing the taxable income, deductions, and credits of the Grantor or any members of the Power of Appointment Committee under § 671 of the Code;

2. That the contribution of property to the Trust by Grantor would not be a completed gift for federal gift tax purposes;

3. That any distribution of property from the Trust by the Committee to the Grantor would not be a completed gift, by any member of Committee;

4. That any distribution from the Trust by the Committee to any Beneficiary (other than the Grantor) would not be a completed gift by any member of Committee (other than Grantor); and

5. The Committee members do not possess a general power of appointment within the meaning of § 2041 of the Code and, accordingly, the Trust would not be includible in any Committee member's estate under § 2041.

Ruling 1.

The IRS concluded that no provisions of the Trust would cause the Grantor or any other person to be treated as the owner of any portion of Trust under §§ 673, 674, 676, 677, or 678 of the Code. Further, an examination of the Trust revealed no provisions that would cause administrative controls to be considered exercisable primarily for the benefit of the Grantor or any other person under § 675 of the Code. Thus, the circumstances attendant on the operation of the Trust would determine whether Grantor or any other person would be treated as the owner of any portion of the Trust under § 675. The IRS ruled that this was a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved were examined.

Rulings 2 & 3.

Under § 25.2511-2(e) of the Code, a donor is considered as having a power if it is exercisable by the donor in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The Committee members were not deemed to be takers in default for purposes of § 25.2514-3(b)(2) of the Code; they were found to be merely co-holders of the power. Under § 25.2514-3(b)(2), a co-holder 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 Committee ceased to exist upon Grantor's death. Accordingly, the Committee members did not have interests adverse to Grantor under § 25.2514-3(b)(2) or for purposes of § 25.2511-2(e). Therefore, the Grantor possessed the power to distribute income and principal to any beneficiary of the Trust because he retained the Grantor's Consent Power. The retention of the Grantor's Consent Power caused the Grantor's transfer of property to the Trust to be wholly incomplete for federal gift tax purposes.

The Grantor also retained the Grantor's Sole Power over the principal of the Trust. Under § 25.2511-2(c), a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries. In this case, the Grantor's Sole Power gave the Grantor the power to change the interests of the beneficiaries. Accordingly, the retention of the Grantor's Sole Power caused the transfer of property by the Grantor to the Trust to be considered wholly incomplete for federal gift tax purposes.

The Grantor retained a testamentary limited power of appointment over the property in the Trust. Under § 25.2511-2(b)(2), the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of this power caused the Grantor's transfer of property to the Trust to be incomplete with respect to the remainder of the Trust.

The Committee possessed the Unanimous Consent Power over income and principal. This power was not a condition precedent to the Grantor's powers. The Grantor's powers over the income and principal were presently exercisable and were not subject to a condition precedent. The Grantor retained dominion and control over the income and principal of the Trust until the Committee members exercised their Unanimous Consent Power. Accordingly, this power did not cause the transfer of property to the Trust to be complete for federal gift tax purposes. See *Goldstein v. Commissioner*, 37 T.C. 897 (1962); *Estate of Goelet v. Commissioner*, 51 T.C. 352 (1968).

Accordingly, the Service concluded that the contribution of property by the Grantor to the Trust was not a completed gift subject to federal gift tax. Any distribution from the Trust to the Grantor would be considered a return of the Grantor's property; therefore, any distribution of property from the Trust by the Committee to the Grantor would not be a completed gift by any member of the Committee. Additionally, the Service concluded that upon the Grantor's death, the fair market value of the property in the Trust would be includible in Grantor's gross estate for federal estate tax purposes.

Rulings 4 & 5.

The powers held by the Committee members under the Grantor's Consent Power were powers exercisable only in conjunction with the Grantor. Accordingly, under §§ 2514(b) and 2041(a)(2), of the Code, the Committee members did not possess general powers of appointment by virtue of possessing such powers. Further, the powers held by the Committee members under the Unanimous Consent Powers were not considered general powers of appointment for purposes of §§ 2514(b) and 2041(a)(2). As in the examples in Treas. Regs. §§ 25.2514-3(b)(2) and 20.2041-3(c)(2), the Committee members had substantial adverse interests in the property subject to these powers. Accordingly, any distribution made from the Trust to a beneficiary (other than the Grantor) pursuant to the exercise of the Grantor's Consent Power and the Unanimous Consent Powers would not be gifts by the Committee members. Instead, such distributions would be gifts by the Grantor.

The Service concluded that any distribution of property by the Committee to any beneficiary (other than the Grantor) would not be a completed gift by any member of the Committee. Further, the Service concluded that any distribution of property from the Trust to a beneficiary (other than the Grantor) would be a completed gift by the Grantor. Finally, the Service concluded that the powers held by the Committee members were not general powers of appointment for purposes of § 2041(a)(2) and, accordingly, the possession of these powers by the Committee members would not cause the Trust property to be includible in any Committee member's gross estate under § 2041(a)(2).

Importantly, the trust in PLR 201510001 was probably established in Nevada in accordance with the Spendthrift Trust Act of Nevada set forth in § 166.010, *et. seq.* of the Nevada Revised Statutes. This is because that act permits a settlor to retain an *inter vivos* special power of appointment that was included in the trust agreement in the facts of this private letter ruling. See N.R.S. 166.040.2(b). This type of trust (commonly referred to as a "**NING Trust**" or a "**Nevada Income Non-Grantor Trust**") is established by a resident of a state that imposes a state income tax to shift certain income from the settlor's state of residence to Nevada which does not impose an income tax. The only possible way for the Service to conclude that the trust in this ruling qualified as a non-grantor trust for federal income tax purposes was for the Service to respect the situs issue, that is, that a non-resident of Nevada could establish a trust in Nevada and obtain the benefits of its asset protection legislation that applies to self-settled asset protection trusts.

4. Section 2036 of the Code provides:

> The value of the gross estate shall include 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 he has retained for his life or for any period which does not in fact end before his death--(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

5. Section 2038 of the Code provides in pertinent part that:

> The value of the gross estate shall include 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, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person...to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

6. If the settlor is a discretionary beneficiary and his creditors, either existing or future, may under applicable state law reach the trust assets in satisfaction of claims, the trust property will be includible in the settlor's gross estate under §2038 of the Code because of the settlor's power to "terminate the trust by relegating his or her creditors to the entire property of the trust." Rev. Rul. 76-103, 1976-1 C.B. 293; see also, *Outwin v. Com'r*, 76 T.C. 153 (1981), *acq.*, 1981-1 C.B. 2.

7. ***Herzog v. Commissioner***. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d. Cir. 1941). On August 23, 1935, Edward Rayne McComb Herzog ("**Herzog**"), transferred securities with a value of $214,137.38 to a trust with Bank of New York ("**BNY**"), as the corporate trustee, and Douglas S. Gibbs ("**Gibbs**"), as the individual trustee. The trust provided that:

> [T]he trustee should hold, invest and reinvest the securities and any additions thereto, and should pay the net income therefrom to [Herzog] and his wife, so long as they should be living together, at such times and in such proportions as [Gibbs], or his successors, should in his or their discretion deem proper, with power on the part of Gibbs or his successors to allocate the entire net income either to Herzog or his wife so long as they are living together as husband and wife. The trust instrument further provided that the trustees upon the death of the wife, or in the event she should cease to live with the grantor, should pay the net income to him and to his children then living at such times and in such proportions as Gibbs, or his successors, should deem proper, with power to allocate the entire net income to the grantor, or among his said children.

Upon Herzog's death if his wife survived him, the trustees were to divide the trust fund into equal shares for his wife and children. Upon the death of Herzog's wife, the principal of her share was to be paid to Herzog's issue, *per stirpes*. Herzog retained no right to alter, amend or revoke the trust, or to change the beneficial interests as fixed by its terms. On the date of the execution of the trust, Gibbs directed BNY to pay all of the income to Herzog until further notice.

Herzog filed a gift tax return reporting the transfer of the remainder interest. The Service argued that the transfer of all of the securities was subject to gift tax. The Board of Tax Appeals ruled for the Service. Herzog appealed.

The issue on appeal was whether Herzog owed gift tax on the entire property transferred

in trust or only the remainder distributable at or after his death.

On appeal, the Tax Court (the "**court**") held for the Service. The court noted that Herzog retained no right to receive income, only a chance to receive it by reason of the exercise of a power in his favor by Gibbs.

Herzog argued that his creditors could reach the income through a lawsuit directing Gibbs to exercise the power in their favor. The court noted that under New York law, where a trust has been created by a third person, the income of which may be applied to the use of some person in the discretion of a trustee, the trustee could not be compelled to exercise discretion in favor of such third person or the creditors of the latter.

Herzog argued that there was no gift of anything except the remainder because no beneficiary could be identified who was entitled to any intervening estate. See *Porter v. Commissioner*, 288 U.S. 436 (1933). In *Porter*, the grantor of a trust reserved a power to revoke the appointments and to substitute other beneficiaries expressly excepting himself and his estate. The court in *Porter* held that the corpus of such a trust should be included in the grantor's estate and subject to an estate tax because the grantor had not parted with control over it relying on the fact that the grantor controlled the disposition while he lived. The court disagreed with Herzog, noting that he parted with every actual right in the corpus and only retained an expectancy.

Herzog then argued that a gift tax should not be imposed on the intermediate interests in the trust because the corpus could be included in his estate at the time of his death. See *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939). The court disagreed with Herzog. The court noted that the Revenue Act (as then promulgated) provided "for the credit of gift taxes on estate taxes subsequently levied on property included in the gift and that the possibility of overlapping [did] not necessarily preclude the imposition of gift tax" to Herzog's transfer. The court reasoned that Herzog had not retained a right to the income, nor retained in conjunction with any person the right to designate the recipients of it. The court explained that if the transfer was complete, likely a gift tax might be imposed regardless of any possible future estate tax.

8. ***Estate of Gramm v. Commissioner***. *Estate of Gramm v. Commissioner*, 17 T.C. 1063 (1951). Christianna K. Gramm ("**Christianna**") created a trust with the Provident Trust Company ("**Provident**"), Ida G. Betelle and Theodore K. Gramm (Ida and Theodore are collectively Christianna's "**children**") as co-trustees. The trust was funded with all of Christianna's securities. Christianna was to receive net income for life and the trustees were to pay her:

> [W]ith the written consent of her children an[y] part or all of the corpus which she might request in writing; but if her children were incapable of giving her approval or written consent, request by decedent herself for any part of the principal would be sufficient if the corporate trustee, the sole judge, determined they were incapable of giving such written approval or consent.

Provident was also given the power to: "expend out of the share of principal from which any beneficiary under this Deed may be receiving income such sums as Trustees may consider to be proper for the comfort, education, maintenance or support of such beneficiary." The trust also

allowed Christianna to revoke or amend the trust with the consent of her children, or, if Provident determined the children could not give consent, Provident's consent.

The Service determined a deficiency in gift tax, arguing that the transfer in trust was a taxable gift. The court held for Christianna, finding no completed gift since the corpus might have been totally depleted by the time of her death without the consent of any adverse party.

The court focused the issue on whether the trust gave a remaindermen an interest which resulted in a taxable gift. Testimony by an assistant trust officer of Provident noted the fact that the trust was to be revocable without consent as first drafted, however, Provident was reluctant to act as corporate trustee under those circumstances. That testimony was important in helping the court determine whether there was a complete taxable gift as the court pointed out that there was no restriction in the trust limiting the extent to which the principal might be used for Christianna's the "comfort, education, maintenance or support." Provident acted under a power of attorney when dealing with Christianna's property prior to the creation of the trust. As Christianna got older, a trust was created *in lieu* of the power of attorney. Thus, money Christianna might have required for her 'comfort,' was incapable of determination or calculation at the time of the trust's creation.

The court noted that the power granted to Provident to invade the principal for Christianna's benefit was not a completely unfettered power. Under these circumstances, the court could not characterize the transaction as a complete taxable transfer for gift tax purposes.

9. ***Paolozzi v. Commissioner***. *Paolozzi v. Commissioner*, 23 T.C. 182 (1954). On December 21, 1949, Alice Spaulding Paolozzi ("**Alice**"), filed a gift tax return for the tax year 1938. Alice owned cash and securities which became distributable to her on her 21st birthday, May 12, 1938. It was suggested by Alice's legal advisers that Alice place these assets in a trust. On June 21, 1938, Alice created a trust (the "**Trust**") and funded the Trust with the aforementioned cash and securities. The fair market value on June 21, 1938 of the property transferred to the Trust was $276,821.66.

The Trust provided for entirely discretionary distributions of income to Alice during her lifetime with the remainder to be held in further trust for Alice's descendants. At the time of creating the trust Alice was assured by the trustees that they would give her the income of the trust if she wanted it, unless the trustees had reason to believe that Alice was acting under compulsion. At the same time, it was explained to Alice that under the provisions of the trust she had no absolute right, as a matter of law, to demand and receive the income, and that the trustees must take all beneficiaries into consideration.

Concerning the transfer to the Trust, Alice reported total gifts of $71,021.37, which was the value on June 21, 1938 of a remainder of $276,821.66 after a life estate of an individual who was then of Alice's age.

The only question presented was whether Alice was taxable on the entire value of property transferred by her to the Trust on June 21, 1938, or whether Alice retained a life interest in the trust susceptible of valuation which would allow a gift tax deduction.

The Tax Court held that Alice retained an interest in the Trust sufficient to allow Alice a deduction for gift tax purposes because Alice's creditors could look to the trust for settlement of their claims under the law of Massachusetts (the governing law of the Trust).

Alice established the Trust of which trust she was, during her lifetime, the sole beneficiary, at a time when she was contemplating marriage to an Italian citizen. By virtue of such marriage, Alice would, under Italian law, become an Italian national. The Italian government was, at that time, subjecting foreign securities held by its nationals to stringent restrictions. To avoid such restrictions and to thwart possible confiscation of the considerable property which was distributed to her on her 21st birthday, Alice, on the advice of counsel, created the Trust and effected the transfer in question. The trustees were empowered by the terms of the trust instrument to hold, manage, invest, and reinvest the property as a trust fund until Alice's death and to pay to her, during her lifetime, so much of the net income as they in their absolute discretion should deem to be to her best interest. Provisions were made for remainders over to Alice's issue, or in failure thereof, to Alice's sister or brother, or to their issue. Subsequent to the transfer Alice filed a gift tax return in which she reported as a taxable gift only the value of the remainder after a life estate of one then of her age.

The Service argued that Alice's transfer was a completed gift of the entire amount of the property transferred to the Trust because Alice reserved no interest in and control over any beneficial interest in the Trust susceptible of valuation by actuarial methods. The Service argued at most Alice had an expectancy which was not the equivalent of a life estate; and that, therefore, no amount of the value of the gift should be deducted from the value of the property transferred for purposes of computing the gift tax pursuant to § 501 of the Revenue Act of 1932.

Alice argued that under the law of Massachusetts (which governed the Trust), Alice's creditors could reach the maximum amount that the trustees could, in the exercise of the trustees' discretion, pay to her or apply for Alice's benefit. Alice reasoned that she could at any time realize all of the economic benefit of the income accruing to the Trust during her lifetime by borrowing money or otherwise becoming indebted, and then relegating the creditor to the Trust income for reimbursement.

In *Ware* v. *Gulda,* 117 N. E. 2d. 137 (1954), the Supreme Judicial Court of Massachusetts held that a creditor of a settlor-beneficiary of a discretionary trust could reach for satisfaction of a claim the maximum amount which the trustee could pay to the settlor-beneficiary or apply for the benefit of the settlor-beneficiary. The fact that the trustee had not exercised the discretionary power would not preclude such creditor from looking to the trust and obtaining payment out of the trust property to which the debtor, however, for such failure, was entitled. In so ruling, the court said, *inter alia:*

> The established policy of this Commonwealth long has been that a settlor cannot place property in trust for his own benefit and keep it beyond the reach of creditors. *Pacific National Bank v. Windram*, 133 Mass. 175; *Jackson v. Von Zedlitz*, 136 Mass. 342; *Taylor v. Buttrick*, 165 Mass. 547, 551, 43 N. E. 507; *Forbes v. Snow,* 245 Mass. 85, 89, 140 N. E. 418.

The rule applied by the Tax Court was found in Restatement: Trusts § 156 (2):

> Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

In view of the clear exposition of Massachusetts law set out in *Ware* v. *Gulda, supra,* the Tax Court held that Alice's creditors could at any time look to the Trust of which she was settlor and beneficiary for settlement of their claims to the full extent of the income thereof. Alice could therefore at any time obtain the enjoyment and economic benefit of the full amount of the trust income. The Tax Court held that Alice correctly reported the transfer for gift tax purposes.

10. ***Vander Weele v. Commissioner***. *Vander Weele v. Commissioner*, 27 T.C. 340 (1956). On March 25, 1950, Sarah Gilkey Vander Weele ("**Sarah**") created a trust, of which she was the sole life beneficiary, consisting of stocks, securities, and the remainder interest in a testamentary trust created by her grandfather. The trust was expressly irrevocable. The trust required payment to Sarah of the trust income for life or until the receipt of the remainder interest in her grandfather's testamentary trust upon the death of her mother. Thereafter, the trustees were directed to pay Sarah "such reasonable and substantial portion of the entire net annual income of the entire trust estate as to the Trustees in their sole judgment and discretion shall deem desirable and ample for the comfortable well-being and enjoyment."

At the time of the trust's creation, Sarah was assured by the trustees that they would construe the terms of the trust liberally and pay her the entire income of the trust before and after the remainder interest was received. If the income of the trust was insufficient for that purpose, the trustees were authorized to invade the trust principal.

Sarah and her husband, Frederick Vander Weele ("**Frederick**"), each filed a gift tax return which treated the transfer of the entire trust assets as having been made one-half (1/2) by each, and each reported one-half (1/2) of the value of the trust created by Sarah. Subsequent to the filing they each took the position that no taxable gift had been made by them and each filed claims for refund of the gift tax reported and paid. The Service issued notices of deficiency to Sarah and Frederick.

The issue was whether the transfer in trust of securities and a remainder interest in trust property constituted a taxable gift.

The tax court ruled that no gifts were made, holding that Sarah retained the dominion, control, and beneficial use and enjoyment of the trust income and corpus.

The Service took the position that the transfer of property in trust constituted a taxable gift of the entire trust, unreduced by an amount equal to the actuarial value of a life estate in the property so transferred. In support of Sarah's argument that the transfer did not constitute a completed gift, she relied on the decisions in *Paolozzi v. Commissioner*, 23 T.C. 182 (1954) and *Estate of Gramm v. Commissioner*, 17 T.C. 1063 (1951).

In its review of *Paolozzi* the court noted that it upheld the taxpayer's contention in that case where:

> [The petitioner's] creditors could reach the maximum amount which the trustees

> could pay to [the petitioner in *Paolozzi*] or apply for her benefit, [the petitioner] could realize the economic benefit of the income accruing to the trust during [the petitioner's] life simply by borrowing money and then relegating the creditor to the trust income for reimbursement.

The court analogized that Sarah's situation was similar to the petitioner in *Paolozzi* where Sarah was entitled to receive the entire net income from the stocks and securities for life or until the vesting in the remainder interest. Upon receipt of the remainder interest in the trust established by her grandfather, the trustees had the power to pay Sarah for life "such reasonable and substantial portion of the entire net annual income" as "to the trustees in their sole judgment and discretion shall seem desirable and ample for the comfortable well-being and enjoyment of the Donor." The trust was governed by Michigan law, and the court noted that Michigan law at the time of the case did not protect the interest of a trust created for the benefit of the settlor. Therefore, Sarah's creditors could reach the income of the trust to the extent that it was distributable to her, and this fact, according to the court, meant Sarah retained sufficient dominion and control over the trust income as to prevent the imposition of gift tax.

The court cited to *Gramm* for the proposition that there was no taxable gift. In *Gramm*, the taxpayer created a trust designating a corporate fiduciary and her children as trustees. The decedent was to receive net income for life, and a provision was made for distribution upon her death. The trust gave the corporate trustee the power to invade the principal for any amount considered proper for the comfort, education, maintenance, or support of the settlor. The court in *Gramm* pointed out that "comfort" was indeterminable, and as such, since there was no restriction in the trust limiting the extent to which principal might be used for "comfort, education, maintenance or support," there was an unlimited possibility of withdrawal of the trust fund and no completed gift.

In *Vander Weele*, the court analogized to *Gramm* since the trustees had an unrestricted power to invade the trust for the benefit of Sarah. It also noted that Sarah's trust provided for her personal financial security due to her understanding with the trustees that funds should be used to pay expenses.

11. ***Estate of Uhl***. *Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957). In 1938, Edgar M. Uhl ("**Edgar**"), transferred property to an irrevocable trust (the "**Trust**") governed by Indiana law. Under the trust instrument, Edgar reserved the right to be paid $100.00 monthly from the Trust, however, Edgar retained no control over the balance of the trust property. At Edgar's death, the remaining trust property was to be divided equally between Edgar's nephew and nieces. Edgar died testate on March 7, 1951.

National City Bank of Evansville, as administrator of Edgar's estate, argued that only the part of the estate which was necessary to produce income of $100 a month was properly included in Edgar's gross estate (it was stipulated that the amount necessary to produce $100 a month was $50,218.85, or 59.63% of the corpus). The Tax Court held that the entire corpus should be included in Edgar's estate, and assessed a deficiency of $9,265.99. In its decision, the Tax Court relied upon a provision of the trust agreement stating that: "[t]he trustee may in his discretion pay a greater sum than $100.00 a month if it shall deem advisable."

The Tax Court did not find that Edgar had retained a right to more than $100.00 a month from the trust income. However, because at the time the trust agreement was executed, Indiana law was such that Edgar's creditors might have successfully brought suit to reach all the income from the Trust, the Tax Court held that "the decedent could have obtained the enjoyment and economic benefit of such income by the simple expedient of borrowing money or otherwise becoming indebted, and then relegating the creditor to the trust income for reimbursement." Therefore, the Tax Court held that Edgar retained sufficient rights to all the income of the trust to make the entire corpus includable in Edgar's gross estate.

The issue presented on appeal was whether the value of the entire trust estate was subject to a federal estate tax as a part of Edgar's gross estate where Edgar had irrevocably transferred property to a trust and had also retained an income interest in the trust of $100 per month.

The court held that the Service properly levied an estate tax deficiency for that part of the corpus necessary to produce the $100.00 a month. However, the remainder of the corpus, over which Edgar had no control and was subject only to the uncontrolled discretion of the trustee, did not remain Edgar's property at Edgar's death and should not have been included in Edgar's gross estate. The pertinent sections of the Revenue Act, § 811(c) (1) (B), 26 U.S.C. 1952 Ed., Sec. 811, provided that the value of a decedent's gross estate included any interest of which the decedent had made a transfer, under which the decedent retained for his life or for any period not ascertainable with reference to the decedent's death, or for any period which did not in fact end before the decedent's death, "the possession or enjoyment of or the right to income from the property." The appellate court found that under this section, by the retention of an income interest of $100.00 a month, Edgar reserved a right to the income from the trust property to that extent; however, the balance of the trust estate was removed from Edgar's dominion or control, such that the only part of the trust estate which should have been included in Edgar's gross estate at his death was that part which represented the income to which Edgar had retained the right of receipt. The remaining amount of the estate irrevocably conveyed to the trustee was a completed gift which was not includible in Edgar's estate.

No cases under the federal estate tax law had previously dealt with this precise issue, so the appellate court looked to precedents under the gift tax law. In *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2nd Cir. 1941), a settlor executed an irrevocable trust which gave the trustee the discretion to pay the income either to the settlor or the settlor's wife. The question presented was whether this discretionary power of the trustee amounted to a reversion in the settlor of the right to enjoyment of the income or whether the title had vested in the trustee exclusive of any such right. The court said:

> It was only by virtue of the trustee's direction, which on this record must be regarded as entirely voluntary, that the [settlor] received any of the income; and this direction might be terminated whenever the trustee deemed it proper that the wife should receive the income. Such a hope or passive expectancy is not a right. It is not enough to lessen the value of the property transferred. *Id.* at 593.

In *Rheinstrom v. Commissioner*, 105 F.2d 642 (1939), a settlor had executed a trust irrevocably transferring property for the benefit of the taxpayer and the taxpayer's four children. The taxpayer retained a life interest in 40% of the net income. fifty percent (50%) was to be paid

to the beneficiaries, and the remaining ten percent (10%) was to be held by the trustees with discretion to pay to taxpayer such part thereof as to the trustees might seem best. The court held that the taxpayer had retained no legal interest in the ten percent (10%), saying:

> Whether she would ever receive any of this reserve fund depended entirely upon the trustees, over whose acts she retained no control. The fact that the record shows that they have paid it to her or used it for her benefit, we do not consider of importance. By the terms of the trust instrument, they might distribute all or part of the reserve fund to her during her lifetime, or they might withhold all of it.

The court added that no one could compute the value of the settlor's mere expectation that her trustees would ever pay her an amount in addition to the enjoyment which she reserved.

The appellate court in *Uhl* therefore concluded that only that part of the trust estate from which income was reserved to Edgar should have been included in Edgar's gross estate, because Edgar could not compel the trustee to pay Edgar any sums other than $100.00 a month, and the trustee was under no duty to pay Edgar more than that.

The Tax Court had based its decision upon the theory that Edgar's creditors might have reached all of the corpus of the estate including that over which the taxpayer had retained no control, saying: "While the decedent may not have been able to force the trustee to distribute the income to him, nevertheless he could have reached the full amount of the trust income through his creditors." The appellate court found that even though part of the estate which produced $100.00 a month might have been reached by Edgar's creditors, the Indiana statute itself did not apply to property or the income therefrom over which Edgar retained no dominion and no control. That part of the corpus of the estate was, after the creation of the trust, the property of the trust beneficiaries, subject only to an uncontrolled discretion in the trustee to divert to Edgar something that Edgar could not have compelled the trustee to give him.

12. ***Estate of Holtz v. Commissioner***. In *Estate of Leon Holtz v. Commissioner*, 38 T.C. 37 (1962), Leon Holtz ("**Leon**"), pursuant to a deed of trust signed on June 12, 1953 (the "**Trust**"), transferred property having a value of over $384,117 that consisted of over 200 mortgages, most of which had a value of less than $2,000. Land Title Bank and Trust Company, which later became Provident Tradesmens Bank and Trust Company ("**Provident**"), served as trustee. The Trust provided, in part, as follows:

> **FIRST**
>
> Trustee shall keep the principal of this trust invested and shall distribute the net income therefrom and the principal thereof as follows: A. During the lifetime of Settlor: 1. The income shall be paid to him or to his order, or upon his direction, shall be accumulated and added to the principal. 2. As much of the principal as Trustee may from time to time think desirable for the welfare, comfort and support of Settlor, or for his hospitalization or other emergency needs, shall be either paid to him or applied directly for his benefit by Trustee . . .
>
> **SEVENTH**

A. Settlor or any other person, upon approval and acceptance by Trustee, may add to the principal of this trust by deed or will or otherwise. B. It is hereby expressly declared by Settlor that he has been fully advised as to the legal affect of the execution of this Deed of Trust and informed as to the character and amount of the property hereby transferred and conveyed; **and further that he has given consideration to the question whether the transfer herein contained shall be revocable or irrevocable and he hereby declares the same to be irrevocable and that it shall without any power in Settlor at any time to revoke, change or annul any of the provisions herein contained; except that Settlor and others may hereafter bring other properties within the operation of this Deed of Trust**. [Emphasis added.]

Upon Leon's death, if his wife survived him, the income of the Trust was to be paid to her during her lifetime, and a similar provision was made for invasion of principal for her benefit during her lifetime. The Trust was to terminate at the death of the survivor of Leon and his wife and the remaining principal was payable to the estate of the survivor.

The facts surrounding the signing of the Trust were stipulated as follows: prior to affixing his signature to the Trust, Leon asked the drafting attorney and the trust officer serving as trustee whether he would have "enough money" following the transfers to the Trust, and the trust officer replied that the Trust provided for the payment of all income to Leon and also he could have money out of the principal. The trust officer assured Leon that the bank would be liberal in giving him money out of the corpus.

Leon transferred an additional $50,000 in cash to the Trust on January 18, 1955. In 1954, trust principal was paid on behalf of Leon for his hospital bills; these were the only amounts paid out of the Trust principal to Leon or for his benefit.

Leon died in 1958 (his wife predeceased him in 1955). Provident, the surviving executor under Leon's Will), filed gift tax returns for the calendar years 1953-1955 on behalf of Leon. The Service determined deficiencies in gift tax against Leon, and argued that as a result of the transfers, Leon made taxable gifts in 1953 in the amount of $263,277.63, and in 1955 in the amount of $35,570, computing the value of the taxable gifts by reducing the value of the property transferred in each instance by the actuarial value of Leon's life estate and reversionary interest in each transfer. Provident, the petitioner in the Tax Court case, argued that the transfers were not completed gifts and that no part of the value thereof was subject to gift tax.

The issue for decision was whether the transfers in trust made by Leon in 1953 and 1955 were completed gifts for purposes of Federal gift tax (the deficiency for 1954 was a result of a technical adjustment dependent on the decision of the issue for 1953). Provident argued that the transfers were not completed gifts and that no part of the value thereof was subject to gift tax. The court held for Provident; no part of or interest in the property transferred to the Trust constituted a completed gift for gift tax purposes when transferred to the trust.

The issue turned on whether the settlor abandoned sufficient dominion and control over the property transferred to put it beyond recall. The court noted that Leon neither reserved the power in himself alone to modify, alter, or revoke the trust and thus revest the trust property in

himself, as in *Burnet v. Guggenheim*, 288 U.S. 280 (1933), nor reserved the power to alter the disposition of the property or income therefrom in some way not beneficial to himself, as in *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939), nor reserved the power in conjunction with someone else to modify, alter, or revoke the trust, as in *Camp v. Commissioner*, 195 F.2d 999 (C.A. 1, 1952), rev'g. in part 15 T.C. 412 (1950).

The court analyzed whether the discretionary power placed in the trustee by the Trust made the gifts of the remainder interests incomplete for gift tax purposes. The court cited to cases that held that if the trustee is free to exercise his unfettered discretion and there is nothing to impel or compel him to invade corpus, the settlor retains a mere expectancy which does not make the gift of corpus incomplete. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d. Cir. 1941). However, if the exercise of the trustee's discretion is governed by some external standard which a court may apply in compelling compliance with the conditions of the trust agreement, and the trustee's power to invade is unlimited, the gift of corpus is incomplete (*Commissioner v. Irving Trust Co.*, 147 F.2d 946 (C.A. 2, 1945), affd. 2 T.C. 1052 (1943)), and this is true even though such words as "absolute" and "uncontrolled" are used in connection with the trustee's discretion, provided the external standards are clearly for the guidance of the trustee in exercising his discretion. *Estate of John J. Toeller*, 6 T.C. 832 (1946), affd. 165 F.2d 665 (C.A. 7, 1948); *Estate of Lelia E. Coulter*, 7 T.C. 1280 (1946). The court noted that the theory behind the rule was that by placing such standards for guidance of the trustee's discretion in a trust agreement itself, a settlor had not actually lost all dominion and control of the trust corpus or put it completely beyond recall.

> The rule of thumb appears to be a reasonable application of the general rule established in the Guggenheim, Sanford, and Shaughnessy cases because where there is a reasonable possibility that the entire corpus might be repaid to the settlor there can be no assurance that anyone else will receive anything in the form of a gift, and if the corpus should happen to be kept intact until the settlor's death, even though the transfer in trust was not subjected to a gift tax, the corpus of the trust will in all likelihood be subjected to the estate tax in the settlor's estate. [*citations omitted*]

The court examined the Trust and Leon's behavior with regards to the Trust's creation in making its decision. Under the terms of the Trust, it was entirely possible that the entire corpus might be distributed during Leon's lifetime and no one other than him would receive any portion of the Trust. As long as that possibility was present, Leon had not abandoned sufficient dominion and control over the property transferred to make a gift. The facts stipulated to indicated that: (a) there was an understanding of the parties that the trustee would distribute principal at any time Leon's needs reasonably justified it; and (b) since the trust consisted of approximately 200 small mortgages, the records to which were inaccurate and inadequate, the management of the Trust's property appeared to be a motivating factor for Leon to establish the Trust.

While the language used in the trusts and the surrounding circumstances involved in *Sarah Gilkey Vander Weele*, 27 T.C. 340 (1956), affd. 254 F.2d 895 (C.A. 6, 1958) and *Estate of Christianna K. Gramm*, 17 T.C. 1063 (1951) were different than the language used in the Trust and the circumstances in the instant case, the court thought that they were close enough to hold

that the transfers were not completed gifts and that no part of the value thereof was subject to gift tax.

13. **PLR 7833062**. PLR 7833062, May 18, 1978, concerns the federal gift tax consequences of making a revocable trust irrevocable.

On February 11, 1966, a settlor transferred corporate stock to a revocable trust executed by the settlor on that date. The trust provided that the net income from the trust would be distributed quarterly or monthly to the settlor or used for the benefit of the settlor and the settlor's wife during the settlor's life. The trust further provided that the trustee shall distribute to the settlor as much of the principal of the trust as the settlor requested. If the settlor was unable to request a distribution of principal, the trustee was authorized to distribute such amounts from the principal as the trustee deemed "advisable for the (settlor's) comfortable maintenance, support and welfare or for that of his wife."

On the death of the settlor the trust principal was to be distributed to the settlor's wife and children.

The trust agreement was modified by the settlor on October 19, 1977 to release the settlor's power to alter, amend or revoke the trust. The settlor further released his power to invade the principal or demand distribution of principal to himself. The modification did not, however, affect the authority of the trustee, in the trustee's discretion, to invade principal for the settlor's benefit.

Generally, if a trustee is given a broad discretionary power to invade the trust corpus on behalf of the settlor, however, the power is not limited by a definite standard, the settlor has parted with dominion and control over the property, and the entire transfer is complete and subject to the gift tax. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d. Cir. 1941); *Higgins v. Commissioner*, 129 F.2d 237 (1st Cir. 1942); Rev. Rul. 77-378, 1977-42 IRB 10. If the power of the trustee to invade on behalf of the settlor is subject to a fixed and ascertainable standard which makes it possible to value the maximum amount to which the settlor might be entitled, the transfer is incomplete to that extent. Regs. § 25.2511-2(b); Rev. Rul. 62-13, 1962-1 C.B. 181. If the trustee's power, although governed by some ascertainable standard, permits the settlor to demand the return of the entire trust corpus, the gift may be wholly incomplete, or partially incomplete and partially complete, depending upon all the facts in the particular case. Regs. § 25.2511-2(b). The gift is normally wholly incomplete, however, only where, under the facts and circumstances of the case, substantial invasion is probable and there is no assurance that anything of value will pass to anyone other than the settlor. *Gramm v. Commissioner*, 17 T.C. 1063 (1951); *Estate of Holtz v. Commissioner*, 38 T.C. 37 (1962).

Treasury Regulation § 25.2511-1(g)(2) provides that an ascertainable standard is a clearly measurable standard under which the holder of a power is legally accountable. Thus, if under the standard provided in the trust agreement and applicable state law, the settlor can compel the trustee to return trust property to the settlor, the standard is ascertainable.

Additionally, the gift may be incomplete, irrespective of whether the trustee's discretion is subject to an ascertainable standard, if the settlor can indirectly recapture the trust property

under applicable state law by borrowing money and relegating his creditors to the trustee for satisfaction of their debts. *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Commissioner v. Vander Weele,* 254 F.2d 895 (6th Cir. 1958); Rev. Rul. 62-13, 1962-1 C.B. 181, Rev. Rul. 76-103, 1976-1 C.B. 292.

The taxpayer in PLR 7833062 stated that the trustee's discretionary power to invade principal for the settlor's "comfortable maintenance, support and welfare" was not an ascertainable standard within the meaning of Treasury Regulation § 25.2511-2(b). Assuming this was a correct statement of the law in New York, the settlor could not compel the trustee to make payments of corpus to the settlor. Thus, the settlor retained no right to principal and no dominion or control over the corpus. Rather, the settlor possessed a mere expectancy. Therefore, the Service ruled the sixth modification of the trust caused the gift of the remainder interest to be complete in its entirety and as such the gift was subject to the gift tax. The gift nevertheless would be incomplete under Revenue Ruling 76-103 if the trust assets were subject to the claims of the settlor's creditors under applicable state law.

Unlike 'State X' in Revenue Ruling 76-103, the Service noted that creditors in New York apparently had no right to the trust corpus in a discretionary trust. Citing *Hamilton v. Drogo,* 241 N.Y. 401, 150 N.E. 496 (1926) and *Sand v. Beach*, 270 N.Y. 281, 200 N.E. 821 (1936), the Court of Appeals in *Herzog v. Commissioner*, *supra*, concluded that, in New York, a trustee of a discretionary trust cannot be compelled to exercise his discretion in favor of the settlor or the settlor's creditors.

Accordingly, the Service held that the settlor's modification of the trust which made the trust irrevocable caused the gift of the remainder to be complete for federal gift tax purposes and subject to the gift tax under § 2501 of the Code.

However, if on further consideration of New York law, it was determined that the trustee's powers of invasion for the benefit of the settlor were subject to an ascertainable standard, enforceable by the settlor, the Service noted that the gift might be deemed wholly incomplete or partially incomplete and partially complete, depending upon the facts and circumstances surrounding the execution of the trust and the modification.

14. **PLR 8037116**. In PLR 8037116, June 23, 1980, a trustee requested a ruling regarding whether trust property was includible in the settlor's gross estate, pursuant to §§ 2036 and 2037 of the Code.

The settlor was a nonresident alien. The settlor created a trust which he funded with various marketable securities. The trust provided that the trustees, in their sole discretion, could pay or apply so much of the principal of the trust estate and so much of the net or accumulated income to or for the support and benefit of any descendants of the settlor's mother, including the settlor during the settlor's lifetime. Upon the death of the settlor, the trust provided for the outright distribution of the trust estate in specified percentages to the settlor's two brothers and the children of one of the settlor's brothers. If, at the time of the settlor's death there was no such issue, the trustees were directed to distribute the trust estate for such charitable purposes as the trustees may decide in their sole discretion. The trustee made distributions of income over the years to beneficiaries other than the settlor. For federal income tax purposes, the trust had been

treated as a grantor trust under § 677 of the Code. There had been no distributions of principal from the trust.

The settlor did not retain the right to alter, amend, or revoke the trust, or to change the beneficial interests under the terms of the agreement.

The settlor did not retain outright control over the disposition of trust principal and income, since the trustee could make distributions as he considered appropriate in the trustee's sole discretion. However, the settlor did place himself within the class of beneficiaries eligible to receive any amount of principal and income during the settlor's lifetime. The only distributions made from the creation of the trust until the settlor's death were payments of income to beneficiaries other than the settlor.

Where a settlor has not expressly reserved the power to modify the trust either as to dispositive or administrative provisions in the trust agreement, no such power will be implied. Bogert, *Trusts & Trustees*, second ed. (1962) section 992; *Comm. v. Guitar*, 72 F.2d 544 (5th Cir. 1934).

Section 2036(a)(1) of the Code provides for inclusion in the gross estate of property over which the decedent had retained possession or enjoyment, or the right to income. In this case, the decedent did not retain the right to possess, enjoy, or receive income from the property, however, he did retain the ***opportunity*** to enjoy it. However, in the same jurisdiction, the Circuit Court of Appeals has characterized such a retained interest a passive expectancy rather than a right to enjoyment of the property, with the result that the property was not includible in the gross estate. *Herzog v. Comm'r*. 116 F.2d 591, 593 (2d Cir. 1941).

Section 2036(a)(2) of the Code requires inclusion where the decedent retains the right to designate beneficiaries of property transferred.

Section 2037 of the Code provides for the inclusion in the gross estate of all property transferred by the decedent for less than adequate and full consideration if (1) possession or enjoyment of the property can be obtained through ownership only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property where immediately before his death the value of the reversionary interest exceeded five percent (5%) of the value of the property. Section 2037(b) of the Code defines reversionary interest as the possibility that property transferred by the decedent may return to him or his estate or may be subject to a power of disposition by the decedent.

In *Uhl's Estate*, 241 F.2d 867 (7th Cir. 1957), the court held that where the trustee had the sole discretion to pay a certain amount of income to the settlor of a trust, the corpus generating that income did not remain the settlor's property until his death, however, passed instead to the trustee at the time the trust was created, so that the value of the corpus was not includible in the settlor's gross estate. Likewise, in *Herzog v. Comm'r*., 116 F.2d 591, 593 (2d Cir. 1941), the court held that the possibility that the settlor-beneficiary might receive trust income at the voluntary discretion of the trustee constitutes a hope or passive expectancy rather than a right, and such expectancy is not sufficient to lessen the value of the property transferred.

The Service determined that the trust in question was irrevocable.

The Service concluded that the ability of the settlor to receive income and principal under the terms of the trust he created was not sufficient to require inclusion of the property under § 2036(a)(1) of the Code.

The settlor gave the trustee sole discretion to distribute principal and income to the beneficiaries designated in the trust. The trust also gave the settlor the right to release the trustees from all liability, responsibility, or accountability for their acts or omissions as trustees, thereby binding all income beneficiaries, remaindermen, and other interested parties. The Service determined that giving the settlor such authority was not the equivalent of giving the settlor the right to designate beneficiaries, however, was a more limited power retained by the settlor for purposes of administrative convenience. Thus, the Service concluded that the trust property was not includible under § 2036(a)(2) of the Code.

With respect to § 2037 of the Code, all beneficiaries (including the settlor) were eligible to possess or enjoy principal and income from the trust during the settlor's lifetime, at the trustee's discretion. This provision was determined to be outside the scope of § 2037(a)(1) of the Code where a beneficiary could assume ownership of trust property only by surviving the settlor.

Furthermore, the Service concluded that the settlor did not retain a reversionary interest subject to the settlor's power of disposition, or to benefit himself or his estate, since the trust agreement provided an irrevocable distribution of property to the trustee during the settlor's life, then upon the settlor's death to others, and any benefits that the settlor could have received would have been at the sole discretion of the trustee. Consequently, the value of the trust property was not includible in the gross estate under section 2037(a) or (b) of the Code.

15. ***Outwin v. Commissioner***. In *Outwin v. Commissioner*, 76 T.C. 153 (1981), petitioners Edson S. Outwin ("**Edson**") and Mary M. Outwin ("**Mary**"), a married couple, each created and funded irrevocable trusts (each trust hereafter referred to as a "**Trust**" and collectively referred to as the "**Trusts**") in 1969 governed by Massachusetts law. Under the terms of each Trust: (1) the trustee had discretion to pay income and principal to grantor during his or her life, however, such distributions were permitted only upon the prior written consent of such grantor's spouse; (2) at the death of each grantor, the surviving spouse (if any) was entitled to mandatory distributions of income, discretionary distributions of principal and was given a testamentary power of appointment over the assets; and (3) two financial advisors to Edson and Mary were named as trustees of the Trusts.

Prior to creating the Trusts, the trustees assured Edson and Mary that (1) any assets conveyed to the Trusts would be transferred back to each respective grantor upon request; and (2) if Edson and Mary became unhappy with the Trusts, the trustees would make discretionary distributions of all of the assets.

The Service subsequently issued a notice of deficiency for unpaid gift tax to each of the petitioners for $167,895.09 (that is, one-half (1/2) of the combined value of the assets the petitioners contributed to all of the Trusts).

The sole question presented was whether the transfers in trust made by Edson and Mary constituted taxable gifts for purposes of § 2501 of the Code.

The Tax Court held that because creditors of the grantor of each Trust could reach the trust assets for satisfaction of claims under Massachusetts law (notwithstanding the veto power given to each such grantor's spouse), Edson's and Mary's transfers to the Trusts were incomplete gifts for gift tax purposes as the grantor of each trust failed to relinquish sufficient dominion and control over of the property.

The gift tax provisions of the Code do not define the term "completed gift," however, it is well settled that a conveyance in trust will not be subject to gift tax where the donor retains dominion and control over the property transferred. *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); *Burnet v. Guggenheim*, 288 U.S. 280 (1933); *Estate of Mandels v. Commissione*r, 64 T.C. 61 (1975); *Hambleton v. Commissioner*, 60 T.C. 558 (1973); *Estate of Holtz v. Commissioner*, 38 T.C. 37 (1962).

Edson and Mary contended that no completed gifts resulted from the creation of their respective Trusts because the trustees had orally agreed prior to the execution of the written agreements to (1) distribute the Trust income or corpus whenever the grantors requested such funds, and (2) terminate the Trusts upon their request by making liquidating distributions of all the remaining corpus. Consequently, Edson and Mary maintained that they never relinquished dominion and control over the property transferred to the trusts.

Edson and Mary alternatively argued that under Massachusetts law, the creditors of a grantor-beneficiary of a discretionary trust could reach the assets of the trust for satisfaction of their claims, notwithstanding the veto power over discretionary trust distributions vested in the grantor's spouse. Accordingly, Edson and Mary contended that the transfers to the Trusts were incomplete under the principle established in *Paolozzi v. Commissioner*, 23 T.C. 182 (1954).

The Tax Court noted that where a trust agreement specifies that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for gift tax purposes. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F.2d 591 (2d. Cir. 1941); *Rheinstrom v. Commissioner,* 105 F.2d 642 (8th Cir. 1939); *Estate of Holtz v. Commissioner*, 38 T.C. 37, 42 (1962); *Commissioner* v. *Irving Trust Co*., 147 F.2d 946 (2d Cir. 1945); *Estate of Toeller v. Commissione*r, 6 T.C. 832 (1946), affd. 165 F.2d 665 (7th Cir. 1948). However, the Tax Court noted that there is a different result where applicable state law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims.

In *Paolozzi v. Commissioner*, 23 (*supra*), the taxpayer ("**Paolozzi**") created a trust under the terms of which the trustees were authorized to pay to Paolozzi so much of the trust income as the trustees, in their absolute discretion, determined to be in Paolozzi's best interest. Upon Paolozzi's death, the trust assets were to be distributed to Paolozzi's issue. Paolozzi reported a taxable gift when the trust was established in an amount equal to the value of the assets transferred reduced by the value of a life estate for an individual Paolozzi's age. Under Massachusetts law, the creditors of a settlor-beneficiary of a discretionary trust could reach for satisfaction of claims the maximum amount which the trustee could pay to the settlor or apply for her benefit. The Tax Court concluded that Paolozzi could at any time obtain the economic benefit of the trust income simply by borrowing and then forcing her creditors to look to her interest in the trust income for a source of repayment. On that basis, the *Paolozzi* court held that

the gift was incomplete to the extent of the value of Paolozzi's retained life estate. Accord, *Vander Weele v. Commissioner*, 27 T.C. 340, 343-344 (1956), affd. 254 F.2d 895 (6th Cir. 1958) (involving Michigan law). See also *Estate of Holtz v. Commissioner*, 38 T.C. 37, 42 n. 3 (1962); *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941) (reaching a contrary result under New York law); Rev. Rul. 76-103, 1976-1 C.B. 293. Cf. *Hambleton v. Commissioner*, 60 T.C. 558, 565-566 (1973).

Under the rule of *Paolozzi*, the Tax Court analyzed whether the assets of each of Edson's and Marys' Trusts could be subjected to the claims of the respective grantor's creditors under Massachusetts law. The Tax Court cited the following general rule regarding the rights of creditors of a settlor-beneficiary of a discretionary trust as expressed in 1 Restatement, Trusts 2d, sec. 156(2) (1959):

> Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

The Tax Court noted that the Supreme Judicial Court of Massachusetts formally adopted this general rule in *Ware v. Gulda*, 331 Mass. 68, 117 N.E.2d 137 (1954).

The Tax Court found that a veto power over discretionary trust distributions bestowed upon Edson and Mary was insufficient to render the *Gulda* rule inapplicable. Additionally, the Tax Court found that (1) absent unforeseen circumstances, such as divorce, the possibility that Edson or Mary would veto a disbursement by the trustee was remote, and (2) the fact that Edson or Mary might reciprocate by veto of disbursements to the other would tend to further discourage use of the veto. The *Gulda* opinion and the cases cited therein evidence a strong public policy in Massachusetts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors. That policy would be easily frustrated if creditors were prevented from reaching the trust assets merely because the settlor's spouse was given an interest in the trust and the right to veto discretionary distributions which might deplete that interest.

The Tax Court saw no basis for assuming that the *Gulda* decision was predicated on the existence of an enforceable right of the settlor to discretionary distributions, regardless of whatever judicial restrictions Massachusetts courts might place on the exercise of trustees' discretion. The rule adopted by the Massachusetts Supreme Court and set forth in 1 Restatement, Trusts 2d, sec. 156(2) (1959), refers only to amounts which the trustee *could* pay to the settlor. It makes no mention of amounts which the trustee could be *required* to pay if the settlor seeks judicial review of the trustee's actions. None of the authorities the Tax Court consulted cite the existence of an enforceable right to discretionary distributions as the rationale for the Restatement rule. See generally 2 A. Scott, Trusts, sec. 156.2 (3d ed. 1967).

The Tax Court therefore held that creditors of Edson or Mary could reach the assets of their respective discretionary Trusts for reimbursement under Massachusetts law, and under the holding of *Paolozzi*, Edson and Mary failed to surrender dominion and control over the Trusts' assets.

In reaching its decision, the Tax Court expressly disavowed any reliance on the oral understandings between Edson and Mary and the trustees to the effect that the trustees would be totally responsive to any requests from Edson and Mary for discretionary distributions. On occasion, the Tax Court has considered extrinsic evidence (such as the settlor's financial condition, his or her purpose in establishing the trust, and oral assurances by the trustees that the funds would be made available upon request) to help determine whether a right to discretionary distributions rendered a transfer in trust incomplete for gift tax purposes. See *Estate of Holtz v. Commissione*r, 38 T.C. 37, 43-44 (1962); *Vander Weele v. Commissioner*, 27 T.C. 340, 345-346 (1956), *affd.* 254 F.2d 895 (6th Cir. 1958); *Gramm v. Commissioner*, 17 T.C. 1063, 1066 (1951). In each of these foregoing cases, a standard limiting the trustee's discretion was provided in the trust instrument and the extrinsic evidence served primarily to indicate the probability that the trust funds would be used to satisfy that standard. However, there were no ascertainable standards in the Trusts. Yet, the provisions vesting absolute discretion in the trustees were flatly contradicted by the oral understandings to which Edson, Mary, and the trustees testified. The Tax Court gave little weight to the testimony regarding the oral understandings for several reasons: (1) Edson's and Mary's testimony was self-serving; (2) the trustees were close personal friends of Edson and Mary; and (3) Edson and Mary had yet to receive any distributions from their respective discretionary trusts. Furthermore, the court found that, while the testimony indicated Edson and Mary received the specified assurances from the trustees, there was insufficient evidence to prove that either Edson or Mary agreed in advance to consent to any proposed distributions from the other's trusts. Accordingly, the Tax Court decided the case solely on the creditor's rights theory set forth in *Paolozzi*.

16. ***Estate of Wells v. Commissioner***. *Estate of Wells v. Commissioner*, 42 T.C.M. 1305 (1981). On December 23, 1969, Gizella Wells ("**Gizella**") created an irrevocable *inter vivos* trust (the "**Trust**"), designating her son, David I. Wells ("**David**") as trustee. Under the terms of the Trust, the trustee had the sole discretion to distribute to distribute income or principal to Gizella during her life. Additionally, the Trust would terminate upon Gizella's death and the remaining principal would be distributed in equal shares to David's daughters.

Prior to creating the Trust, Gizella indicated to her accountant, Arthur Steinthal ("**Arthur**"), that Gizella wished to make a gift to her grandchildren. Gizella, concerned with the effect of the gift on her cash flow and standard of living, was advised by Arthur that if Gizella sold certain stocks, made a $30,000 gift to the Trust, and also sold a certain rental property on the installment method, Gizella could receive more annual income than she had previously been receiving. On Arthur's advice, Gizella sold her stocks and rental property and funded the Trust with $30,000 in cash. Gizella filed a gift tax return for 1969 reporting the $30,000 gift to the Trust.

Gizella did not request any funds from the Trust during her life, however, the trustee distributed all of the Trust income to Gizella to allow Gizella travel for recreation. Gizella died in 1975 and the petitioner was appointed as the executor of Gizella's estate. The Service asserted that Gizella retained an interest in the trust within the meaning of § 2036 of the Code and determined an estate tax deficiency of $8,901.80.

The sole question presented in the case was whether Gizella retained any interest in the Trust within the meaning of § 2036 (a)(1) of the Code.

The Tax Court held that as Gizella transferred the property to the trust absolutely, unequivocally, irrevocably, and without possible reservations, the trust corpus was not includible in Gizella's gross estate under § 2036 of the Code.

The Service argued that Gizella retained for life "possession or enjoyment" of the $30,000 initially transferred to the trust, and therefore, the Trust corpus was includible in her estate under § 2036 of the Code. Additionally, the Service argued that the trustee, in paying the income to Gizella, was acting pursuant to a prearrangement in which it was understood that Gizella would "enjoy" the income from the property that she transferred to the Trust.

David contended that Gizella unconditionally, absolutely, and irrevocably transferred the property to the Trust and that no income was received by Gizella pursuant to an arrangement entered into contemporaneously with the transfer to the Trust. Therefore, David, contended, § 2036(a)(1) of the Code was inapplicable.

Section 2036(a) of the Code provides:

> (a) General Rule. — The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death — (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The Tax Court noted that § 2036(a) of the Code reflects a "legislative policy of subjecting to tax all property which has been the subject of an incomplete *inter vivos* transfer." *United States v. O'Malley*, 383 U.S. 627, 631 (1966). Section 2036(a)(1) applies if the decedent retained the "right to income" from or "possession or enjoyment" of the transferred property. Thus, although a decedent may not have reserved or retained the "right" to the income, the transfer may still come within § 2036(a)(1) if the decedent retained "possession or enjoyment" of the transferred property. *Skinner's Estate v. United States*, 316 F. 2d 517 (3rd Cir. 1963); *McNichol's Estate v. Commissioner*, 265 F. 2d 667, 670-671 (3rd Cir. 1959), affg. 29 T.C. 1179 (1958), cert. denied 361 U.S. 829 (1959); but see Stephens, Maxfield & Lind, Federal Estate and Gift Taxation, par. 4.08(4)(c), p. 4-139, ft. 35 (4th Ed. 1978).

However, the mere receipt of all the income from the transferred property does not of itself trigger inclusion in the gross estate under § 2036(a)(1) of the Code. Such enjoyment must have been "retained." *Estate of Green v. Commissioner*, 64 T.C. 1049, 1061 (1975); *Estate of Nicol v. Commissioner*, 56 T.C. 179, 182 (1971); *Estate of Barlow v. Commissioner*, 55 T.C. 666, 670 (1971). See also *Uhl's Estate v. Commissioner*, 241 F. 2d 867 (7th Cir. 1957), revg. and remanding 25 T.C. 22 (1955). Thus, § 2036(a)(1) of the Code applied only if Gizella "retained"

enjoyment pursuant to an agreement or understanding reached contemporaneously with the transfer. *McNichol's Estate v. Commissioner, supra; Estate of Hendry v. Commissioner*, 62 T.C. 861, 872 (1974); *Estate of Kerdolff v. Commissioner*, 57 T.C. 643, 648 (1972); *Estate of Barlow v. Commissioner, supra* at 670; *Estate of Beckwith v. Commissioner*, 55 T.C. 242, 247 (1970), cf. *Estate of Wyly v. Commissioner*, 610 F. 2d 1282 (5th Cir. 1980).

The Tax Court noted that retention or reservation need not be expressed in the instrument of transfer, nor need it be legally enforceable, for § 2036(a)(1) of the Code to apply. *Estate of McCabe v. United States,* 475 F. 2d 1142, 1146 (1973); *Skinner's Estate v. United States, supra; McNichol's Estate v. Commissioner, supra; Atkinson v. United States*, 231 F. Supp. 933 (E.D.S.C. 1964). The existence of such an agreement or prearrangement can be inferred from the facts and circumstances surrounding the transfer, and the subsequent use, of the property. *Skinner's Estate v. United States, supra; McNichol's Estate v. Commissioner, supra; Estate of McCabe v. United States, supra; Estate of Kerdolff v. Commissioner, supra* at 648; *Estate of Hendry v. Commissioner, supra* at 872. Additionally, the Tax Court noted that the burden was upon David to show that no implied understanding or arrangement existed. *Estate of Hendry v. Commissioner, supra* at 872, and cases cited therein. *Estate of Kerdolff v. Commissioner, supra* at 648; *Estate of Linderme v. Commissioner*, 52 T.C. 305, 309 (1969), also see *Skinner's Estate v. United States, supra* at 520.

The Tax Court found that Gizella's intent in transferring property to the Trust was to provide a gift for her grandchildren. Gizella placed the property in an irrevocable trust and filed a gift tax return for the *entire value* of the property, $30,000. Compare *Skinner's Estate v. United States, supra* at 520 and *Estate of Green v. Commissioner, supra* at 1062-1063 (where the taxpayers filed gift tax returns reporting only the value of the property less a retained life estate). Concerned with the effect of the gift on her cash flow, Gizella specifically asked her accountant how such a gift would affect her standard of living. Only after being informed that she could afford to complete such a gift did Gizella transfer the property to the Trust. **The Tax Court was swayed by the testimony of David and Arthur that Gizella intended to make an absolute, unequivocal, irrevocable transfer.**

Additionally, the Tax Court noted that the Trust provisions granting the trustee discretionary power to distribute income or corpus to Gizella in and of themselves did not alter its finding that Gizella's motive in transferring the property to the Trust was to make a completed gift to her grandchildren. Nor did the provisions render the trust corpus includible under § 2036(a)(1) of the Code. See *Uhl's Estate v. Commissioner, supra.* Arthur informed Gizella that such a provision would not affect the taxability of the gift and would *allow* the trustee to distribute funds to her in case of a medical emergency without violating the terms of the Trust. The triggering event of § 2036(a)(1) of the Code is not the mere receipt of income. Rather, some arrangement or understanding, and certainly not the mere inclusion of a provision allowing the trustee to distribute and Gizella to receive such income or corpus, is necessary for § 2036(a) of the Code to apply. See *Estate of Green v. Commissioner*, *supra*; *Uhl's Estate v. Commissioner*, *supra.*

Furthermore, the cash flow analysis which Arthur presented to Gizella further supported the Tax Court's finding that Gizella transferred the property to the trust without an agreement, express or implied, that Gizella would receive the income. The Tax Court noted that in the years

immediately following the transfer, Gizella, as projected, did not need the income from the Trust for her yearly support or ordinary living expenses. She used that income to take trips all over the world. Thus, the Tax Court found that Gizella never counted on, relied upon, or expected the income from the Trust.

Faced periodically with the choice of accumulating the income for his children or distributing the income to Gizella that she could travel, David chose the latter, however, was never obligated to distribute the money to Gizella, and with each period he could have changed his mind. Decedent never asked for any of the income, was reluctant at first to take it. David never felt he was required to make any distributions. It was his decision alone, exercised in his absolute discretion. Additionally, David testified that he never at any time prior to the creation of the Trust discussed with his mother his discretionary power to distribute trust income or principal to her.

After careful consideration of the entire record, the Tax Court found that David sustained his heavy burden of showing that no income was received by Gizella from the Trust pursuant to an agreement, express or implied, entered into contemporaneously with the transfer of the property to the Trust. Thus, Gizella did not reserve or retain any "enjoyment or possession" of the property in the Trust within the meaning of § 2036 (a)(1) of the Code when she transferred such property to the Trust. The Tax Court held that the corpus of the trust was therefore not includible in Gizella's gross estate under § 2036 of the Code.

17. **TAM 8213004**. In TAM 8213004, December 7, 1981, the two issues were: 1) Whether a settlor made a completed gift when he transferred property to an irrevocable trust where the independent trustee had discretion to pay income to the settlor during the settlor's life; and 2) Whether the settlor's transfer to an irrevocable trust was a transfer to a "trust for the use of the creator" under Section 7.31 of the New York Estates Powers, and Trust Law, so that it was void as to the creditors of the settlor's estate and therefore includible in the settlor's estate under Section 2038 of the Internal Revenue Code.

The settlor executed an irrevocable trust agreement in 1973, and transferred property to the trust in 1974 having a fair market value of approximately $630,000 to A as the sole trustee. The trust was governed by New York law.

Pursuant to the trust instrument, A had discretion to pay all or some of the net income of the trust to the settlor during the settlor's life. Additionally, A had the power to pay such amounts of principal to the settlor's wife during the settlor's life. After the settlor's death, the trustee had the power to pay such amounts of income and principal to the settlor's spouse as A determined in its sole discretion. After the death of both the settlor and his spouse, the trustee was authorized to pay such amounts of income and principal to the settlor's son as the trustee determined.

The settlor filed a gift tax return for the year 1974, but did not include the transfer to the irrevocable trust in the return, citing Revenue Ruling 62-13, 1962-1 C.B. 181, for the proposition that the transfer to the irrevocable trust was an incomplete gift.

The settlor died testate on February 16, 1979. The executor of the settlor's estate did not include the assets of the irrevocable trust in the settlor's gross estate.

The estate tax examiner contended that the settlor made a completed gift to his spouse and son at his death rather than in 1974 when the property was transferred to the trust. Additionally, the examiner contended that the trust assets were includible in the settlor's estate under Section 2038 of the Internal Revenue Code. The examiner's Section 2038 argument was based upon his reading of Section 7-3.1 of the New York Estates, Powers and Trust Law which provides that a transfer in trust wholly for the benefit of the settlor is void as against existing or subsequent creditors. The examiner contended that the trust the settlor created violated Section 7-3.1 of the New York Estates, Powers and Trust Law and therefore, the assets transferred were available for the purpose of satisfying the claims of creditors of the settlor's estate.

Law & Analysis – Issue 1: In Revenue Ruling 62-13, 1962-1 C.B. 181, the Service stated that where property was transferred to a trust under the terms of which the trustee was given broad discretionary powers over the distribution of income and corpus to the settlor such transfer constitutes an incomplete gift for federal gift tax purposes.

Revenue Ruling 62-13 was later clarified by Revenue Ruling 77-378, 1977-2 C.B. 347, which provides that a transfer of property to a trust under the terms of which the trustee has the discretionary power, entirely voluntary under applicable state law, to distribute income and corpus to the settlor constitutes a completed gift of the entire value of the property transferred. Revenue Ruling 62-13 was clarified and distinguished because under the state law in the prior ruling, the settlor retained the economic benefit of the trust income and corpus by virtue of assigning, selling, or transferring his interest in the trust to his creditors. Since under the facts of Revenue Ruling 62-13 the settlor retained the ability to relegate his creditors to the trust fund for payment, there was no assurance that anything of value would pass to anyone other than the settlor and, thus, the gift was incomplete.

In the instant case, the settlor transferred property to an irrevocable trust and relinquished all control over the trust income and principal to A as trustee. Under New York law at the time, the settlor did not have the power to relegate his creditors to the trust fund for payment nor did he have any power to compel the trustee to make distributions to him. See *Herzog v. Commissioner*, 41 B.T.A. 509 (1940); aff'd, 116 F. 2d 591 (2d. Cir. 1941). Accordingly, the Service ruled that the transfer of property to the irrevocable trust in 1974 constituted a completed gift for federal gift tax purposes, and pursuant to § 6019 of the Code, the settlor should have included the transfer in the total taxable gifts for that quarter.

Section 6501(e)(2) of the Code extends the general three (3) year limitation for assessing the tax to six (6) years after the date a gift tax return is filed if the taxpayer omits from the total amount of gifts made during the period an amount which exceeds twenty-five percent (25%) of the total amount of gifts stated on such return. Since the settlor failed to report the transfer of approximately $630,000 on his return for the period ending March 30, 1974, and the amount omitted exceeded twenty-five percent (25%) of the total gifts reported ($102,000), the Service ruled the tax due on the settlor's transfer should have been assessed on or before June 25, 1980. Barring fraud, no tax on that transfer could be assessed after such date.

<u>**Law & Analysis – Issue 2**</u>: Section 7-3.1 of the New York Estates, Powers and Trusts Law (the "**E.P.T.L.**") provides that "a disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."

There have been several New York cases interpreting Section 7-3.1 of the E.P.T.L. The cases are in agreement that the statute is applicable only to those transfers in trust which are *solely* for the use of the settlor. See *Curtis v. Leavitt*, 15 N.Y. 2 (1857); *Newton v. Jay*, 107 Div. 457, 95 N.Y.S. 413 (1905); *Liberty Storage & Warehouse Co. v. Van Wyck*, 256 App. Div. 641 (1939); and *In re Bourne's Will*, 158 N.Y.S. 2d 1009 (1957).

Since several individuals other than the settlor had interests in the income and corpus of the trust, the trust was not deemed to be a "trust for the use of the creator" within the meaning of Section 7-3.1 of the E.P.T.L. Accordingly, the trust created by the settlor in 1973 was not void under New York law as to the creditors of the settlor's estate. The Service ruled there was no reason to address the includability of the trust assets in the settlor's estate under § 2038 of the Code.

Thus, the TAM held (1) the settlor made a completed gift for federal gift tax purposes in 1974, and (2) the trust created by the settlor was not a "trust for the use of the creator" within the meaning of Section 7-3.1 of the E.P.T.L., and there was no basis for including the trust in the settlor's estate under § 2038 of the Code.

18. ***<u>Estate of German v. U.S.</u>*** *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985). On July 31, 1969, Estelle E. German ("**Estelle**") made transfers of property to six separate trusts (the "**Trusts**") for her sons, Frederick A. German ("**Frederick**") and Arthur W. German ("**Arthur**"), as trustees, jointly. Each trust agreement provided that the trustees should accumulate the net income of the trust, and that at the end of each year should add the accumulated net income to the principal of the trust. Three of the trusts were for the benefit of Frederick, and three were for the benefit of Arthur. Each trust provided that after Estelle's death the trustees, in their sole and absolute discretion, were to accumulate for, pay to or apply for the benefit of the respective trust beneficiary all or part of the net income and principal of the trust, and, upon the death of the beneficiary, to such members of Frederick's or Arthur's family, as the case may be, as each should appoint.

Notwithstanding the foregoing, during Estelle's life, the trustees had the power at any time in their absolute and uncontrolled discretion to pay to or apply for the benefit of Estelle all or part of the net income and principal as the trustees should determine, in their absolute and uncontrolled discretion, for any reason whatsoever, subject only to the condition that the trustees receive the written consent of the respective beneficiary of the particular trust, Frederick or Arthur, individually, as the case may be.

Estelle filed a gift tax return for 1969 which reflected that she had made no taxable gift during that year. Estelle died on November 21, 1970. Her estate tax return, filed August 11, 1972, did not include in her estate the value of the assets transferred to the Trusts in 1969. Subsequently, a federal estate tax deficiency of $355,959 was assessed against Estelle's estate, which amounts were paid on various dates in 1973 and 1974. A timely claim for refund was filed on December 17, 1975, which was denied on December 28, 1979.

The question presented was whether Estelle divested herself of her interest in property in 1969 when she transferred such property to the Trusts with a proviso that the trustees might, in their absolute discretion, pay any or all of the income or principal to Estelle at any time during her lifetime, if they received the written consent of the person who was entitled to receive the principal and accumulated income of the Trusts after her death, or, whether Estelle continued to enjoy the right to the income or principal of the Trusts up to the date of her death, because under Maryland law if Estelle chose to incur any debts, Estelle's creditors could attach or levy upon the Trusts' assets to collect on such debts.

On the government's motion for summary judgment, the Claims Court held that the government could not assess an estate tax deficiency on the grounds that the value of six trusts established by Estelle during her lifetime should have been included in the Estelle's gross estate, where the government did not establish that under Maryland law that Estelle's creditors could have reached the income or principal of the trusts up to time of her death. Estelle's estate was not equitably estopped from recovering estate tax overpayment.

Section 2036 of the Code includes in the gross estate the value of any interest in property of which a decedent has at any time made a transfer under which he has retained for his life the possession or enjoyment of, or the right to income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. Section 2038 of the Code includes in the 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, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power by the decedent alone or by the decedent in conjunction with any other person, to alter, amend, revoke, or terminate.

The government's theory that the value of the Trusts established by Estelle during her lifetime should have been included in her gross estate was based upon the rationale of *Outwin v. Commissioner*, 76 T.C. 153 (1981) (acq., 1981-2 C.B. 2), a gift tax case. In *Outwin*, a settlor had created four irrevocable trusts, which were to accumulate the income during the settlor's lifetime. After the settlor's death, if the settlor's wife survived him, the settlor's wife was entitled to mandatory distributions of the trust income annually, and to distribution of the corpus to her only in the absolute and uncontrolled discretion of the trustee. Additionally, the settlor's wife was given a special testamentary power of appointment over the corpus. Notwithstanding the foregoing, the trustees were given the power at any time during the life of the settlor to pay to or apply for the benefit of the settlor such part or parts of the income and principal as the trustees should determine in their absolute and uncontrolled discretion, for any reason; however, such distributions by the trustees required the prior written consent of the settlor's wife. The Service determined that in transferring property to such trusts that the taxpayer had made a completed taxable gift, while the taxpayer contended to the contrary. The Tax Court overruled the Commissioner on the ground that the gift was not completed because the taxpayer retained dominion and control over the property transferred. The Tax Court stated that "[w]here the trust agreement specifies that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for tax purposes." *Id*. at 162. However, "[a] different result obtains where state law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims." *Id*. This result follows, the court said, from the fact that if under state law the creditors of a settlor-beneficiary

of a discretionary trust may reach for satisfaction of claims the maximum amount which the trustee may pay to the settlor or apply for her benefit, the taxpayer could at any time "obtain the economic benefit of the trust income simply by borrowing and then forcing [his] creditors to look to [his] interest in the trust income for a source of repayment." *Id*. The Tax Court held that the gift was incomplete to the extent of the value of the taxpayer's life estate because it found that the taxpayer's creditors did have such a right under Massachusetts law (which applied to the *Outwin* trust). *Accord, Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir.1958) (applying Michigan law); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954) (also applying Massachusetts law); and Rev. Rul. 76-103, 1976-1 C.B. 293. But see *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir.1941), and *Uhl's Estate*, 241 F.2d 867 (7th Cir.1957), reaching contrary results under New York and Indiana law, respectively.

The government in *German* claimed that under Maryland law (which governed the Trusts), Estelle's creditors could have reached the principal and interest of the Trusts until the time of her death. Accordingly, the government claimed that Estelle had not disposed of her right to possession and enjoyment of the property, and the transfer took effect upon her death. Estelle's estate maintained that Maryland law did not give Estelle's creditors such right, and, accordingly, her gifts were completed at the time she transferred the assets in trust and they were no longer subject to estate tax. Thus, the narrow issue to be decided by the Court of Claims was the extent of the rights of Estelle's creditors with respect to the trust income and assets under Maryland law.

The government relied primarily on the Maryland case of *Warner v. Rice*, 66 Md. 436, 8 A. 84 (1887). In *Warner*, the court held that the income of property placed in trust by a debtor was subject to attachment by such debtor's creditors where the trust provided that (A) the trustees had discretion to pay income to the debtor and his family, (B) the debtor retained the right to appoint the remaining principal at his death by will (in default of appointment, the remaining principal would be distributed under Maryland law) and (C) the deed specified that it was to be "free from liability for any of [the debtor's] debts, contracts or engagements." *Warner* at 85. The court held that the debtor's creditors could reach the income of such trust because "a beneficial legal estate, in fee or for life, cannot be conveyed or devised to a person with a provision that it shall not be alienated, or that it shall not be subject to the debts of the legal owner." The court further noted:

> "[t]he object of the deed of trust was not to destroy or divest himself of his right of property, but simply to place a legal estate therein in a trustee, as, perhaps, a guard against improvident management. But the equitable estate remains in [the debtor] during his life, with full power of disposition by will, and, in default of will, the property devolves on his heirs and representatives at his death, when the trust will terminate . . . As we have seen, there is no limitation over or cesser of [the debtor's] equitable life-estate, or his interest in the rents and profits of the property, upon seizure of the same by his creditors." *Warner* at 86.

The Court of Claims distinguished the instant case from *Warner* in several respects. First, if the trustee, in the exercise of his discretion, did not distribute the income or principal to Estelle, it would go to the specified remaindermen; whereas in *Warner,* the undistributed trust income would be accumulated for the settlor's benefit and the corpus distributed pursuant to his

will. Second, before Estelle could receive any distribution from the trustees, the consent of a beneficiary having an adverse interest had to be obtained. Third, the Trusts in the instant case, however, not in *Warner*, made dispositions of the property upon Estelle's death and were not intended solely to shield Estelle's assets from her creditors.

In *Mercantile Trust Co. v. Bergdorf Goodman & Co*., 173 A. 31 (1934), the Maryland Court of Appeals confirmed that where there is no proof of fraud, the rights of attaching creditors to property in a trust created by a debtor depend upon whether the property which is not distributed to the settlor-beneficiary or according to his direction reverts to the settlor or to a third-party at his death. In *Mercantile Trust,* the settlor had created an *inter vivos* trust, retaining a life estate in the trust assets and a power of appointment by will, which, if not exercised, would result in the property passing to her then living issue or next of kin. The Maryland court held that although the creditors could attach the settlor's income from the life estate, in the absence of a fraudulent conveyance they could not reach the corpus of the trust, because, "there was an immediate vesting of the remainder in the next of kin of the settlor," and "[w]ith the ownership of the corpus in the remaindermen, even though the possession may be delayed or defeated by the will of the donor, the corpus cannot be attached to satisfy the creditors of the settlor." (*Id*. at 34-35.) *Accord*, *United States v. Baldwin*, 283 Md. 586, 391 A.2d 844 (1978).

The Court of Claims reasoned that if the unexercised right of the settlor in *Mercantile Trust Co.* and *Baldwin* to dispose of the corpus by will was not sufficient to render the trust property subject to execution by creditors because of the interests of the remaindermen in such property in default of appointment, the unexercised discretion of the trustees of the Trusts with respect to both principal and income would not render either vulnerable to Estelle's creditors under Maryland law.

The Court of Claims noted that apart from *Warner* the government did not cite any Maryland decision in which creditors were able to reach income or corpus which could be distributed to the settlor of a trust, not as a matter of right, however, in the uncontrolled discretion of the trustee. Additionally, the Court of Claims noted that the government cited no decision, either in the Maryland courts or elsewhere, where the creditor was held to be entitled to attach trust property where the trustee's discretion could only be exercised with the prior consent of those who would receive the property in default of such exercise.

In *Outwin*, the Tax Court admitted that it had been unable to find any authorities in any state which addressed the precise issue. *Outwin*, 76 T.C. at 165. However, the Tax Court resolved that problem by reasoning that in view of the strong public policy of the Massachusetts courts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors, the veto power of a spouse would not be a barrier to such creditors under Massachusetts law, because it assumed (1) that (in the absence of divorce) the possibility that the spouse would veto a disbursement by the trustee to her husband was remote, and (2) the fact that the husband might reciprocate by veto of disbursements to the wife under her similar trust would tend to further discourage her veto. *Id.* at 166-67. The Court of Claims found no such strong public policy in the Maryland courts where there is a remainder interest, and found no assumption by the Maryland courts that a settlor's spouse may be deemed merely the settlor's alter ego for purposes of insulating property from the settlor's creditors in a non-fraudulent conveyance transaction.

The Court of Claims held that the government failed to establish that under Maryland law Estelle's creditors could have reached the income or principal of her the Trusts up to the time of her death, and thus, the government could not assess an estate tax deficiency on grounds that the value of the Trusts established by Estelle during her lifetime should have been included in Estelle's gross estate.

19. ***Estate of Paxton et al. v. Commissioner***. In *Estate of Paxton et al. v. Commissioner*, 86 T.C. 785 (1986), Floyd G. Paxton ("**Floyd")** organized a corporation, Kwik Lok Corporation of Yakima ("**Kwik Lok**") and in 1965 Floyd owned all of Kwik Lok's outstanding stock. Floyd also participated in the organization of Kwik Lok Corporation of Indiana ("**Kwik Lok Indiana**") in 1960 and Paxton Industries, Inc., ("**Paxton Industries**") in 1962. Kwik Lok held nearly all of the stock of Kwik Lok Indiana except three shares which were held by Floyd prior to August 1967. Floyd held all of the stock in Paxton Industries up to that date.

Floyd created the F.G. Paxton Family Organization Trust (the "**PFO Trust**") Trust in 1967. Additionally, Floyd and his wife, Grace Paxton, ("**Grace**") created the International Development Trust (the "**IDT Trust**") in 1968. Floyd, his family members and several of his close associates contributed assets to the PFO Trust. Floyd and Grace contributed assets to the IDT Trust. Under the terms of the PFO Trust and the IDT Trust (collectively, the "**Trusts**"), both of which were amended on several occasions:

(A) certificates of interest (the "**Certificates**") were issued as consideration for the contributions to the trusts;

(B) the only right possessed by the holder of the Certificates was the receipt of trust distributions, which were determined in the absolute discretion of the trustees; and

(C) the Certificates were negotiable only with the express prior consent of the trustees.

PFO Trust and IDT Trust Certificates were issued to Floyd, to his family, and to company employees. Floyd and Grace initially held, collectively, 86.38% of the PFO Trust Certificates and, after conveying Certificates in 1971, 50.02% of the Certificates. Floyd and his Wife held, collectively, 50% of the IDT Trust Certificates. Floyd's son, Jerre Paxton ("**Jerre**"), was appointed as First Trustee for both Trusts. As First Trustee, Jerre had sole discretion to make trust distributions.

Floyd died on December 10, 1975 and Jerre was appointed as the personal representative of Floyd's estate. A family attorney advised Jerre that no estate tax return was required as the value of the assets in Floyd's community estate did not exceed $60,000. No estate tax return was filed for Floyd's estate. Floyd's Certificates were distributed to his children and other family members.

The issue presented to the court in this case was whether Floyd's gross estate included, under §§ 2033, 2036, 2037, or 2038 of the Code, certain property which Floyd had transferred to Trusts during his life.

The Tax Court held that Floyd's transfers to the Trusts were includable in his estate under § 2036(a) of the Code because:

1. Floyd made the transfers subject to an understanding, express or implied, that he would receive the trust income or corpus or both when requested; and

2. Floyd retained an interest in the trust income and corpus that his creditors could reach.

The Tax Court saw the Trusts as an attempt on the part of Floyd to convey wealth to his children without transfer tax. Floyd established two trusts during his life to which he and his wife transferred nearly all of their property. Neither Floyd nor Grace filed a gift tax return in connection with such transfers. The Tax Court found it incomprehensible that Floyd, a wealthy man, would transfer nearly all of his property to irrevocable trusts making no provisions for (A) his own support after a stream of licensing agreement royalties expired in 1982, when Floyd would have been just 64; and (B) Grace's support. The Court noted that Floyd's son, Jerre, was given absolute discretion to make trust distributions. The Court determined that there was an understanding between Floyd and Jerre that Floyd would receive distributions when needed, and for that reason held that the transfer to the Trusts were includable in his estate under § 2036(a) of the Code.

Additionally, the Tax Court noted that in a self-settled trust, the grantor's creditors can reach the maximum amount which the trustee can pay to the grantor. The Tax Court found that under Washington law, Floyd's creditors could reach the entire trust corpus because the trustees had the authority to distribute the entire trust corpus to Floyd. The Tax Court held that because Floyd's creditors could reach the maximum amount which, under the terms of the Trusts, could be distributed to him, Floyd's transfer to the Trusts were includable in his estate under § 2036(a)(1) of the Code.

20. **PLR 8829030**. In PLR 8829030, April 20, 1988, the taxpayer requested a determination of whether certain interests in trusts were includible in the gross estates of such taxpayer's child and grandchild.

In January 1944, A transferred stock to B, his spouse, and to C, and D, his children. Within a short period, B, C, and D transferred the stock to trust X. A subsequently transferred stock to B, C, and D several more times before his death. This stock was invariably transferred by the recipient to trust X or to trust Y, as described below.

B, C, and D were named as grantors of trust X, and C was the trustee of trust X. Trust X provided that the trustee shall, in its absolute discretion, pay all of the income of the trust to B during her life, and upon the death of B the trustee shall, within its absolute discretion pay all of the income to A for his life. Upon the death of the survivor of A and B, the trustee was directed to divide the trust assets into three equal parts and distribute one share each to C, D, and E respectively. E was D's child and A's adopted child.

B died on November 15, 1948. On January 18, 1950, A, C, and D executed trust Y, which amended and revoked trust X. C and D were the named grantors of trust Y, and C was the trustee. Under the terms of trust Y, the trustee was to pay the net income, in the trustee's absolute discretion, to A, C, D, and E. The trust was to terminate upon the death of the survivor of A and

D or on December 31, 1964, whichever occurred later. If A or D or both died before December 31, 1964, the trustee was to, in the trustee's absolute discretion, pay the income to the surviving income beneficiaries until the termination of trust Y. If C or E died before Y terminated, the trustee was to, in the trustee's absolute discretion, pay the income to the surviving income beneficiaries and the issue of C and E until the termination of trust Y. Upon the termination of trust Y, the trustee was to divide the remaining trust property, into two equal parts, and distribute one part to C and one part to E, or their respective issue if C or E was not then living. A died in April 1954, C died in January 1977, E died in August 1986, and D died in April 1987. D was a resident of State Z when she died and E was a resident of State W when he died. The trust is administered in State W.

The trustee distributed the income of trust X and trust Y as required by the governing instruments. From 1944 to 1948 the trustee distributed all of the income of trust X to B. In 1949 the trustee distributed all of the income of trust X to A. After trust X was revoked and from January 23, 1950 until C's death, the trustee distributed the income of trust Y in equal shares to C, D, and E. After C's death, the trustee distributed C's share of the income from trust Y to C's issue, *per stirpes*. The trustee continued to distribute the respective shares of income to D, E, and C's issue from trust Y until D's death in 1987.

Where state law deems that the assets of a discretionary trust are subject to claims of the grantor's creditors, the transfer of property to such a discretionary trust does not constitute a completed gift for federal gift tax purposes. Additionally, if the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate under § 2038 of the Code because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

Under the law of State W, if the trustee has absolute discretion to withhold from the beneficiary all payments or beneficial use, such that the beneficiary could not compel the trustee to distribute anything to him, a creditor of a beneficiary cannot reach the assets of the trust in satisfaction of the beneficiary's debts. See *e.g.*, *Huffman v. Chasteen*, 209 S.W.2d 705 (1948); *Department of Public Welfare v. Meek*, 95 S.W.2d 599 (1936).

State Z's courts have generally applied the law where the trust is administered in resolving legal issues involving the administration of the trust. In *Farmers and Merchants Bank v. Woolf*, 523 P.2d 1346 (1974), the State Z Supreme Court held that where a settlor creates a trust to be administered in a state other than that of his domicile, the law of the state where the trust is administered is the proper choice of law rather than the testator's domicile or some other jurisdiction. See also 5 *Scott, Law of Trusts*, sections 625-628 (3d ed. 1967). ***Accordingly, in determining whether a creditor could attach D's interest in trust Y, the law in State W governed.***

In the instant case, the trustee possessed, pursuant to the terms of the governing instrument, absolute discretion to distribute income to D and E. The law under the applicable state would not allow a creditor of a beneficiary to reach the interest of a beneficiary of a discretionary trust. Since D and E are beneficiaries of the discretionary trust in question, their creditors could not reach their interests in the trust in satisfaction of debts. As such, assuming arguendo that D and E were grantors, D and E did not possess any interests in the trust at death

that would require inclusion of any trust corpus in their respective gross estates under § 2038 of the Code.

Trust Y had two levels of grantors. On one level, D and E were grantors of trust Y to the extent that each of their one-third (1/3) remainder interests in trust X passed to Y when X was amended and revoked. For the exchange of their respective remainder interests in X, D received a discretionary income interest in trust Y, and E received a discretionary income interest and a possible remainder interest in one-half (1/2) of trust Y. On another level, D may also have been a grantor of trust Y. As noted above, D was one of the named grantors of trust Y. Each time A transferred stock to B, C, and D, they, in turn, transferred the stock to either trust X or trust Y, whichever was in effect when the stock was transferred. The taxpayer represents that B, C, and D were mere conduits and that the real grantor of both trusts was A. The taxpayer represented that the parties had agreed that when A transferred stock to B, C, and D, they would in turn transfer the stock to the respective trust (either X or Y). However, the taxpayer was unable to submit any written agreement between the parties. In the absence of the written agreement, the existence of an implied or oral agreement between the parties is a question of fact on which the Service declined to rule.

Similarly, the Service declined to rule whether D and E, with respect to property which they transferred to trust Y, retained interests therein which would necessitate the inclusion of the values in their respective gross estates pursuant to § 2036 of the Code. Under trust Y, D received the right, at the discretion of the trustee, to receive trust income for life and E received a similar discretionary income interest. However, during the term of Y, D and E were each consistently paid one-third (1/3) of the trust income. The taxpayer maintained that there was an implied agreement between the parties regarding the transfer of stock into trust X and trust Y. Whether D and E retained any income interests under trust Y would depend upon whether there existed an implied agreement between the beneficiaries and the trustee of trust Y to distribute income. The Service ruled that the existence of an implied agreement required a factual determination which is appropriately made by a District Director.

Additionally, the Service noted that § 2037 of the Code would be applicable in the case of E's transfer to trust Y. As noted above, the Service concluded that E was the grantor of trust Y to the extent of the value of the one-third (1/3) remainder interest in trust X that E possessed and transferred. Under the terms of trust Y, E possessed the right to receive one-half (1/2) of the trust corpus if he survived termination of the trust. If E failed to survive termination, his share of the trust corpus would pass to his issue. Thus, for purposes of § 2037 of the Code, E made a transfer to trust Y pursuant to which: (1) possession or enjoyment of the property transferred could be obtained by E's issue only if they survived E; and (2) E retained a reversionary interest in the property transferred. See Regs. § 20.2037-1(e), example 3. The Service determined that § 2037 of the Code was applicable to the transfer provided the factor for valuing E's reversionary interest, determined in immediately before E's death, exceeded five percent (5%). Additionally, the Service determined that the appropriate factor to be utilized would be dependent on E's age and D's age immediately before the death of E. If this factor exceeded five percent (5%), a proportionate part of the value of the trust corpus on the date of E's death would be includible in E's gross estate.

21. **PLR 9332006**. In PLR 9332006, the taxpayer sought rulings regarding the income, excise, gift, and estate tax consequences upon the establishing and funding a trust organized under the laws of Country X.

Settlor A and Settlor B (hereinafter referred to individually as a "**Settlor**" and collectively as the "**Settlors**") were siblings. Both Settlors were United States citizens. Each Settlor owned Percentage A interest in Corporation A, a domestic corporation. Corporation A owned all of the voting common stock of Corporation B, also a domestic corporation. That voting common stock represented Percentage B of the value of Corporation B. The balance of Corporation B's stock, represented by non-voting common shares, was owned by the Partnership, a domestic limited partnership. The Partnership conducted no active business. Each Settlor directly owned Percentage C of the interests in the Partnership. Together, those interests comprised all of the Partnership's limited partnership interests. Corporation A, which owned a Percentage B general partnership interest in the Partnership, was the sole general partner of the Partnership.

The Settlors created an irrevocable trust (the "**Trust**") under the laws of Country X and contributed nominal consideration to fund it. The beneficiaries of the trust included the Settlors, Beneficiary A (a living parent of the Settlors and a United States citizen), and the Settlors' living and future heirs. Either (1) the Trustee (an independent Country X corporation) with the consent of the Protector, or (2) Beneficiary A, could direct trust income or principal be appointed to or for the benefit of any beneficiary, provided, however, that only the Protector may make any such appointment for the benefit of Beneficiary A or of either Settlor. The term of the trust was 100 years, unless it was terminated earlier in the sole discretion of the Trustee. Upon termination, the Trustee could, in its discretion, appoint assets of the Trust to any or all of the then beneficiaries, or, if there were no then living beneficiaries, for charitable purposes. Each Settlor was precluded from becoming a successor trustee.

Under the laws of Country X, a trust may include provisions pertaining to the rights and obligations of a Protector. The Trust named a United States citizen as Protector and made provision for the appointment of successor Protectors. The Trust further provided that the Protector may appoint new or additional trustees (however, not, as noted above, a Settlor), and that neither a Protector nor the estate of a Protector was a permissible beneficiary of the Trust.

It was represented that: (1) the Protector could not be a person or entity related to or under the control of either Settlor; (2) under the laws of Country X neither a beneficiary nor any creditor of any beneficiary, including the Settlors, could compel the trustee to distribute the Trust's assets to or for their benefit at any time during the trust term; (3) that transfers by the Settlors of interests in the Partnership to the Trust were not in any way liable to be set aside under any applicable fraudulent conveyance or other law, domestic or foreign; (4) neither the Trustee nor the Settlors planned to hold Trust assets anywhere other than Country X; and that the Trust was a "**foreign trust**" within the meaning of § 7701(a)(31) of the Code.

The Settlors proposed to transfer each of their interests in the Partnership to the Trust.

Rulings were requested regarding the following issues:

(1) Were the transfers of interests in the Partnership to the Trust by the Settlors completed gifts for purposes of § 2511 of the Code at the time of the transfers to the Trust?

(2) Would any portion of the Trust be includible in the estates of either Settlors A or B under §§ 2033, 2036, 2037, or 2038 of the Code?

Issue 1: *Were interests in the Partnership transferred to the Trust by the Settlors completed gifts subject to federal gift tax under § 2511 of the Code?*

The Sixth Circuit Court and Tax Court have held that a grantor of an irrevocable *inter vivos* trust has not completely parted with dominion and control over trust assets where the grantor could in actuality retain the economic benefit and enjoyment of the entire trust income and corpus by borrowing money or by selling, assigning, or transferring the grantor's interest in the trust fund and relegating the grantor's creditors to the trust fund for payment. *Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958); *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986). In view of the Settlors' retained rights in these cases, there was no assurance that anything of value had passed to the remaindermen and the gifts were held to be entirely incomplete. See also Rev. Rul. 76-103, 1976-1 C.B. 374 (concluding that such an incomplete gift would be includible in the gross estate for estate tax purposes under § 2038 of the Code).

In the instant case, the Settlors, however, could part with dominion and control over the property being transferred into the Trust. Although the Trustee had an unrestricted power to pay over trust assets to the Settlors, the Settlors could not individually or together require that any of the assets of the Trust be distributed to themselves. Further, assuming taxpayers' representation regarding the law of Country X was correct, neither of the Settlors could utilize assets transferred to the Trust by incurring debt and relegating Settlor's creditors to the trust.

Accordingly, based on the taxpayers' representations regarding Country X law, the Service ruled that transfers of interests in the Partnership to the Trust were completed gifts and the entire value of the interests in the Partnership transferred to the Trust by the Settlors was subject to the federal gift tax.

Issue 2: *Would interests in the Partnership transferred to the Trust by the Settlors be includible in their gross estates under §§ 2033, 2036, 2037, or 2038 of the Code?*

In *United States v. Byrum*, 408 U.S. 125 (1972), 1972-1 C.B. 518, the decedent was a controlling shareholder and a member of the board of directors of a closely-held corporation. The Supreme Court held that stock in the corporation transferred by the decedent to an irrevocable trust was not included in his gross estate under § 2036 of the Code even though the decedent expressly retained the right to vote the transferred stock and to veto the sale or disposition of the stock by the trustee. The Court held that the decedent, as a controlling shareholder and a member of the board of directors, had a fiduciary duty to promote the interests of the corporation and not to exercise his voting power to promote his personal interests at the expense of the minority shareholders. Accordingly, the decedent's retained power to vote the stock did not constitute the retained enjoyment of the transferred stock or the right to designate the income from the transferred stack for purposes of § 2036 of the Code.

In the instant case the Settlors were the sole shareholders of Corporation A, which was the general partner in the Partnership. Accordingly, the grantors had management authority over the Partnership, which would include the authority to control partnership distributions. However, similar to the decedent in *Byrum*, each Settlor in the instant case occupied a fiduciary position with respect to the limited partners of the partnership, and could not distribute or withhold distributions or otherwise manage the Partnership for purposes unrelated to the conduct of the partnership business.

Furthermore, based on the taxpayer representations regarding the law of Country X, the property transferred to the Trust would not be included in the gross estate of either Settlor under § 2033 of the Code, since the gift to the Trust would be complete and neither Settlor would have the right to compel a distribution from the trust. Similarly, interests in the Partnership transferred to the Trust by either Settlor would not be included in that Settlor's gross estate under §§ 2036, 2037, or 2038 of the Code since under the facts presented the Trustee's discretion to make distributions to a Settlor was not a retained interest or power for purposes of those sections. See *e.g.*, Rev. Rul. 76-103, 1976-1 C.B. 374.

Accordingly, the Service ruled that the value of the interests in the Partnership transferred by a Settlor to the Trust would not be includible in the gross estate of that Settlor under §§ 2033, 2036, 2037, or 2038 of the Code.

22. **PLR 200822008**. In PLR 200822008, a grantor established an irrevocable trust on a date after September 25, 1985. The grantor's spouse was designated as the initial trustee of the trust and at the time of the ruling was currently serving as the trustee. Immediately upon execution of the trust agreement and in accordance with its terms, the trust was divided into two separate shares, the "Exempt Trust" and the "Non-Exempt Trust." The Non-Exempt Trust was funded with the first $5,000 transferred to the trust as the initial gift. Thereafter, the Exempt Trust was directed to be funded with a pecuniary amount equal to the lesser of the balance of the initial gift allocated to the Non-Exempt Trust or the grantor's remaining GST exemption and the remaining GST exemption of the grantor's spouse under Section 2631 of the Code.

Until the "Triggering Event," the trust agreement gave the trustee of the Exempt Trust the authority to distribute all, part or none of the trust income and principal, in the trustee's discretion to any of the grantor's descendants for any such descendant's health, education, maintenance, or support. The Triggering Event is defined in the trust agreement as the earlier to occur of (a) the date that the Exempt Trust is no longer considered a grantor trust under Section 671, *et. seq*. of the Code (the "**grantor trust rules**") or (b) the date the Trustee elects.

After the Triggering Event, until the first to die of the grantor or the grantor's spouse, the trustee is authorized to distribute to the grantor's spouse as much or all of the income and/or principal of the Exempt Trust as the trustee determines in its sole discretion. Notwithstanding the foregoing, any such distribution can only be made with the consent of an adverse party (as such term is defined in Section 672 of the Code). Upon the first to occur of the death of the grantor or the grantor's spouse, the trustee is directed to distribute the remaining trust corpus to any one or more of the grantor's descendants as the grantor's spouse may appoint by will. The balance of the trust assets that are not appointed are directed to be divided into equal shares for the grantor's then living children with any then living child of a deceased child being treated as a

child of the grantor. Any such shares established by this division are directed to be held in further trust for the benefit of the beneficiaries.

Until the "Triggering Event," the trust agreement gave the trustee of the Non-Exempt Trust the authority to distribute all, part or none of the trust income and principal, in the trustee's discretion to any of grantor's children for their health, education, maintenance, or support. The term Triggering Event is defined in the same manner as it is for purposes of the Exempt Trust. Upon the Triggering Event the trustee is directed to divide the remaining assets of the Non-Exempt trust into as many equal shares as are necessary to provide one share for each of the grantor's children who are then living and one share for each of the grantor's children who are deceased but have descendants then living. Each share for a deceased child is directed to be further divided into shares, *per stirpes*, for such child's then living descendants. These shares are to be administered under Article VI of the Trust instrument. Each separate share is directed to be distributed outright to the beneficiary for whom the share was established.

Although the facts of the ruling do not disclose the terms of the provision causing grantor trust status, the ruling acknowledges that the grantor is the owner of the Exempt Trust and the Non-Exempt Trust under the grantor trust rules. Therefore, the grantor is required to include the income, gains, losses, credits, etc. of the trust in determining his personal income tax liability. The trust agreement also provided that the trustee may not reimburse the grantor for any such income tax that he is required to pay as a result of the trust constituting a grantor trust. Furthermore, the trust agreement provides that the grantor waives any right he may have to be reimbursed for such tax liability.

The trustee proposed to petition an appropriate court to modify the terms of the trust to allow the trustee, in its discretion, to pay to the grantor or his legal representative such amounts as are sufficient to satisfy the grantor's federal, state, or local income tax liability incurred by the grantor by reason of the grantor trust status of the trust. Furthermore, this reimbursement power would only be exercisable by the trustee with the consent of a "Reimbursement Committee" and at least one child of the grantor who is also a beneficiary of the trust and who is an adult (provided such child qualifies as an adverse party Section 672(c) of the Code).

E, an independent attorney, will be appointed as the initial member of the Reimbursement Committee. E is not an employee of grantor or an employee of a corporation whose stock is owned by the grantor (or any trust under the trust agreement) or whose executives include the grantor, or a relative of the grantor listed in Section 672(c) of the Code. The grantor's spouse, if she is then living, and if not, the grantor's children who are then living by majority vote, or if there are no such children then living, the grantor's then living descendants (also by majority vote), may remove any person serving on the Reimbursement Committee for any reason. These same individuals (in the same circumstances) may also appoint additional persons to serve on the Reimbursement Committee at any time with or without cause. Notwithstanding the foregoing, no one who is related or subordinate to the grantor (within the meaning of Section 672(c) of the Code) is permitted to be appointed as a member of the Reimbursement Committee.

As is typically the case, the facts of the ruling do not disclose the state where the settlor is a resident, the jurisdiction where the trust is being administered or governing law of the trust. Since Florida, New York and Texas all have "tax reimbursement statutes" it may be a good

assumption that the trust is administered in one of those states, and the law of one of those states is the governing law of the trust.

In regards to estate tax and GST tax issues, the taxpayer requested the Service rule that:

(a) Any income taxes that the grantor is reimbursed will not cause the value of the assets in the trust to be included in the grantor's gross estate.

(b) The reformation will not result in the trust assets being included in the grantor's gross estate.

(c) The modification of the trust agreement proposed in the ruling will not affect the inclusion ratio of the Exempt Trust for GST tax purposes.

The ruling examined the application of § 2036 of the Code. According to Regulation § 20.2036-1(b)(2), the use, possession, right to income, or other enjoyment of transferred property is treated as having been retained by the decedent to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the decedent. See also *Estate of Prudowsky v. Com'r*, 55 T.C. 890 (1971), *aff'd*, 465 F.2d 62 (7th Cir. 1972) (property held under the state Uniform Gifts to Minors Act was included in the decedent's gross estate under § 2036(a)(1) of the Code because the decedent, as custodian, retained the authority to use the property to satisfy his legal obligation to support a minor for whose benefit the custodianship was created); *Richards v. Com'r*, T.C.M. 1965-263, *aff'd*, 375 F.2d 997 (10th Cir. 1967) (trust corpus includible in decedent's gross estate under Section 2036(a)(1) because mandatory distributions of trust income to his spouse satisfied his spousal support obligation). Nevertheless, Section 2036 generally will not apply where trust assets may be used to satisfy a decedent-settlor's legal obligations only in the discretion of the trustee, whether or not such discretion is exercised by the trustee. *Com'r v. Estate of Douglas*, 143 F.2d 961 (3d Cir. 1944), *acq.* 1944 C.B. 7; *Estate of Mitchell v. Com'r*, 55 T.C. 576 (1970), *acq.* 1971-2 C.B. 3.

The ruling neglects to discuss the potential application of Section 2038 of the Code to the trust, however, this section would most likely be the proper section to be applied to include any portion of the trust assets in the grantor's estate attributable to gifts made by the grantor prior to the reformation. Technically, Section 2036 of the Code is only applicable where a grantor retains an interest in a trust or a power over trust assets or the income from such assets. On the other hand Section 2038 merely requires the grantor to hold a proscribed power at death. Section 2036 could technically cause inclusion of the portion of the trust attributable to gifts made the grantor after the reformation is completed and Section 2038 could be applicable to cause inclusion of the trust assets before and after the reformation.

The Service issued Revenue Ruling 2004-64, 2004-27 I.R.B. 7 on July 6, 2004 which provides rules related to payment by the trustee of the grantor's income tax liability on income generated by assets held in a wholly-owned grantor trust. Important to this discussion, the ruling contains rules related to estate tax inclusion when a trust agreement or applicable law provides that the trustee may reimburse the grantor from the trust for the grantor's income tax liability incurred from income generated by the trust.

In the Revenue Ruling the taxpayer ("**T**"), a United States citizen, establishes and funds an irrevocable *inter vivos* trust for the benefit of his descendants. The trust agreement contains a provision requiring the trustee be a person who is not related or subordinate to the taxpayer within the meaning of Section 672(c) of the Code. Under the terms of the trust (except as discussed below) T retains no beneficial interest in or power over the trust income or corpus that would cause any gift to the trust to constitute an incomplete gift for federal gift tax purposes. Except as discussed below, T also retains no beneficial interest in or power over the trust income or corpus that would cause the trust assets to be included in his gross estate for federal estate tax purposes at his death. Nonetheless, the trust agreement contains certain provisions that cause T to be treated as the owner of the trust under the grantor trust rules. During the first year of the trust it generates taxable income of $10*x*. Pursuant to the grantor trust rules T must include the $10*x* in his taxable income. As a result T's personal income tax liability for the first year of the trust increases by $2.5*x*. T dies in the third year after he established the trust. On the date of his death the fair market value of trust's assets is $150*x*.

The Revenue Ruling contains three fact "situations." In the third fact situation the trust agreement contains a discretionary tax reimbursement provision. According to the Revenue Ruling, if T is treated as the owner of any portion of trust under the grantor trust rules for any taxable year, the trustee may, in the trustee's discretion, distribute to T for the taxable year, a sufficient amount of assets from the trust to satisfy T's personal income tax liability attributable to the inclusion of such income in T's taxable income. Accordingly, to reimburse T for his tax liability attributable to the income from the trust generated in its first year, the trustee exercises its discretionary power by distributing $2.5*x* to T. According to the ruling, provided there is no express or implied understanding between T and the trustee regarding the trustee's exercise of the trustee's discretion, the discretionary authority granted to the trustee to satisfy T's obligation to pay his tax liability would not alone cause the inclusion of the trust assets in T's gross estate for federal estate tax purposes. The ruling provides that this will be the case regardless of whether the trustee actually reimburses T from trust assets for the income tax he pays that is attributable to the trust's income. Further, the ruling states that the same result will occur if the trustee's discretion to reimburse T for this income tax is granted under applicable state law rather than under the trust agreement. Nevertheless, the ruling cautions:

> such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between [T] and the trustee regarding the trustee's exercise of this discretion; a power retained by [T] to remove the trustee and name [T] as successor trustee; *or applicable local law subjecting the trust assets to the claims of [T]'s creditors*) may cause inclusion of Trust's assets in [T]'s gross estate for federal estate tax purposes. [Emphasis added.]

Similar to Revenue Ruling 2004-64, PLR 200822008 neglected to provide an extensive discussion of the concept of a self-settled trust, that is, a trust in which the settlor, *i.e.,* the donor, remains eligible to receive distributions of income and/or principal from the trust. Nonetheless, the treatment of this type of trust under the law governing to the trust is important to the result the taxpayer seeks to achieve in the ruling, that is, avoiding any portion of the trust becoming subject to inclusion in the grantor's estate for estate tax purposes.

In PLR 200822008, after the proposed reformation, the trustee will have the discretion to reimburse the grantor for his income tax liability actually incurred by the grantor because of items of income and gain in the trust. Accordingly, if there is no express or implied understanding between the grantor, the members of the Reimbursement Committee and the trustee with respect to the trustee's exercise of discretion to reimburse the grantor, the trustee's discretion to satisfy grantor's tax liability would not by itself cause inclusion of the trust in the grantor's estate for estate tax purposes. Nonetheless, this authority in conjunction with other factors (such as an understanding or pre-existing arrangement between grantor and the trustee, or member(s) of the Reimbursement Committee regarding the trustee's use of this authority; or applicable law subjecting the trust assets to the claims of the grantor's creditors) could cause inclusion of trust assets in grantor's estate for estate tax purposes.

Interestingly, the law of Delaware and Alaska each contain statutes that render any express (that is, not contained in the trust agreement) or implied agreement or understanding between a grantor and a trustee void. See 12 Del. Code Ann. § 3571; A.S. §§34.40.110(i). States that have or will enact discretionary tax reimbursement provisions should strongly consider enacting this type of prophylactic statutory rule. Such a rule might prove to be beneficial in combating an argument by the Service that there is an understanding or pre-existing arrangement between a grantor and a trustee as to the trustee exercising its reimbursement authority.

PLR 200822008 examined the potential application of the GST tax to the proposed modification. The ruling noted that the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. Nonetheless, the GST tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. A trust that became irrevocable on or before September 25, 1985, is referred to as a "grandfathered trust" or a trust that is not subject to GST tax. An "exempt trust" is a trust executed and funded after September 25, 1985, to which a grantor has allocated all or a portion of his GST exemption to exempt the trust from the GST tax.

The ruling noted that Regulation Section 26.2601-1(b)(4)(i) set forth rules for determining whether a modification, judicial construction, settlement agreement, or action taken by a trustee in regards to a grandfathered trust that is not subject to the GST tax will cause the trust to forfeit its exempt status. In this regard, Regulation Section 26.2601-1(b)(4)(i)(D) provides that a modification of a governing instrument of an exempt trust by judicial reformation, or non-judicial reformation that is valid under applicable law, will not cause a grandfathered trust to be subject to the GST tax provided the modification does not shift a beneficial interest in the trust to a beneficiary who is in a lower generation (as defined in Section 2651 of the Code) than the individual or individuals who held the beneficial interest prior to the modification. Additionally, the modification cannot extend the time for vesting of any beneficial interest in the trust beyond the period set forth in the original trust. The Regulation cautions that a modification of a trust will result in a shift in beneficial interest to a lower generation beneficiary where the modification results in an increase in the amount of a GST transfer or the creation of a new GST transfer.

The ruling noted that guidance has never been provided regarding the GST tax consequences of the modification of a trust established after September 25, 1985. According to the ruling, "At a minimum, a modification that does not affect the exempt status of a trust that is

not subject to the GST tax because it was irrevocable on to September 25, 1985 should similarly not affect the inclusion ratio of a trust created after September 25, 1985." Thus, the ruling held that the same rules that apply under Regulation Section 26.2601-1(b)(4)(i) will be applied to trusts that are made exempt by allocation of a transferor's GST exemption which were established after the effective date of the GST tax.

The ruling held that the proposed modification would not shift a beneficial interest in the trust to a beneficiary that occupies a lower generation than the beneficiaries who have beneficial interests prior to the modification. It also noted that the modification does not extend the time for vesting of a beneficial interest in the trust beyond the perpetuities period provided in the original trust. Therefore, the ruling held that the proposed modification would not affect the inclusion ratio of the Exempt Trust for purposes of the GST tax.

The ruling expressed no opinion on the gift tax consequences of the proposed transaction. Nevertheless, if no estate tax inclusion would occur as a result of inclusion of the discretionary tax reimbursement provision in the trust agreement, that provision should not affect the grantor's ability to gift cash or other assets to the trust and have any such transfer treated as a completed gift for federal gift tax purposes. This result is consistent with the holdings in Revenue Ruling 76-103, 1976-1 C.B. 293, Revenue Ruling 77-378, 1977-2 C.B. 347, PLR 200944002; PLR 9837007 and PLR 9332006.

23. **Gift Splitting, Discretionary Trusts and Self-Settled Completed Gift Trusts.** Generally, "[a] gift made by one spouse to a person other than his (or her) spouse may, for the purpose of the gift tax, be considered as made one-half (1/2) by his spouse. . . ." Regs. § 25.2513-1(a). Both spouses must signify their consent to gift splitting. This consent, if signified during any calendar period, is effective for all gifts made to a beneficiary, however, there are five exceptions:

> (1) If the consenting spouses were not married to each other during a portion of the calendar period, the consent is not effective with respect to any gifts made during such portion of the calendar period. . . .
>
> (2) If either spouse was a nonresident not a citizen of the United States during any portion of the calendar period, the consent is not effective with respect to any gift made during that portion of the calendar period. . . .
>
> (3) The consent is not effective with respect to a gift by one spouse of a property interest over which he created in his spouse a general power of appointment (as defined in section 2514(c)) . . . .
>
> (4) If one spouse transferred property in part to his spouse and in part to third parties, the consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to his spouse. . . .
>
> (5) The consent applies alike to gifts made by one spouse alone and to gifts made partly by each spouse, provided such gifts were to third parties and do not fall within any of the exceptions set forth in subparagraphs (1) through (4) of

this paragraph. The consent may not be applied only to a portion of the property interest constituting such gifts. . . . Regs. §§ 25.2513-1(b)(1)-(5).

Under Regulation § 25.2513-1(b)(4), if a donor gifts property in part to the donor's spouse and in part to others, gift splitting may only be elected with respect to the interest given to third parties only if such interest is ascertainable when the gift is made and thus severable from the interest given to the donor's spouse. Where the donor is a discretionary beneficiary of a self-settled completed gift trust, under the same principles, gift splitting may not be elected as it is not possible to determine how much will be severable to third parties, and it cannot be determined if it will be distributed to the donor or the donor's spouse.

There is authority in three tax court cases that carves out a limited exception to allow gift splitting where a spouse is not likely to ever receive a distribution under a standard because, for instance, she is exceedingly wealthy. In these cases, the court considered the non-donor spouse's financial condition and incorporated that analysis into its opinions. See *Robertson v. Commissioner*, 26 T.C.M. 246, 251-52 (1956); *Kass v. Commissioner*, TC Memo 1957-227, 876; and *Falk v. Commissioner*, T.C.M. 86, 93 (1965).

24. ***Crummey* Powers.** In *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the grantors executed an irrevocable trust in 1962 for the benefit of their four children, ages twenty-two (22), twenty (20), fifteen (15), and eleven (11). The trust was divided into separate equal shares for each child. Under the terms of the trust, income of a minor's share was to be accumulated until the minor attained the age of twenty-one (21) unless the trustee in his discretion thought that a distribution should be made to a "needy beneficiary." From ages twenty-one (21) to thirty-five (35) a child was entitled to all income from the child's share. Thereafter, all distributions were within the trustee's discretion. Except for the foregoing, the only way a child could receive a benefit from his or her trust was by exercising the withdrawal right. In the year that the trust was established, the grantors gifted $53,867.77 to it and each grantor claimed a gift tax annual exclusion.

The Service determined that each grantor was entitled to only one gift tax annual exclusion because the portion of the gifts in trust for the grantors' minor children were future interests. However, the court held that the grantors were allowed all of the claimed exclusions because the minors had a "right to enjoy" the property. The court noted that it is only necessary to find that the demand could not be resisted, *i.e.*, legally resisted.

Crummey was not the first case where a trust granted a beneficiary a power of withdrawal over contributions to qualify transfers for the annual exclusion. However, it is the seminal case involving qualifying transfers to a trust for the annual exclusion, and lent its name to withdrawal rights granted to a beneficiary as a result of a gift to a trust (a "*Crummey* Power"). A *Crummey* Power permits a beneficiary to demand that the trustee distribute the gift (or cash or other assets of equivalent value in the trust) to the beneficiary. See *e.g.*, *id.*; *Halsted v. Com'r.*, 28 T.C. 1069 (1957), *acq*., 1958-1 CB 5; *Perkins v. Com'r.*, 27 T.C. 601 (1956); *Gilmore v. Com'r.*, 213 F.2d 520 (6th Cir. 1954); *Kieckhefer v. Com'r.*, 189 F.2d 118 (7th Cir. 1951). Usually, a *Crummey* Power may be exercised for a limited period, such as thirty (30) days following, or until the end of the year in which, the gift creating the *Crummey* Power is made to the trust. Upon the

expiration of the withdrawal period, the property (or value) that was subject to the power continues to be administered and disposed of as provided in the trust agreement. The gift that qualifies for the annual exclusion is the withdrawal right. See Fiore & Ramsbacher, "IRS Takes Tougher Position on *Crummey* Trusts in TAM," 413 EP 23 (Nov. 1996). A *Crummey* Power is probably the most common withdrawal power included in trust agreements.

25. **<u>Gift Splitting and *Crummey* Trusts.</u>** In many *Crummey* Trusts the spouse may be a discretionary beneficiary. Thus, a trustee might be given the discretionary power to distribute income and principal to the donor's spouse. As previously noted, if such a trust did not contain *Crummey* Power provisions, the donor should not be able to split a gift to the trust with his or her spouse under § 2513 and Regs. § 25.2513-1(b)(4). The same would be the case with a completed gift asset protection trusts where the donor is also a current discretionary beneficiary. However, if such a trust contains *Crummey* Power provisions granting withdrawal rights to third parties such as the donor's descendants, the donor should be able to split the portion of each gift to the trust that is subject to withdrawal rights in the third parties. See, *e.g.*, PLRs 8143045, 8015133, 8008040 and 8044080.

26. **<u>Effect of *Crummey* Powers on Gift Splitting.</u>** *Crummey* provisions should take into account the possibility that a donor and a donor's spouse could elect to gift split under § 2513 when making a gift to a *Crummey* trust. The amount subject to withdrawal by a powerholder should not be contingent upon a donor and a donor's spouse electing to gift split. The election to gift split is made on a gift tax return. A gift tax return is generally not filed until the year following the year of the gift because it is not due until April 15 of that year. §§ 6019 and 6075. If the amount subject to a powerholder's *Crummey* Power is contingent upon the donor's spouse electing to gift split, the powerholder's interest will not qualify as a present interest for the portion of a gift that is not withdrawable until the donor's spouse consents to gift split. This is because the withdrawal right is contingent upon the occurrence of a future event. For example, in PLR 8022048, a *Crummey* Trust contained the following *Crummey* Power provisions:

> (a) In any calendar year, the beneficiary shall have the power to withdraw from the corpus the lesser of:
> (i) all amounts added to the trust during such year by the grantor and by any additional grantors; or
> (ii) the sum of the following amounts:
> (A) the product of Three Thousand Dollars ($3,000) multiplied by the number of grantors who have made gifts totaling $3,000 or more during such year to the trust and have not elected to have such gifts treated as being made one-half by the donor's spouse pursuant to §2513 of the Internal Revenue Code.
> (B) the product of Six Thousand Dollars ($6,000) multiplied by the number of grantors who have made gifts totaling $6,000 or more during such year to the trust and have elected to have such gifts treated as being made one-half by the donor's spouse pursuant to §2513; and
> (C) the sum of all gifts to the trust from all donors whose aggregate gifts to the trust during such year are less than $3,000. Such power of withdrawal may be exercised by the beneficiary at any time, and from time to time, during the year up to and including midnight of December 31. The power is not cumulative; it

> lapses if, or to the extent, it is not exercised by delivery to any trustee of written notice of exercise of the power signed by the beneficiary or by any person lawfully empowered to act for the beneficiary. The trustee shall immediately satisfy the withdrawal in cash or, if additions to the trust have been made during such year in kind, by delivery in kind of such property.

The Service recognized in the ruling that the election to gift split might not be made until the due date for filing the donor's gift tax return. This could be several months following a donor's gift to the trust. Thus, under the foregoing *Crummey* Power provision, the trustee could not be required to make an immediate distribution in excess of $3,000 to a powerholder based on a married donor's gift. According to the ruling, "Such a delay on the right of withdrawal … would render the gift a future interest."

Crummey Provisions should be drafted to automatically increase the amount that a powerholder may withdraw if the donor is married at the time of the gift. Such a provision should be operative regardless of whether the donor and the donor's spouse eventually elect to gift split. For example, if the donor is not married, a *Crummey* Power provision should grant a powerholder the right to withdraw up to the amount of the annual exclusion (currently $14,000) of any gift to the trust, however, if the donor is married, the *Crummey* Power provision should grant a powerholder the right to withdraw up to twice the amount of the annual exclusion (currently $28,000) of any gift to the trust.

27. **<u>Gift Splitting With Regards to Preceding Calendar Periods</u>**. In PLR 201523003, the Service ruled that otherwise ineffective gift splitting by a husband ("**Husband**") and wife ("**Wife**") for tax years where the period of limitations under § 6501 for the gift tax return had expired was irrevocable, however, the husband could file amended gift tax returns reporting gifts as made only by him for tax years that were not yet closed. Additionally, Husband and Wife's allocation of GST exemption based upon the otherwise invalid gift splitting was likewise held to be effective.

During Year 1, Husband created and funded a trust ("**Family Trust**") for the benefit of Wife and their descendants. The independent trustee of Family Trust had the power to pay to or use for the benefit of any one or more of Wife, Husband's descendants and the spouses of such descendants for their welfare and best interests. Also during Year 1, Husband established and funded two grantor retained annuity trusts ("**GRAT**") ("**Trust 1**" and "**Trust 2**"). Trust 1's annuity term ended during Year 2 and Trust 2's annuity term ended during Year 3. Upon termination of the annuity terms, the property of Trusts 1 and 2 was distributable to Family Trust.

Husband and Wife filed gift tax returns for Year 1 and consented to gift split under § 2513. On the gift tax returns, Husband and Wife opted out of the GST automatic allocation rules with respect to the gift to Family Trust, however, both Husband and Wife affirmatively allocated GST exemption to a portion of the property transferred to Family Trust. Husband and Wife did not allocate GST exemption to the transfers to Trust 1 and Trust 2 because the estate tax inclusion periods ("**ETIP**") had not closed with respect to those trusts.

Husband filed a gift tax return for Year 2 reporting the transfer of property from Trust 1 to Family Trust, but he did not allocate GST exemption to this transfer. Wife did not file a gift tax return for Year 2.

During Year 3, Husband established and funded two additional GRATs ("**Trust 3**" and "**Trust 4**"). Both Trust 3's and Trust 4's annuity terms ended during Year 4 and at that time, the property of Trust 3 and Trust 4 became distributable to Family Trust.

Husband and Wife both filed a gift tax return for Year 3. They again consented to gift split made in Year 3 under § 2513. Neither Husband nor Wife allocated GST exemption to Trust 3 or Trust 4 because of the ETIP, however, they both affirmatively allocated GST exemption to Trust 2 because the ETIP for that trust ended. Additionally, they took the position on the Year 3 gift tax returns that their respective GST exemptions had been automatically allocated in Year 2 to the transfer of property from Trust 1 to Family Trust.

At the time of the ruling request, Husband and Wife had not filed gift tax returns for Year 4. Further, the period of limitations under § 6501 had expired for Year 1 and Year 2, so those tax years were closed.

The following rulings were requested:

- 1) The election to split gifts in Year 1 is effective with respect to Family Trust, Trust 1, and Trust 2.
- 2) Husband and Wife's allocation of his and her GST exemption equal to $b to the Year 1 transfer to Family Trust is effective.
- 3) At the close of the ETIP in Year 2, Husband's and Wife's GST exemption was automatically allocated to one-half of the transfer of property from Trust 1 to Family Trust.
- 4) At the close of the ETIP in Year 3, Husband's and Wife's GST exemption was affirmatively allocated to one-half the transfer of property from Trust 2 to Family Trust.
- 5) The election to split gifts in Year 3 is ineffective with respect to the transfers to Trust 3 and Trust 4.
- 6) Husband may file a Form 709 to allocate his remaining GST exemption to the Year 4 transfers of property from Trust 3 and Trust 4 to Family Trust.

The PLR stated that because Wife was a permissible beneficiary of Family Trust and her interests were not susceptible of determination and, consequently, were not severable from the interests of other beneficiaries, Husband's gifts to Family Trust, Trust 1, Trust 2, Trust 3, and Trust 4 should not have been eligible for gift splitting. However, because the period of limitations had expired for Year 1 and Year 2, gift split treatment for Husband's transfer to Family Trust and the transfers from Trust 1 and Trust 2 to Family Trust were irrevocable and thus determined to be effective. Since the period of limitations had not yet expired for Year 3, Husband could file an amended return reporting the gifts to Trust 3 and Trust 4 as being made solely by him. The ruling also stated that gift splitting was effective for GST purposes so Husband's and Wife's allocation of GST exemption to Family Trust and automatic allocation to

Trust 1 was irrevocable. Although Husband and Wife's allocation of GST exemption to the transfer of property from Trust 2 to Family Trust was effective, it could be modified by Husband filing an amended gift tax return for Year 3.

C. Income Tax Issues.

When "**violated**," the grantor trust rules attribute income earned by a trust and items of deduction and credits to the grantor. See I.R.C. § 671; Regs. § 1.671-2(b). In general, much of the income tax attributes of foreign and domestic asset protection trusts overlap. Nonetheless, there are some important differences to consider. The grantor trust rules are set forth in §§ 671 through 679. For purposes of this outline, references to a "**grantor trust**" refer to a trust that is treated as owned entirely by the grantor for income tax purposes under § 671, *et seq*.

1. **<u>Domestic Asset Protection Trusts</u>**. The grantor will be treated as the owner of a trust under § 677(a)(1) and (2) if a nonadverse party has the power to distribute income to the grantor or the grantor's spouse. A "**nonadverse party**" is any person who is not an adverse party. § 672(a). For purposes of the grantor trust rules, adversity is measured on the basis of an individual's interest in the trust and not whether an individual is adverse to the grantor or other deemed owner. See 819 T.M., Grantor Trusts: Income Taxation Under Subpart E, IV, A, 1. A trustee is not an adverse party merely because of the interest as a trustee. Regs. § 1.672(a)-1 (a). An individual's interest in a trust is substantial "if its value in relation to the total value of the property subject to the power is not insignificant." *Id.* According to one commentator "use of the double negative [in the quoted language in the text] implies that the standard [of substantiality] is rather low; the interest need only be 'not insignificant"' to be substantial. See 860 T.M., Revocable Inter Vivos Trusts, V, B, 1, c. A beneficiary will ordinarily be an adverse party. Regs. 1.672(a)-1(b). Nonetheless, if a beneficiary's right to share in the income or corpus of a trust is limited to only a portion, the beneficiary may be only an adverse party as to that portion. *Id.*

Unlike a foreign asset protection trust a domestic asset protection trust can be designed to be a non-grantor trust or separate taxpayer. Of course, in states with high income tax rates it may be possible to remove certain income from a taxpayer's state tax base by transferring the assets that generate such income to a trust having a situs and is administered in a state with no income tax that would apply to such trust income. Thus, a popular technique known as a Delaware Income Non-Grantor Trust ("**DING**") or a Nevada Income Non-Grantor Trust ("**NING**") was born from the minds of practitioners seeking to help their clients reduce state income tax liability. A string of private letters rulings over the years have been issued demonstrating how a DING and then a NING should be designed to obtain the proper income and estate and gift tax result. See *e.g.*, PLR 201653001; PLR 201653002; PLR 201653003; PLR 201653004; PLR 201653005; PLR 201653006; PLR 201653007; PLR 201653008; PLR 201653009; PLR 201650005; PLR 201636027; PLR 201636028; 201636029; 201636030; 201636031; PLR 201636032; PLR 201628010 (Service deferred ruling on income tax status of trust); PLR 201614008; PLR 201614007; PLR 201614006; PLR 201613009; PLR 201550005 PLR 201550006; PLR 201550007; PLR 201550008; PLR 201550009; PLR 201550010; PLR 201550011; PLR 201550012; PLR 201550005 PLR 201550006; PLR 201550007; PLR 201550008; PLR 201550009; PLR 201550010; PLR 201550011; PLR 201550012; PLR 201510008; PLR 201510007; PLR 201510006; PLR 201510005; PLR 201510004; PLR

201510003; PLR 201510002; PLR 201510001; PLR 201440012; PLR 201440011; PLR 201440010; PLR 201440009; PLR 201440008; PLR 201436032; PLR 201436031; PLR 201436030; PLR 201436029; PLR 201436028; PLR 201436027; PLR 201436026; PLR 201436025; PLR 201436024; PLR 201436023; PLR 201436022; PLR 201436021; PLR 201436020; PLR 201436019; PLR 201436018; PLR 201436017; PLR 201436016; PLR 201436015; PLR 201436014; PLR 201436013; PLR 201436012; PLR 201436011; PLR 201436010; PLR 201436009; PLR 201436008; PLR 201430007; PLR 201430006; PLR 201430005; PLR 201430004; PLR 201430003; PLR 201426014; PLR 201410001, PLR 201410002, PLR 201410003, PLR 201410004, PLR 201410005, PLR 201410006, PLR 201410007, PLR 201410008, PLR 201410009, PLR 201410010, PLR 200148028, PLR 200247013, PLR 200502014, PLR 200612002, PLR 200647001, PLR 200715005, PLR 200729025, PLR 200731019, PLR 200731019, PLR 201310002, PLR 201310003, PLR 201310004, PLR 201310005 and PLR 201310006. PLR 201510008; PLR 201510007; PLR 201510006; PLR 201510005; PLR 201510004; PLR 201510003; PLR 201510002; PLR 201510001; PLR 201440012; PLR 201440011; PLR 201440010; PLR 201440009; PLR 201440008; PLR 201436032; PLR 201436031; PLR 201436030; PLR 201436029; PLR 201436028; PLR 201436027; PLR 201436026; PLR 201436025; PLR 201436024; PLR 201436023; PLR 201436022; PLR 201436021; PLR 201436020; PLR 201436019; PLR 201436018; PLR 201436017; PLR 201436016; PLR 201436015; PLR 201436014; PLR 201436013; PLR 201436012; PLR 201436011; PLR 201436010; PLR 201436009; PLR 201436008; PLR 201430007; PLR 201430006; PLR 201430005; PLR 201430004; PLR 201430003; PLR 201426014; PLR 201410001, PLR 201410002, PLR 201410003, PLR 201410004, PLR 201410005, PLR 201410006, PLR 201410007, PLR 201410008, PLR 201410009, PLR 201410010, PLR 200148028, PLR 200247013, PLR 200502014, PLR 200612002, PLR 200647001, PLR 200715005, PLR 200729025, PLR 200731019, PLR 200731019, PLR 201310002, PLR 201310003, PLR 201310004, PLR 201310005 and PLR 201310006.

The taxpayer in PLR 201510001, for example, requested rulings under §§ 671, 2041, 2501, and 2514 of the Code in designing the taxpayer's NING. (For purposes of this portion of the outline, we are only concerned with the issues regarding § 671.) In the ruling, the grantor (the "**Grantor**") created an irrevocable trust (the "**Trust**"), for the benefit of the Grantor, his issue, his spouse ("**Spouse**"), Individual 1, Individual 2, and Individual 3 (collectively, the "**Beneficiaries**"). The Trust provides that, during the Grantor's lifetime, the trustees shall distribute such amounts of net income and principal as directed by a Power of Appointment Committee (the "**Committee**") and/or the Grantor as follows:

> (1) At any time, the Co-Trustees, pursuant to the direction of the majority of the Committee members, with the written consent of the Grantor, shall distribute to the Grantor or the Beneficiaries such amounts of the net income or principal as directed by the Committee (the "**Grantor's Consent Power**");
>
> (2) At any time, the Co-Trustees, at the direction of all of the Committee members other than the Grantor, shall distribute to the Grantor or the Beneficiaries such amounts of the net income or principal as directed by the Committee (the "**Unanimous Consent Power**"); and

(3) The Grantor shall have the power in a nonfiduciary capacity, at any time, to appoint to any one or more of the Beneficiaries such amounts of the principal as the Grantor deems advisable to provide for such Beneficiary's health maintenance, support and education (the "**Grantor's Sole Power**").

Upon the Grantor's death, the balance of the Trust may be distributed to such persons or entities (other than Grantor, his estate, his creditors, or the creditors of his estate) as the Grantor appoints by his will. In default of the exercise of the Grantor's limited power of appointment, the balance of Trust will be divided into shares and distributed to the Grantor's issue, to Individual 1, to Individual 2, and to Individual 3.

The Trust provides that the Committee may direct distributions from the Trust to or for the benefit of any one or more of Beneficiaries equally, or unequally, and to the exclusion of others. The members of the Committee serve in a non-fiduciary capacity. The Committee is composed of the Grantor, Child 1, Child 2, Individual 1, Individual 2, Guardian 1, and Guardian 2. If the Committee at any time consists of at least three or more members other than Grantor, all the members of the Committee, including the Grantor, may by unanimous vote add one or more members to the Committee provided that such members are beneficiaries of the Trust. If at any time Committee does not include at least one member other than Grantor, the Committee will cease to exist. In any event, the Committee will cease to exist upon Grantor's death.

The taxpayer requested a ruling that so long as the Power of Appointment Committee is serving, no portion of the items of income, deductions, and credits against tax of the Trust would be included in computing the taxable income, deductions, and credits of the Grantor or any members of the Power of Appointment Committee under § 671 of the Code.

The IRS concluded that no provisions of the Trust would cause the Grantor or any other person to be treated as the owner of any portion of Trust under §§ 673, 674, 676, 677, or 678 of the Code. Further, an examination of the Trust revealed no provisions that would cause administrative controls to be considered exercisable primarily for the benefit of the Grantor or any other person under § 675 of the Code. Thus, the circumstances attendant on the operation of the Trust would determine whether Grantor or any other person would be treated as the owner of any portion of the Trust under § 675. The IRS ruled that this was a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved were examined.

Importantly, the trust in PLR 201510001 was probably established in Nevada in accordance with the Spendthrift Trust Act of Nevada set forth in § 166.010, *et. seq.* of the Nevada Revised Statutes. This is because that act permits a settlor to retain an *inter vivos* special power of appointment that was included in the trust agreement in the facts of this private letter ruling. See N.R.S. 166.040.2(b). The only possible way for the Service to conclude that the trust in this ruling qualified as a non-grantor trust for federal income tax purposes was for the Service to respect the situs issue, that is, that a non-resident of Nevada could establish a trust in Nevada and obtain the benefits of its asset protection legislation that applies to self-settled asset protection trusts.

The DING was not without controversy on the estate and gift tax side. In calendar year 2007, the Service took a particular interest in issues related to general powers of appointment in DING type trusts and to the methods that could be used to cause transfers to the trust to constitute incomplete gifts for Federal gift tax purposes. The Service publicly stated that it was studying such issues closely and requested comments. See IR-2007-127. The Estate and Gift Tax Committee of the Trust and Estate Division of the ABA's Section of Real Property Trust and Estate Law Section submitted comments in response to IR-2007-127 on September 26, 2007. See ABA Section of Real Property, Trust and Estate Law, Letter to Internal Revenue Service dated September 26, 2007. Between PLR 200715005 and PLRs 201310002-201310006, no DING Trust rulings were issued. Further, CCA 201208026 concluded that testamentary powers of appointment retained by grantors over a trust under which the grantors were not beneficiaries caused the remainder interest to be an incomplete gift, however, the testamentary powers of appointment related only to the remainder interest. This had the effect of raising concerns that merely reserving a testamentary limited power of appointment in the grantor could have been insufficient by itself to cause the transfer to a DING trust to be an incomplete gift by the grantor. See Akers, "Private Letter Rulings 201310002-201310006 (March 8, 2013): Favorable 'DING Trust' Letter Rulings; Confirmation of IRS's Position That Settlor's Retention of Testamentary Power of Appointment Does Not Necessarily Cause Full Transfer to Trust to be Incomplete Gift," Bessemer Trust (Mar. 2013).

Some see the use of DING and NINGs as a mechanism to avoid taxes, "[t]he only purpose of setting up these trusts, near as far as we can tell, is avoiding state tax. . ." Rubin, "Wealthy N.Y. Residents Escape Tax With Trusts in Nevada," Bloomberg (December 18, 2013) (quoting James Wetzler, former New York state tax commissioner). One commentator went as far as to analogize the use of DING trusts by residents from high tax states such as New York as "another example of how those who steal with a pen get richer, while those who steal at the point of a gun get jail." See David Cay Johnston, "Getting Dinged by the DING," 2010 TNT 59-8, 1655 (March 29, 2010).

On March 31, 2014, Governor Andrew Cuomo signed into law the 2014-2015 Executive Budget for the state of New York. See N.Y. Laws 2014, ch. 59. Under the legislation, income non-grantor trusts (such as NINGs and DINGs) created by New York residents are deemed to be "grantor trusts" for New York income tax purposes, which results in the income being included in the New York grantor's income whether or not the income is distributed to the grantor. N.Y. Tax Law § 612(b)(41). This provision is effective for income earned on or after January 1, 2014, however, not for trusts that were liquidated before June 1, 2014. Additionally, the legislation provides that distributions from Exempt New York Resident Trusts (trusts established by New York residents that have no New York trustees, no New York tangible property or real estate, and no New York source income) to a New York resident beneficiary after 2014 are subject to New York income taxes with respect to certain accumulations of trust income. This "throwback" tax, similar to the tax imposed by the state of California, will not apply to income that was accumulated in the trust either (A) before 2014, or (B) before the beneficiary first became a New York resident. There is no interest charge on the throwback tax. Capital gains are not typically considered income for these purposes (if the capital gains are not included in distributable net income). See Montesano, "New York Enacts Significant Changes to Its Estate, Gift, GST and Trust Income Tax Laws," 39 Estates, Gifts and Trusts Journal 165 (July 10, 2014).

<u>Gift Tax Domestic</u>. A settlor must report a transfer to his domestic asset protection trust on a Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return (a "**Gift Tax Return**"). See I.R.C. § 6019. A gift tax return will need to be filed even though the gift is designed as an incomplete gift. See Regs. §§25.2511-2(j) and 25.6019-3. When reporting gifts by a grantor to an incomplete gift trust on Schedule A of a Gift Tax Return, the gifts should be reported at a value of zero and a statement similar to the following should be included on the return:

> The donor has retained such dominion and control (within the meaning of Treasury Regulations §25.2511-2) over the assets transferred to this trust as to render the gift incomplete for federal gift tax purposes. The donor has retained an inter vivos and a testamentary special power of appointment over the trust assets.

The foregoing statement alerts the Service of the grantor's position that the gift is not a taxable transfer. According to Regs. §25.6019-3(a):

> If a donor contends that his retained power over property renders the gift incomplete . . . and hence not subject to tax as of the . . . calendar year of the initial transfer, the transaction should be disclosed in the return for the . . . calendar year of the initial transfer and evidence showing all relevant facts, ***including*** a copy of the instrument of transfer, shall be submitted with the return. [Emphasis added.]

Although the gift should be reported at a value of zero (0) on the return for purposes of circulating the donor's gift tax liability, the full value of the transfer should be disclosed on an appropriate attachment to the return.

<u>Form 1041</u>. The domestic asset trust should also file its own Form 1041. Regs. § 1.671-4. The trustee of the domestic asset protection trust is required to file a statement referred to as a grantor trust information letter. This statement must be attached to the Form 1041 to report the income of the trust. The form and attached statement should be filed with the appropriate IRS Service Center by the fifteenth day of the fourth month following the close of the taxable year of the trust. If the trust is a grantor trust, this will correspond to the grantor's taxable year. The person preparing this return for the asset protection trust should check the box in the upper left corner of the return to indicate that the return is for a grantor-type trust or for a complex type trust, as the case may be. No income should be reported by the foreign asset protection trust on its Form 1041 if the trust is a wholly owned grantor trust. Instead, the return for the domestic asset protection trust should identify its grantor as the person to whom the income, deductions, and credits of the trust are taxable.

Private Letter Ruling 201550005 also contains interesting facts and a holding that makes it worth noting. The ruling held that a South Dakota trust was a non-grantor trust even though the settlors were both beneficiaries. The ruling also held that each settlor's gifts to the trust were incomplete for federal gift tax purposes. Nevertheless, under the facts of the ruling the settlors (who were both residents of California) transferred community property to the trust and the

ruling held that such property retained its characteristic as community property when transferred to and held in the trust. Thus, the settlors would be able to obtain a stepped up basis in the entire community property held in the trust upon the death of the first of the settlor's to die. See I.R.C. § 1014. Perhaps important to obtaining a favorable ruling from the Service, the taxpayer obtained opinion letters as to the status of the community property as community property both from counsel in California and in South Dakota. For a more detailed discussion of this ruling, see Lipkind, "Bill Lipkind's 2016 ING Update," LISI Estate Planning Newsletter #2373 (January 8, 2016). Alaska, South Dakota and Tennessee all have statutes that enable married settlors to establish and fund asset protection trusts in these respective states with community property and have that property retain its character as community property. Furthermore, each of these states permits married residents and non-residents to establish an asset protection and transfer property to it designating such property as community property. Alaska Stat. § 34.77.060; SD Codified Laws § 55-17-3; and Tenn. Code Annotated § 35-17-105.

2. **Foreign Asset Protection Trusts**. In general, under § 679 of the Code a "**United States person**" (see discussion *infra*.) who directly or indirectly contributes property to a foreign trust will be treated as the owner of the portion of the foreign trust attributable to such contribution if there is a United States beneficiary of any portion of the trust. The definition of a foreign trust is set forth in § 7701(a)(30) and (31) and is discussed *infra*. Thus, in addition to the numerous ways a trust can violate the grantor trust rules under §§ 671-677, almost any foreign trust with a United States beneficiary that is established and funded by a citizen or resident of the United States will violate the grantor trust rules while the grantor is living.

3. Generally, the transfer of property to a foreign trust by a citizen or resident of the United States will be treated as a taxable sale for the fair market value of the property transferred. I.R.C. § 684(a). Nevertheless, this rule does not apply if the transfer is made to a foreign trust to the extent that the grantor-donor is treated as the owner of the trust under the grantor trust rules. I.R.C. § 684(b). In addition to the numerous ways a trust can violate the grantor trust rules, as previously mentioned, almost any foreign trust with a United States beneficiary that is established and funded by a citizen or resident of the United States will violate the grantor trust rules while the grantor is living.

The tax imposed under § 684 of the Code could also apply to a foreign trust upon cessation of grantor trust status. Grantor trust status can cease upon the death of the grantor of a trust. Nevertheless, the tax imposed under § 684 of the Code will not apply to assets in a grantor trust if such assets are includable in the estate of the grantor for estate tax purposes because "the basis of the property in the hands of the foreign trust is determined under" § 1014(a) of the Code. The assets in an incomplete gift trust should be includable in the grantor's estate for estate tax purposes at the grantor's death.

When a foreign grantor trust that is not included in the United States grantor's estate for Federal estate tax purposes ceases to be treated as a grantor trust as to its United States grantor, under § 684 the grantor-donor is "*treated as having transferred, immediately before (but on the same date that) the trust is no longer*" a grantor trust, the assets of the former grantor trust to a foreign trust. Regs. § 1.684-2(e)(1). Grantor trust status ceases at the grantor's death. Therefore, upon his death the grantor is treated as having transferred assets to a foreign trust

immediately before, but on the same date that the trust ceases to be a grantor trust. Illustrating the application of this rule Example (2) of Regulation § 1.684-2(e)(2) provides in relevant part:

> On July 1, 2003, A dies, and as of that date no other person is treated as the owner of [Foreign Trust]. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X…*A is treated as having transferred the property to* [Foreign Trust] *immediately before his death, and generally is required to recognize 850X of gain at that time*. [Emphasis added.]

Thus, the § 684 income tax liability generated because of a deemed transfer of assets to a foreign trust when a grantor dies is deemed to be incurred by the grantor while living and not following his death. This is important because in general § 2053 permits an estate tax deduction for the amount of claims against the estate if such claims are allowable under the laws of the jurisdiction where the estate is administered. Unpaid income taxes are deductible as a claim against an estate under § 2053 provided such taxes are attributable to income properly includible in an income tax return of a decedent for a period prior to the decedent's death. Regs. § 20.2053-6(f). Any income taxes on income received after a decedent's death are not deductible on a decedent's estate tax return. See also Regulation § 2053-6(a) providing in relevant part "Taxes are deductible in computing a decedent's gross estate only as claims against the estate…and only to the extent not disallowed by section 2053(c)(1)(B)." Section 2053(c)(1)(B) provides in relevant part "Any income taxes on income received after the death of the decedent…shall not be deductible under this section." The legal obligation for payment of the § 684 tax is imposed on the grantor. Therefore, similar to the liability imposed on the grantor for the tax on the income of a grantor trust, payment of the § 684 tax by the grantor's estate should not constitute a taxable gift to the foreign trust even though an economic benefit is being passed to the trust and its beneficiaries.

In several private letter rulings the Service takes the position under §§ 678(a)(1) and (a)(2) that an individual possessing a Crummey withdrawal power (a "**Powerholder**") is treated as the owner for income tax purposes of all or a portion of a trust since the Powerholder possesses or possessed a Crummey Power over such property. See *e.g.*, PLRs 201216034, 201039010, 200747002, 200238012, 200238011, 200238010, 200238009, 200238008, 200238007, 200238006, 200238005, 200238004, 200235009, 200235008, 200235007, 200147044, 200022035, 200011054, 200011055, 200011056, 200011058, 9812006, 9810008, 9810007, 9810006, 9809004, 9809005, 9809006, 9809007, 9809008, 9801025, 9745010, 9739026, 9625031, 9541029, 8142061, 8521060, 8545076, 8809043, 8805032, 8701007, 9034004, 9320018 and 9311021. See also Rev. Rul. 67-241, 1967-2 CB 225.

Under § 678(a), an individual who is not the grantor is treated as the owner of any portion of a trust if such individual has a power exercisable solely by the individual to withdraw trust corpus or the income therefrom. Additionally, if that person previously released or modified his or her withdrawal power and thereafter retains such control over the trust which would otherwise make the grantor the owner under §§ 671 to 677 of the grantor trust rules, then § 678(a) will continue to treat the Powerholder as the owner. Use of the term "control" in § 678 should be read in light of the grantor trust rules and viewed with an expansive meaning (*i.e.*, "within the principles of sections 671 to 677").

Section 678(a)(2) uses the terms "release" and "modify" which seem to indicate the need for an overt act on the part of the Powerholder for the statute to apply. Conversely, most Crummey Powers generally lapse by operation of the terms of the trust instrument. Compare also, §§ 2041(b)(2) and 2514(e) (the 5 and 5 exemption), provisions which specifically use the term "lapse." Under these provisions it would seem ***inaction*** may be necessary to claim the desired tax benefits.

Section 678(b) provides that the general rule of § 678(a) shall not apply with respect to a power over income if the grantor of the trust is otherwise treated as the owner under any other provision in the grantor trust rules. Consequently, § 678(b) resolves any potential overlap in favor of treating the grantor, rather than a beneficiary, as owner of the trust income. Thus, assuming any other provision of the grantor trust rules initially causes the grantor to be treated as the owner of a trust, the existence of a *Crummey* Power in one or more beneficiaries should not change this treatment due to the ordering rule of § 678(b).

However, the holding of two earlier private letter rulings, P.L.R. 8142061 and P.L.R. 8545076, may be based on a different theory from the rulings cited in paragraph A above. Some commentators believe these earlier rulings could be read to hold that a Powerholder who allows a *Crummey* Power to lapse is treated as having withdrawn the assets subject to the withdrawal right and to have recontributed such assets to the trust. See Early, "Income Taxation of Lapsed Powers of Withdrawal: Analyzing their Current Status." 62 J.Tax'n 198 (April 1985); Mulligan, "Defective Grantor Trusts Offer Many Tax Advantages," 19 E.P. 131 (May/June 1992). Under this theory, a Powerholder is treated as the new grantor of the trust upon the lapse of the *Crummey* Power. Furthermore, the original grantor cannot be taxed on the income earned by a grantor trust after the lapse because he is no longer considered the grantor of the trust. From an economic standpoint, this "recontribution" theory has merit. (Support for the application of the recontribution theory can also be found in *Jalkut v. Com'r.*, 96 T.C. 675 (1991).) If followed, however, the recontribution theory would render § 678(b) nugatory in all but the rarest of circumstances. From a tax perspective, it is unlikely that Congress intended such a result.

The law regarding the taxation of items relating to trust principal over which a Powerholder possesses or possessed a *Crummey* Power may also be unclear because of the peculiar language used in § 678(b). Section 678(b) refers to competing powers "over income" whereas § 678(a)(1) refers to a power to vest "corpus or the income therefrom." The Code is silent on this issue. Some commentators suggest that this was merely an oversight in drafting the statute. See Early, "Income Taxation on Lapsed Powers of Withdrawal: Analyzing their Current Status," 62 J.Tax'n 198 (April 1985); Wark, "IRS Rulings Hint "Super" Life Insurance Trust Okay for Gift, Income and Estate Tax Savings," 54 J.Tax'n 162 (March 1981); Dye, "Several Routes Exist to Avoid IRS' Income Tax Roadblock to Use of Crummey Trust," 9 EP 220 (July 1983); Adams, "Irrevocable Life-Insurance Trusts, What are the Current Tax Considerations?," 120 TE 6 (July 1981). The holdings of Private Letter Rulings 9321050, 9309023, 9140127, 8308033, 8326074, 8142061, 8103074, and 7909031 seem to reach the same conclusion. In these private letter rulings the IRS takes the position that the grantor is treated as the owner of the corpus (whenever possible) despite the existence of a § 678 power held by a beneficiary. These rulings also suggest that the IRS agrees that the language in § 678(b) referring only to income and not corpus was an error in drafting and should be ignored. The expansive definition of the term "income" under Reg. § 1.671-3(b) also supports this interpretation of the statute. For a discussion of this point see Davis, "Interaction of the Grantor Trust Rules and Life Insurance,"

26 EP 418 (Nov. 1999). Additionally, the Congressional committee reports support the interpretation of § 678(b) set forth in the foregoing private letter rulings. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

Grantor trust status must cease either through the lapse or suspension of the power which violates the grantor trust rules or because of the death of the grantor. Consideration should be given to the income tax consequences of a trust with *Crummey* Power provisions following cessation of grantor trust status. In PLR 9321050, a Powerholder was granted a *Crummey* Power for a period of thirty (30) days over a contribution of property to a trust. After the lapse of the *Crummey* Power, the Powerholder retained an interest in the trust which would have caused him to be treated as the owner for income tax purposes of the portion of the trust previously subject to his *Crummey* Power. Nonetheless, the trust also contained provisions which triggered grantor trust treatment as to the grantor. Thus, it was determined that the grantor would be treated as the owner of the income and corpus of the trust under the grantor trust rules during her lifetime. Following the grantor's death, however, the ruling held that the Powerholder who formerly possessed the lapsed *Crummey* Power would not be treated as the owner of the income or corpus of the trust related to his lapsed *Crummey* Power. The Service cited no authority to support its position in P.L.R. 9321050. Additionally, P.L.R. 9026036, a ruling involving the same facts, reached the opposite conclusion. It held that following the grantor's death, the Powerholder who formerly possessed the lapsed Crummey Power right would be treated as the owner of the income or corpus of the trust related to that right. P.L.R. 9026036 was withdrawn by the Service on February 25, 1993 and replaced by P.L.R. 9321050.

If the holding in P.L.R. 9321050 is incorrect, it would seem that § 684(b) would be inapplicable upon the grantor's death as the trust would continue to be treated as owned by one or more of the Powerholders assuming such Powerholders are all US persons.

4. Generally, under the law of US income taxation of trusts the amounts of income required to be distributed to a trust beneficiary or on the discretionary amounts actually distributed to a trust beneficiary are taxed to such beneficiary, while all other amounts of income not distributed are taxable to the trust. Therefore, for a wholly discretionary non-grantor trust, US income tax is only imposed when US beneficiaries receive a distribution from the trust. I.R.C. § 662(a)(2). When such beneficiary receives a discretionary distribution from the trust, the trust receives an income tax deduction for such amounts distributed, limited by the Distributable Net Income ("**DNI**") of the trust, which is a trust's taxable income subject to certain statutory modifications. I.R.C. § 643(a). To the extent distributions are not made to US beneficiaries, the income earned by such trust is not subject to income taxation currently in the US unless, as mentioned above, it is US source income or effectively connected with a trade or business. I.R.C. § 871.

However, foreign non-grantor trusts also must consider the "**Undistributed Net Income**" ("**UNI**") of such trust. The UNI of a foreign non-grantor trust is any income and gains that have accrued in a current year and not distributed to any one or more of the beneficiaries that same year. The treatment of the UNI of a foreign non-grantor trust is subject to certain throwback rules under §§ 665 through 668 of the Code which are designed to impose on the beneficiaries of a foreign non-grantor trust with UNI the same income taxes that would have been imposed had

the trust distributed its income currently. Unfortunately, the UNI receives draconian treatment under these rules.

The throwback rules compute the tax on an accumulation distribution to a US beneficiary in a five (5) step process, after which an "**interest**" charge is imposed. This process includes:

a. The number of preceding taxable years of the trust to which the distribution is attributable is determined. I.R.C. § 67(b)(1)(A). (The years to which the distribution is attributable are the earliest years of the trust in which the trust had UNI. I.R.C. § 666(a).)

b. The average taxable income years are determined. (These are the US beneficiary's five (5) immediately preceding taxable years, ignoring the years with the highest and lowest total taxable incomes. I.R.C. § 667(b)(1)(B).)

c. The average annual accumulation is computed by dividing the total accumulation distribution, which includes the amount of any taxes paid by the trust on the distribution by the number of years in which it was accumulated. (This average annual accumulation is then added to the US beneficiary's taxable income in each of the three base years. I.R.C. § 667(b)(1)(C). Additionally, the US beneficiary's income includes any amounts added to the taxable income from prior accumulation distributions. I.R.C. § 667(b)(4).)

d. The increase in the beneficiary's tax caused by the addition of the average annual accumulation in each of the three (3) base years is computed and averaged. I.R.C. § 665(b)(1)(D).

e. The "**partial tax**" on the accumulation distribution is computed by multiplying the average of the annual additional tax by the number of years of accumulation and subtracting the credit for taxes paid by the trust on the distribution. I.R.C. § 667(b)(1).

A foreign non-grantor trust makes an accumulation distribution in any year in which the trust distributes more than its current year's DNI, if it has UNI. I.R.C. § 665(b).

When capital gains are accumulated in a foreign non-grantor trust, the US beneficiaries of such a trust receive disparate tax treatment from the treatment that is applicable to US beneficiaries of a non-grantor domestic trust. Generally, capital gains recognized by a domestic trust are allocated to corpus so that the trust itself is taxed on such gains and if later distributed to the beneficiaries such gain is distributed tax free to them. However, a foreign non-grantor trust allocates all of its capital gains to DNI and if the trust's capital gains are not currently distributed, such capital gains become a part of the trust's UNI. I.R.C. § 643(a)(6)(C). When such UNI is distributed to US beneficiaries **the gains lose their character as capital gains and are taxed to the beneficiaries as ordinary income**. I.R.C. § 667(a); S. Rep. No. 938, 94th Cong., 2d Sess. 222 (1976). Under I.R.C. § 667(a), only tax-exempt interest retains its character. Note that, with respect to capital gains realized by a domestic trust, such loss of characterization would normally have no effect because such income is not generally included in DNI; however, as mentioned, DNI of a foreign trust includes capital gains.

Furthermore, § 668 of the Code imposes a nondeductible "**interest**" charge on a US beneficiary's tax on an accumulation distribution from a foreign non-grantor trust for each year of accumulation beginning after December 31, 1976. The interest charge is levied on the amount of the additional tax imposed on the US beneficiary on account of the accumulation distribution, after the credit for any taxes paid by the trust on the distributed income. See *e.g.*, I.R.C. §§ 667(d)(1) and 667(d)(1)(C) for the application of the foreign tax credit limitation rules and the retention of the income tax character of the particular income, deduction, or credit item for this purpose. The interest charge on accumulations after December 21, 1995 is based on a compound interest rate determined in the same manner as the interest imposed on underpayments of income tax under § 6621(a)(2) of the Code. I.R.C. § 668(a)(1).

The interest charge on distributions of income accumulated over a period of years will be based on the average number of years of accumulation. I.R.C. § 668(a)(3). The interest rate would be determined by multiplying the charge by a fraction, the numerator is the sum of the taxable years between each year of accumulation and the year of distribution and the denominator is the number of taxable years to which the distribution is attributable. I.R.C. § 668(a)(3).

The interest charge is calculated annually and there is no proration for partial years. As a result, if income is deemed distributed in one year and actually distributed in the following year, the tax on the distribution is subject to a full year's interest charge, regardless of when during the first year the income was earned by the trust. I.R.C. § 667(a). However, the interest charge plus the tax incurred on the accumulation distribution *cannot* exceed the amount of the distribution itself but it may equal one hundred percent (100%) of the distribution. I.R.C. § 668(b).

The interest charge is computed without regard to the age of the UNI of a foreign non-grantor trust. For example, it is irrelevant how much of the total accumulation distribution was accumulated five (5) years ago and how much was accumulated two (2) years ago.

For the foregoing reasons and the reasons that follow, as a result of the draconian tax treatment of a foreign non-grantor trust, if the beneficiaries of the Trust are US persons at the death of the settlor, it may be advisable to take one of the following actions upon the settlor's death:

a. It may be advisable to migrate the Trust to the US on or shortly after it becomes a foreign non-grantor trust, thereby transforming it into a domestic non-grantor trust. After a trust is migrated to the US, the throwback rules would no longer apply because the trust would no longer be considered a foreign trust. *See* IRC §665(c); Revenue Ruling 91-6, 1991-1 CB 89. Therefore, a US-resident trustee may be appointed after the settlor's death to avoid the application of the throwback rules, so long as the situs and administration of the Trust are also moved to a domestic jurisdiction. However, the migration of a trust to the US would need to be completed before the accumulation of UNI by the trust to avoid the application of the throwback rules. Revenue Ruling 91-6, 1991-1 CB 89.

b. Instead of migrating the trust to the US another strategy would be for the trustee to make a decanting distribution from the trust to a separate domestic trust.

However, this decanting distribution would also need to be made before UNI is accumulated in the trust to avoid the application of the throwback rules

c. There are other options as well. These may include:

i. Merging the foreign trust with a domestic trust;

ii. Distributing all DNI out to beneficiaries on an annual basis, thus avoiding accumulation of income under the throwback rules;

iii. Distributing all DNI to a domestic trust via annual decanting distributions (however, this would include distributing all capital gains in this manner);

iv. Distributing UNI to beneficiaries under the averaging rules mentioned above to escape the interest charge penalty; and

v. Retaining all income and build up UNI for years adding it to principal and then never distribute principal and contain UNI problem by investing the trust corpus in an annuity or bond that produces income to be distributed annually forever thereafter.

D. Tax Compliance for a Foreign Trust.

1. Definition of Foreign Trust.

a. Section 7701(a)(31)(B) of the Code contains the definition of a "**foreign trust**" stating that it is "any trust other than a trust described in subparagraph (E) of paragraph (30)" of the same section. See also, CCA 201509035. Section 7701(a)(30) defines the term "**United States person**" and subsection (E) of such section includes in that definition any trust provided a court within the United States is able to exercise primary supervision over the administration of the trust (the "**court test**"), **and** one or more United States persons possess the authority to control **all substantial decisions** of the trust (the "**control test**"). Additionally, the term United States person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation and any estate other than a foreign estate (as defined in § 7701(a)(31)(A) of the Code). See I.R.C. § 7701(a)(30).

b. A trust must meet both the court test and the control test to constitute a domestic trust. Regs. § 301.7701-7(a)(2). See also, CCA 201509035.

c. With limited exception a trust will fail the court test if it contains a migration provision. See Regs. § 301.7701-7(c)(4)(ii), providing:

> A court within the United States is not considered to have primary supervision over the administration of the trust if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States. However, this paragraph (c)(4)(ii) will not apply if the trust instrument provides that the trust will migrate from the United States only in

the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.

See also, CCA 201509035.

d. Regulation § 301.7701-7(d)(ii) provides that "**substantial decisions**" are those decisions that persons are permitted or mandated to make under a trust instrument and applicable law and that are not ministerial.

i. Ministerial decisions include decisions regarding details related to bookkeeping, collection of rents, the execution of investment decisions and similar decisions. Regs. § 301.7701-7(d)(ii).

ii. According to Regulation §301.7701-7(d)(ii)(A)-(J), substantial decisions include, but are not limited to, decisions regarding:

(A) if and when to distribute income and principal and the amount of any such distribution;

(B) selecting a beneficiary;

(C) allocating receipts to income or principal;

(D) terminating a trust;

(E) compromising, arbitrating or abandoning claims for or against a trust;

(F) suing or defending suits for or against a trust;

(G) removing, adding or replacing a trustee;

(H) appointing a successor trustee to succeed a trustee who resigns, dies, or otherwise ceases to act as a trustee even though the authority to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless such authority is restricted so that it cannot be exercised in a way that would alter the residency of the trust from a foreign jurisdiction to a domestic jurisdiction or from a domestic jurisdiction to a foreign jurisdiction; and

(I) making investment decisions. Nevertheless, if a United States person retains an investment advisor for a trust, investment decisions made by the advisor will be considered substantial decisions controlled by the United States person if such person can terminate the advisor's authority to make investment decisions at will.

2. Cessation of Grantor Trust Status of a Foreign Trust.

a. To fully understand the tax consequences of the cessation of grantor trust status for a foreign trust, it is important to have an understanding of some basic tax

consequences of non-grantor trusts. The basic principles of non-grantor trust taxation include the following steps:

i. **<u>Trust's Tax Liability</u>**

(A) A non-grantor trust's taxable income (before the deduction for distributions to beneficiaries, discussed at step 3, below) is computed in the same way as the taxable income of an individual, subject to modifications prescribed by I.R.C. § 642.

(B) The trust's distributable net income ("**DNI**") is computed under I.R.C. § 643. The concept of DNI plays a central role in separating distributions of income, which are taxed to beneficiaries and allowed as deductions in determining trust taxable income, from distributions of corpus, which beneficiaries receive tax-free and do not affect the trust's taxable income.

(C) The trust's deduction for distributions to beneficiaries is computed under I.R.C. §§ 651 or 661 as the lesser of (1) DNI (adjusted to exclude tax-exempt income and any deductions allocable thereto) and (2) the sum of income required to be distributed currently (whether distributed or not) and the trust's other distributions during the taxable year.

(D) The trust's taxable income (that is, the amount computed in step 1 less its deduction for distributions in step 3) is taxed at the rates prescribed by I.R.C. § 1(e). The tax rates under I.R.C. § 1(e) are highly compressed, and the highest marginal rate of 39.6% is reached at just $7,500 of income, adjusted for inflation. For the year 2016, a trust's taxable income in excess of $12,400 will be taxed at the maximum 39.6% tax rate. Revenue Procedure 2015-53. Additionally, the Net Investment Income Tax (the "**Obamacare Tax**") is imposed by I.R.C. § 1411. The Obamacare Tax applies at a rate of 3.8% to non-grantor trusts if they have undistributed "**Net Investment Income**" and also have adjusted gross income over the dollar amount at which the highest tax bracket for a trust begins for such taxable year under I.R.C. § 1(e).

ii. **<u>Beneficiaries' Tax Liabilities</u>**

(A) If trust distributions made during the taxable year do not exceed DNI for the year (discussed at step 2, above), beneficiaries must include all distributions in gross income, except for any portion attributable to tax-exempt items. I.R.C. §§ 652(b) and 662(b).

(B) If distributions exceed DNI, DNI is first distributed to first-tier beneficiaries (recipients of mandatory distributions of current trust income), and if any DNI is left over, to other beneficiaries (second-tier beneficiaries). I.R.C. §§ 662(a)(1) (first tier) and 662(a)(2) (second tier).

(C) Beneficiaries' gross incomes include their allocable shares of current DNI (step 5 or 6, as the case may be), except for any portion consisting of tax-exempt items. I.R.C. §§ 662(a)(1), 662(a)(2).

(D) If a foreign trust makes a distribution exceeding DNI, (a) I.R.C. § 666 allocates any DNI left over from past years to the recipient, (b) the recipient is taxed on such an "**accumulation distribution**" under the "**throwback rules**" at I.R.C. § 667, and (c) an interest charge is added under I.R.C. § 668. These rules are discussed in further detail below.

(E) Distributions not taxed to beneficiaries under the foregoing rules are tax-free receipts of trust corpus.

Subchapter J of the Internal Revenue Code distinguishes between two types of trusts: (1) those that are required to distribute all income currently, do not provide for charitable contributions, and distribute nothing but fiduciary accounting income in the current year ("**simple trusts**") and (2) trusts not satisfying these conditions ("**complex trusts**"). The income taxation of simple trusts is governed under I.R.C. §§ 651 and 652, while complex trusts are governed by the provisions of I.R.C. §§ 661 and 662.

3. Compliance Related to Foreign Trust.

a. See I.R.C. § 6048.

i. A donor-settlor of (or other transferor to) a foreign trust must report a "**reportable event**." I.R.C. § 6048(a)(1).

ii. Information required to be reported under § 6048(a) of the Code. See I.R.C. § 6048(a)(2).

iii. Under § 6048 of the Code a reportable event is:

(A) the establishment of any foreign trust by a United States person;

(B) the transfer of any funds or property to a foreign trust by a United States person;

(C) the death of a United States person who was treated as the owner of the foreign trust under the grantor trust rules (§§ 671-679 of the Code) or if any portion of the foreign trust is included in the estate of the United States person.

iv. Exceptions to reporting requirements:

(A) Transfers for fair market value.

(B) Transfers to deferred compensation arrangements under §§ 402(b), 404(a)(4) or 404A of the Code or transfers to charitable trusts described in § 501(c)(3) of the Code.

v. The "**responsible party**" must report the information required to be reported by § 6048 of the Code. Under § 6048(a)(4) of the Code the responsible

party is the settlor who established an *inter vivos* foreign trust. In the case of a reportable event the responsible party is the transferor, except in the case of a transfer at death, in which case the personal representative of the transferor's estate is the responsible party.

vi. Annual reporting by the trustee of a foreign trust is also required when any United States person is treated as the owner of any portion of a foreign trust under the grantor trust rules (§§ 671-679 of the Code). I.R.C. § 6048(b)(1). The return must be filed by the trustee of the foreign trust, however, the requirement to ensure the return is filed is imposed on the settlor (or the person treated as the owner of any portion of the trust under the grantor trust rules). *Id*.

vii. Requirement that a foreign trust appoint a United States Agent. See I.R.C. § 6048(b)(2)(B). If the trust does not appoint a United States Agent, the Service may compute the tax liability of the owner of the trust under the grantor trust rules. I.R.C. § 6048(b)(2)(A).

viii. Reporting requirements of beneficiaries of a foreign trust. See I.R.C. § 6048(c).

b. A number of returns may be required to be filed by the settlor and the trustee to report transfers to a foreign trust, assets held by such a trust, distributions and/or transactions between the trust and the settlor or another beneficiary. These returns may include the following:

- A settlor must report a transfer to his foreign asset protection trust on a Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return (a "**Gift Tax Return**"). See I.R.C. § 6019. A gift tax return will need to be filed even though the gift is designed as an incomplete gift. See Regs. §§25.2511-2(j) and 25.6019-3. When reporting gifts by a grantor to an incomplete gift trust on Schedule A of a Gift Tax Return, the gifts should be reported at a value of zero and a statement similar to the following should be included on the return:

  > The donor has retained such dominion and control (within the meaning of Treasury Regulations §25.2511-2) over the assets transferred to this trust as to render the gift incomplete for federal gift tax purposes. The donor has retained an inter vivos and a testamentary special power of appointment over the trust assets.

  The foregoing statement alerts the Service of the grantor's position that the gift is not a taxable transfer. According to Regs. §25.6019-3(a):

  > If a donor contends that his retained power over property renders the gift incomplete . . . and hence not subject to tax as of the . . . calendar year of the initial transfer, the transaction should be disclosed in the return for the . . . calendar year of the initial transfer and evidence showing all relevant facts, including a copy of the instrument of transfer, shall be submitted with the return.

Although the gift should be reported at a value of zero (0) on the return for purposes of circulating the donor's gift tax liability, the full value of the transfer should be disclosed on an appropriate attachment to the return.

i. Form 3520. See I.R.C. § 6048. A Form 3520 is used to report the information required by *IRC* §6048. A United States person who establishes a foreign asset protection trust or transfers assets to a foreign asset protection trust must report the establishment of the trust or the transfer of assets to it on a Form 3520. The Form 3520 is also required to be filed on an annual basis by the grantor of a foreign asset protection trust. The return is required to be filed even if the grantor did not make any transfers to the trust during the applicable period. The return must be filed annually with the IRS Service Center located in Philadelphia, Pennsylvania. The penalty for failing to file this return is 35% of the amount transferred. *IRC* §6677(a). Furthermore, additional $10,000 penalties will be imposed each 30-day period (or fraction thereof) for persisting in failing to file such a return after notice is received from the Service. *Id.*

ii. Form 3520A. I.R.C. §6048(b)(2)(B). A Form 3520-A is used to report the information required by *IRC* §6048(b). A United States person who is treated as the owner of a foreign asset protection trust under the grantor trust rules is responsible for ensuring that the trustee of a foreign asset protection trust files a Form 3520-A annually. The trustee of the foreign asset protection trust is responsible for filing this return, but the penalty for failing to file this return is enforced against the grantor of the trust. *IRC* §6677(b)(1). The penalty for failing to file this return is 5% of the trust assets that are treated as owned by the grantor. *IRC* §§6677(a), (b)(2). Furthermore, additional $10,000 penalties will be imposed each 30-day period (or fraction thereof) for persisting in failing to file after receipt of notice from the IRS. *Id.* Form 3520-A must be filed annually by the trustee with the IRS Service Center in Philadelphia, Pennsylvania. It is important to note that this return is due by the fifteenth day of the third month following the close of the grantor's tax year (unless the return is extended pursuant to Form 7004). In practice, many return preparers fail to recognize that the due date for this return is one month before the due date of the grantor's personal income tax return. The trustee of a foreign asset protection trust that is a grantor trust is required to provide a Foreign Grantor Trust Owner Statement to the United States grantor when the trustee files Form 3520-A. (This form is included on page 3 of Form 3520-A.) No noncompliance penalty is applicable for failure to comply with this rule. It is important to note that a taxpayer should notify the IRS of any inconsistency between the taxpayer's income tax return and the information contained in the Foreign Grantor Trust Owner Statement. *IRC* §§6048(d)(5), 6034A(c).

iii. Form 1041. The trust should also file its own Form 1041. Regs. § 1.671-4. The trustee of the foreign asset protection trust is required to file a statement referred to as a grantor trust information letter. This statement must be attached to the Form 1041 to report the income of the trust. The form and attached statement should be filed with the IRS Service Center in Philadelphia, Pennsylvania, by the fifteenth day of the fourth month following the close of the taxable year of the trust. If the trust is a grantor trust, this will correspond to the grantor's taxable year. The person preparing this return for the foreign asset protection trust should check the box in the upper left corner of the return to indicate that the return is for a grantor-type trust. No income should be reported by the foreign asset protection trust on its Form

1041. Instead, the return for the foreign asset protection trust should identify its grantor as the person to whom the income, deductions, and credits of the trust are taxable.

iv. Form 1040*NR*. The Service has intimated that it will issue a Form *1041NR* for use by foreign trusts filing United States tax returns. Nonetheless, as of the date of the last revision to this outline, the Service has not published this form. When this form is published by the Service it will probably be the most appropriate form for a foreign asset protection trust to file annually. As of the date of this manual, a joint project between the Service and the AICPA Foreign Trust Task Force is currently underway to develop a Form *1041NR*. See McNamara, "New Foreign Trust Tax Form Project: 1041NR," 38 The Tax Adviser 516 (Sept. 2007). It should also be noted that the instructions to Form *1040NR* currently provide that it should be used to report the income of a foreign trust. The first page of Form *1040NR* also provides a box for the taxpayer to check indicating whether the taxpayer is an individual or an estate *or trust*.

v. Authorization of Agent Agreement. An Authorization of Agent Agreement should be filed to notify the Service regarding who is appointed to serve as the United States agent of the trust. The agent is appointed pursuant to this agreement, and the agreement should be filed with the IRS Service Center in Philadelphia, Pennsylvania, when the initial Form 3520 is due to be filed. The name, address, and taxpayer identification number of the United States agent must be included on Forms 3520 and 3520-A.

vi. Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) may also be required to report certain information regarding foreign accounts held in a foreign asset protection trust. As the grantor of a foreign trust the grantor, or as discretionary beneficiaries of a foreign asset protection trust, the grantor and one or more of the other beneficiaries may be required to file this form. A United States grantor of a foreign trust that is a grantor trust under *IRC* §§671–679 and owns foreign financial accounts must file an annual Form TD F 90-22.1. A United States beneficiary of a foreign trust who has a beneficial interest in more than 50% of the assets or income of a trust that owns foreign financial accounts must file an annual Form TD F 90-22.1. Filing this form is currently required when the aggregate value of the foreign account exceeds $10,000. For this purpose, a financial account includes any bank, securities, derivatives, or other financial instruments account. This form must be filed electronically with the Department of the Treasury by April 15th of the succeeding year in which the filer is required to report such an account. Taxpayers should also be aware that *IRC* §6038D imposes similar reporting requirements. See Weller & Gonzales, "Final Regulations on Specified Foreign Financial Asset Reporting By Domestic Entities," Steve Leimberg's International Tax Planning Newsletter #7 (Apr. 20, 2016). See also § 3 below for a further discussion of the FBAR. As discussed in § 3, the FBAR is only available electronically through the BSA E-Filing System, which allows the filer to enter the calendar year reported, including past years, on the online FinCEN Report 114. H.R. 3236, Sec. 2006(b)(11). Public Law No: 114-41 was passed on July 31, 2015, affecting taxable years after December 31, 2015. The new law allows for an extension under rules similar to the rules in Treas. Reg. § 1.6081-5. Also, for any taxpayer required to file the FBAR for the first time, any penalty for failure to timely request for, or file, an extension, may be waived by the Secretary. Part I question 2 "**type of filer**" provides this option for an "individual, partnership or corporation." For purposes of filing Form 114, a "U.S. Person" is a United States citizen (including minor children); United States resident; and entity,

including but not limited to, corporations, partnerships, or limited liability. See BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114). Reviewing Public Law No: 114-41, it only specifies that "[t]he due date of FinCEN Report 114 (relating to Report of Foreign Bank and Financial Accounts) shall be April 15." The law does not specify "due date for entities" versus "due date for individuals."

vii. Form 8938, Statement of Specified Foreign Financial Assets, is generally required if an individual United States person (including residents, certain nonresident aliens, and residents of Puerto Rico or a United States possession) files a federal income tax or information return with the IRS and had an interest in a foreign financial account or asset that exceeded $50,000 on the last day of the tax year or $75,000 at any point during the year. The reporting is done on Form 8938 and, commencing with returns filed in 2012, is attached to the annual income tax return for tax years beginning after March 18, 2010. It is proposed, but not yet required, that Form 8938 be filed by domestic corporations, partnerships, and trusts specified in regulations that have not yet been issued. The intent is to require reporting by entities that may be used by individuals to hide assets. See *IRC* § 6038D; and Internal Revenue Bulletin 2014-53.

3. **Foreign Bank Account Reporting.**

Formerly Form TD F 90-22.1 and now FinCen Form 114, Report of Foreign Bank and Financial Accounts (the "**FBAR**") are required to report interests in foreign bank and financial accounts. Effective as of July 1, 2013, Form TD F 90-22.1, must be filed electronically. FinCEN News Release, *FinCEN Reports Going Paperless*, February 24, 2012. This electronic filing requirement was originally due to begin in July of 2012; however, it has been subject to several extensions to foster public awareness regarding the requirement to register with FinCEN, and to obtain a user ID and password from FinCEN in time to file FBARs through the BSA E-Filing System for the 2014 and 2015 reporting years by June 30, 2016. FinCEN Notice 2014-1 FBAR Filing Requirement–Extended Filing Date Related to Notice 2013-1. If a US person has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, exceeding certain thresholds (discussed below), that person may be required to file an FBAR. For this purpose a financial account includes any bank, securities, derivatives, or other financial instruments account. Prior to this e-filing mandate, US persons could file an FBAR by mailing in the paper form to the Department of the Treasury in Detroit, Michigan. See Instructions to Form TD F 90-22.1, p.7. Section 7701(a)(30) of the Internal Revenue Code provides a general overview of what constitutes a US person. Nevertheless, the Treasury Regulations and the instructions to the FBAR provide great detail with respect to specific situations. In accordance with Section 7701(a)(30) of the Internal Revenue Code a US person is:

1. a citizen or resident of the United States,
2. a domestic partnership,
3. a domestic corporation,
4. any estate (other than a foreign estate (the term "**foreign estate**" is defined in paragraph (31) of Section 7701(a) of the Internal Revenue Code.)), and
5. a trust if a court within the United States can exercise primary supervision over the administration of the trust (referred to as the "**court test**." See also Treasury Regulation §

301.7701-7(c)(4)(ii)), and one or more U.S. persons have the authority to control all substantial decisions of the trust. (The definition of "**substantial decisions**" is set forth in Treasury Regulation § 301.7701-7(d).)

An FBAR must be filed before June 30th of the year immediately following the calendar year being reported. (IRS News Release IR 2011-66, 6/10/2011; Instructions to Form TD F 90-22.1, p.6.) The e-filing requirement applies for FBARs that are required to be filed in calendar year 2014, reporting accounts for the 2013 calendar year. The instructions state that forms filed in paper format will be returned unfiled and this change in policy may preclude the ability of taxpayers to do a quiet (or noisy) disclosure of his or her foreign accounts by filing past year returns. It will also require taxpayers to do the work for the government by registering with FINCEN and inputting their foreign financial information directly into the governmental database in electronic form, making it vastly easier to assimilate and utilize. US persons are required to file an FBAR if (a) the U.S. person had a financial interest in or signature authority over at least one financial account located outside of the United States; and (b) the aggregate value of all foreign financial accounts exceeded $10,000 at *any time* during the calendar year to be reported. (31 CFR §§ 1010.350(a) and 1010.306(c).) Filing exceptions exist for certain foreign financial accounts jointly owned by spouses, U.S. persons included in a consolidated FBAR, correspondent/*nostro* accounts (*i.e.*, an account at a foreign bank in which a domestic bank keeps a reserve of foreign currency), foreign financial accounts owned by a governmental entity, foreign financial accounts owned by an international financial institution, Individual Retirement Account owners and beneficiaries, participants in and beneficiaries of tax-qualified retirement plans, certain individuals with signature authority over, however, no financial interest in a foreign financial account, trust beneficiaries (however only if a US person reports the account on an FBAR filed on behalf of the trust), and foreign financial accounts maintained on a US military banking facility. 31 CFR § 1010.350. Failure to properly file a complete and correct FBAR may subject you to a civil penalty of up to $10,000 per violation for violations that are not due to reasonable cause. 31 USC § 5321(a)(5)(B). (One has to wonder how many wealthy individuals who are valued taxpayers will choose to expatriate rather than become subject to such intrusive rules.) For an excellent discussion of the new FinCen Form 114 see Gopman, Morgan & Simmons, "Electronic Filing Requirement for FBAR," LISI Income Tax Planning Newsletter #52 (August 29, 2013). See also, Bowers, "U.S. Tax Reporting Obligations of Foreign Trusts," 39 Estates, Gifts and Trusts Journal 136 (May-June 2014).

The grantor of a foreign asset protection trust must file an FBAR annually to report any foreign financial accounts held in the trust. 31 CFR §§ 1010.350(a) and (e)(2)(iii). Furthermore, a US beneficiary of a foreign asset protection trust who has a beneficial interest in more than fifty percent (50%) of the assets or income of a trust that owns foreign financial accounts must file an annual FBAR. 31 CFR §§ 1010.350(a) and (e)(2)(iv). A US beneficiary of a foreign grantor trust is not required to file an FBAR if the trust, trustee of the trust, or agent of the trust is a US person that files an FBAR. 31 CFR 1010.350(g)(5).

Failure to properly file a complete and correct FBAR may subject a taxpayer to a civil penalty of up to $10,000 per violation for violations that are not due to reasonable cause. 31 USC § 5321(a)(5)(B). Where a person willfully violates or willfully causes any violation of 31 USC § 5314, the maximum penalty is increased to the greater of $100,000 or fifty percent (50%) of the amount determined under 31 USC § 5314(D). 31 USC § 5321(a)(5)(C). A person who willfully

violates the FBAR reporting requirements may also be prosecuted criminally and upon conviction, fined up to $250,000, imprisoned for not more than five (5) years, or both. 31 USC § 5322(a). "A civil [monetary] penalty may be imposed . . . notwithstanding the fact that a criminal penalty is imposed [for] the same [FBAR reporting] violation." 31 *U.S.C.* §5321(d).

For an excellent discussion of penalities related to failure to file FBARs see Rubin, "IRS Telegraphs What It Expects Will Be "Normal" FBAR Failure To File Penalties," LISI Asset Protection Planning Newsletter #300, (June 24, 2015).

4. **Foreign Account Tax Compliance Act.**

Enacted in 2010 as part of the HIRE Act (Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147), March 18, 2010.), the Foreign Account Tax Compliance Act ("**FATCA**") (see §§ 1471 and 1472 of Code of 1986) seeks to prevent US taxpayers from evading tax by hiding wealth in foreign financial accounts. FATCA requires foreign financial institutions ("**FFIs**") to report to the Service certain information about financial accounts owned by US taxpayers or by foreign entities in which US taxpayers have substantial ownership interests. See I.R.C. § 1471. Foreign entities that are not financial institutions are non-financial foreign entities ("**NFFEs**") and must identify United States persons' substantial ownership interests, if any, to avoid FATCA withholding. See I.R.C. § 1472.

If an FFI fails to comply with the requirements imposed by FATCA, a thirty percent (30%) withholding tax is applied on any "**withholdable payment**" made to the FFI unless the United States withholding agent can reasonably rely on documentation that the payment is exempt from withholding. I.R.C. § 1471(a); Regs. § 1.1471-2T(a)(1). A withholdable payment means a payment of US source fixed or determinable annual or periodical income and gross proceeds from sale of property which can produce US source interest or dividends. I.R.C. § 1473(1). FATCA withholding applies regardless of whether the FFI receives a withholdable payment as a qualified intermediary or beneficial owner. Regs. § 1.1471-2T(a)(1).

A foreign entity will be an FFI if it comes within one or more of the categories of FFI contained in the Regulations under FATCA. Regs. § 1.1471-5(d). In the case of an entity that is resident in a jurisdiction that has in effect a Model 1 or Model 2 Intergovernmental Agreement ("**IGA**") with the US, that entity is treated as an FFI according to the Model 1 or Model 2 IGA and has reporting alternatives and modified withholding obligations. *Id.*

In the context of an offshore trust an FFI includes an investment entity that (1) "**primarily conducts as a business**" specified activities "**for or on behalf of a customer**" (see Regs. § 1.1471-5(e)(4)(i)(A)); (2) whose gross income is "**primarily attributable**" to specified investment activities and that is "**managed by**" an FFI (see Regs. § 1.1471-5(e)(4)(i)(B)); and (3) a collective investment vehicle or one of several different types of funds (see Regs. § 1.1471-5(e)(4)(i)(C)). Specified activities that can trigger FFI status include financial trading and portfolio management activities, and "**otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons**." Regs. § 1.1471-5(e)(4)(i)(A)(1)-(3).

Most corporate trustees will be classified as investment entity FFIs because trustees manage and administer the funds or money, or financial assets of a trust according to the

mandates in such trusts. Regs. § 1.1471-5(e)(4)(i)(A). The Final Treasury Regulations provide examples that demonstrate the Service considers a trust with primarily investment income that is professionally managed by a corporate trustee to be an investment entity. Regs. § 1.1471-5(e)(4)(v), Ex. 6. A trust primarily has investment income if its gross income attributable to investing, reinvesting, or trading in financial assets equals or exceeds fifty percent (50%) of its gross income during the stated period. Regs. § 1.1471-5(e)(4)(iv). The definition of an investment entity in the Model IGA does not require the entity to primarily have investment income. See *Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA*, Article 1(j).

A trust is "**professionally managed**" if the managing entity performs, directly or through a third party, any financial trading, portfolio management, or "**otherwise investing, administering, or managing funds, money, or financial assets on the trust's behalf**." Regs. § 1.1471-5(e)(4)(i)(B). This "**professionally managed**" test can be satisfied for either the trust itself or the trust's assets. Regs. § 1.1471-5(e)(4)(iv), Ex. 5 and Ex. 6. Trusts with individual trustees and individual asset managers are not FFIs. Regs. § 1.1471-5(e)(4)(iv), Ex. 5. Under an IGA, however, not under the Regulations, the "**professionally managed**" test can be satisfied although the trust's assets are managed by a US investment management firm because the managing entity need not be a non-US financial institution. See *Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA (Model 1 IGA), Article 1, para. (j)*.

If an entity is classified as an FFI, it must meet the reporting requirements under FATCA to avoid withholding. I.R.C. § 1471(b). An FFI can meet the reporting requirements by entering into an agreement with the Service to become a participating FFI and provide the required information. *Id.* Generally, a participating FFI must:

- identify US accounts it maintains in accordance with certain verification and due diligence procedures;
- report certain information to the Service regarding the US accounts and accounts held by a US person who is unwilling to provide the required information (recalcitrant account holder); and
- deduct a withholding tax on any payment of US source income by the FFI to a recalcitrant account holder or nonparticipating FFI. I.R.C. § 1471(b); Regs. §§ 1.1471-4(a) and 1.1471-4T(a).

Additionally, an FFI can avoid withholding if it is treated as a deemed-compliant FFI. I.R.C. § 1471(b)(2); Regs. § 1471-5(f). A trust can become a registered deemed-compliant FFI if the trustee, which is also an FFI, agrees to sponsor the trust. Regs. § 1.1471-5(f)(1)(i)(F). As the trust's sponsoring FFI, the trustee handles the reporting obligations for the trust. *Id.* A trust that is not resident in a FATCA partner jurisdiction can also avoid withholding by becoming a certified deemed-compliant FFI. Regs. §§ 1.1471-5(f)(2)(iii) and 1.1471-5(f)(3). For example, an owner-documented trust must identify both US and non-US beneficiaries to the "**designated withholding agent**" that in turn reports the information about the US beneficiaries to the Service. Regs. § 1.1471-3(d)(6)(iv). To certify its status to the withholding agent, the trust can either provide an owner's report or obtain an auditor's letter from an auditor or US licensed attorney certifying the trust qualifies as an owner-documented FFI. Regs. § 1.1471-3(d)(6)(ii).

Trusts resident in a jurisdiction that has in effect a Model 1 or Model 2 IGA with the US are treated as FFIs pursuant to the Model IGAs. Under a Model 1 IGA FFIs are treated as registered deemed compliant FFIs and report to the tax authorities in the partner jurisdiction instead of the Service. See *e.g.*, Model 1 IGA, Article 4, para. 1. A Model 1 IGA also alters the reporting requirements and eliminates the withholding responsibilities of financial institutions resident in that jurisdiction. Model 1 IGA, Article 4, para. 1(e). Financial institutions resident in a Model 2 IGA jurisdiction must enter agreements with the Service to become participating FFIs as described above.

If the non-US trust does not fall within the definition of an FFI, it will be an NFFE. I.R.C. § 1472(d). If an NFFE is the beneficial owner of a withholdable payment, it must report certain information to the withholding agent. I.R.C. § 1472(b); Regs. §§ 1.1472-1; and 1.1472-1T. An NFFE meets this reporting requirement if the NFFE provides identifying information for each of its substantial US owners or certifies that it has no such owners. A substantial US owner is in the case of a trust, a US person treated as an owner of any portion of the trust under the grantor trust rules (see I.R.C. §§ 671-679) and any US person holding more than ten percent (10%) of the beneficial interests. I.R.C. § 1473(2); Regs. § 1.1473-1(b).

If the NFFE fails to meet the reporting requirement, the withholding agent must deduct and withhold thirty percent (30%) from the withholdable payment. I.R.C. § 1472(a). However, a withholding agent is not required to withhold on a payment treated as beneficially owned by an excepted NFFE. I.R.C. § 1472(c). An excepted NFFE includes an Active NFFE, meaning any NFFE if less than fifty percent (50%) of its gross income for the preceding tax year is passive income, and less than fifty percent (50%) of its assets produce or are held for the production of interest, dividends, rents or royalties (other than those derived in the active conduct of a trade or business), annuities, or other passive income. Regs. § 1.1472-1T(c)(1)(iv).

E. QTIP/Back End Trusts.

Florida Statutes § 736.0505(3) provides:

> Subject to the provisions of s. 726.105, for purposes of this section, the assets in:
>
> (a) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made; and
>
> (b) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a),
>
> **shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor**.

This provision creates **an exception** to the self-settled trust doctrine. It protects the assets in a self-settled trust from the claims of a creditor of the settlor. The exception relates to any trust for the benefit of the settlor that is established after the death of the settlor's spouse when the settler created and funded an inter vivos general power of appointment or QTIP marital trust for the initial benefit of the settlor's spouse. A settlor can fund an inter vivos QTIP trust for the settlor's

spouse by gifting assets to such trust. A QTIP election **must** be made with respect to any gift to this QTIP trust. As a result of the QTIP election the trust will be includible in the estate of the settlor's spouse for estate tax purposes. See § 2044. The gift by the settlor to the trust will (must - it would seem) qualify for the unlimited marital deduction. The inter vivos QTIP trust may contain provisions that provide for the donor-settlor following the donee-spouse's death. The trust assets should not be subject to the claims of the donor's creditors although the trust is self-settled. According to F.S. § 736.0505(3), the settlor would **not be treated** as the settlor of the trust.

Several other states offer similar statutory benefits to those found in Florida Statutes § 736.0505(3). See Ariz. Rev. Stat. § 14-10505(E); Del. Code Ann. Tit. 12 § 3536(c)(1); Ky. Rev. Stat. Ann. § 386B.5-020(8)(a); Md. Est. & Tr. Code Ann. § 14.5-1003(a)(1)-(2); Mich. Comp. Laws § 700.7506(4); New Hampshire Chapter 564-B:5-505(a)(2)(C)-(D); N.C. Gen Stat. § 36C-5-505(c); Or. Rev. Stat. § 130.315(4); S.C. Code Ann. § 62-7-505(b)(2); Tenn. Code Ann § 35-15-505(d); Tex. Prop. Code § 112.035(g); Va. Code Ann. § 64.2-747(B)(2); and Wyo. Stat. Ann. § 4-10-506(e).

Queries: • Can the reciprocal trust doctrine be applied to uncross trusts created contemporaneously by spouses for the benefit of each other? For an excellent discussion of this issue see Rothschild & Akhavan, "Creditor Protection – The Reciprocal Issue for Reciprocal Trusts (It's Not Just About Estate Taxes)," 38 Est. G. & Tr. Jrnl. 187 (Mar.-Apr. 2013). See also *Security Trust v. Sharp*, 77 A.2d 543 (Del. Ch. 1950); Ariz. Rev. Stat. Ann. §14-10505(E)(4); and Restatement (Third) of Trusts, §58, cmt. f, Reporter Note's cmt. f.

a. If the reciprocal trust doctrine is applicable, what period is sufficient between one spouse establishing a funding a trust and the other spouse doing the same to avoid the application of the doctrine?

b. Query whether the federal government would be concerned about the application of the reciprocal trust doctrine in this instance.

c. If Florida courts will apply the reciprocal trust doctrine in a manner similar to the way it is applied under Federal tax law, it would seem possible to structure an arrangement with sufficient care to avoid a problem at the state level. It should be noted, however, that there is no existing guidance on this issue in Florida.

d. It may be malpractice to not recommend that spouses each establish QTIP trusts for the other. Any estate planning conference with clients should certainly now include a discussion of the benefits of creating an *inter vivos* QTIP trust under Florida Statutes § 736.0505(3) by at least one spouse.

e. The protection afforded to the successor trust or trusts is dependent upon a Federal tax election in the case of a QTIP trust and the trust containing the proper provisions to ensure it qualifies as a marital trust under either of §§ 2523(e) and 2523(f). This does not appear to be the case in other states that have or may soon have similar laws. (See discussion *infra*, regarding Arizona law, North Carolina law and Texas.)

f. See §§ 2523(f)(4) and 6075(b). These sections of the Code provide the rules and time limitations for making the QTIP election for an *inter vivos* QTIP trust.

g. Serious public policy concerns may exist regarding the application of this statute and similar to Florida Statutes § 736.0505(1)(c), it is questionable whether the Florida legislature carefully considered some of the ramifications of the statute it enacted. For example, consider the situation where A creates and funds a trust for the benefit of his spouse B. A retains a secondary life interest following B's death that can either be wholly discretionary or include a mandatory income interest for potential QTIP treatment based on a formula or a *Clayton* type QTIP election. (The decision to make the Clayton QTIP election may (should) be vested in an independent fiduciary.) Two months after the gift A and B are involved in a car crash. B dies and three unrelated individuals are severely injured in the accident. A is at fault. A's gifts to the *inter vivos* QTIP trust were not fraudulent under the applicable Florida fraudulent transfer rule. At the time of the accident B has not filed his gift tax return. The gift tax return may not be due for almost a year or more in some cases if the gifts were made in early January. Whether A's creditors from the car accident can collect on a judgment from the assets in the trust will depend on whether A makes a QTIP election. Is this a fair result? In PLR 201025021, the Service apparently mistakenly granted the taxpayer an extension to make a QTIP election for a gift to an *inter vivos* QTIP trust. Could a private letter ruling issued by the Service affect the substantive law of Florida in regards to a trust created pursuant to Florida Statutes § 736.0505(3). For an excellent analysis of PLR 201025021 see Steiner, LISI Estate Planning Newsletter #1699 (September 16, 2010) at http://www.leimbergservices.com. (It should be noted that PLR 201025021 was revoked by PLR 201109012 and then reinstated in PLR 201233011, which granted the taxpayer relief pursuant to § 7805(b). Nevertheless, it should serve as a lesson to attorneys who plan in this area and to litigators attacking and defending such trusts that rulings issued by the Service and decisions in tax cases in court can affect the outcome of litigation under Florida law.)

h. What is the purpose of the specific reference to Florida Statutes § 726.105? Does this preclude the application of Florida Statutes § 726.106?

i. The extended bankruptcy fraudulent transfer period of ten (10) years applicable to transfers to self-settled trusts should apply to this trust arrangement. See §548(e)(1) of the Bankruptcy Code. Since this rule is new and little or no case law exists to provide guidance on the application of §548(e)(1) to this type of trust arrangement, all practitioners can do is speculate on this issue. (Perhaps this uncertainty simply dictates that this type of trust arrangement be established as a foreign trust structure that complies with all of the requirements of Florida law.) Furthermore, while it is likely that the ten (10) year extended bankruptcy fraudulent transfer period under §548(e)(1) of the Bankruptcy Code would apply to a transfer to a SQIT, perhaps the use of a general power of appointment trust as the lead trust would prevent this rule from applying to the successor trust. Providing a donee-spouse with a general power of appointment could vitiate the application of §548(e)(1). Perhaps an independent trustee of a SQIT could be given the authority to grant the donee-spouse a testamentary general power of appointment if it is necessary to avoid the application of the ten (10) year extended fraudulent transfer rule under §548(e)(1).

j. How will this provision be applied to property added to the QTIP trust during the donee-spouse's lifetime that cannot qualify for the marital deduction?

k. How will this provision be applied to property held in a trust for which only a partial QTIP election has been made?

l. What happens if there is a disposition of the donee-spouse's income interest in the original trust prior to the donee-spouse's death? For gift tax purposes it might be difficult to imagine a donee-spouse renouncing his or her income interest, however, it might happen for other non-tax reasons. If the assets in the original QTIP trust pass to a successor trust or trusts for the benefit of the donor-spouse, it appears that the assets in the trust will not be protected from the donor-spouse's creditors during the donee-spouse's lifetime.

m. Practitioners should carefully review Chapter 739 of the Florida Statutes (that is, the Florida Uniform Disclaimer of Property Interests Act) to see how it may benefit a client seeking to implement this type of trust arrangement.

n. Regardless of the foregoing issues, practitioners must recognize that this is not your father's type of trust. It should be designed from an asset protection point of view. A quality asset protection trust contains numerous provisions that are not typically included in more traditional trust forms.

o. It is now significantly easier and presumably less expensive for Florida residents to create asset protection trust structures. Thus, Florida Statutes § 736.0505(3) could be a game changer if used properly.

p. Florida Statutes § 736.0505(3) also presents some unique estate planning opportunities. Practitioners should carefully review *Bonner Est. v. U.S.*, 84 F.3d 196 (5th Cir. 1996) and *Mellinger Est. v. Com'r.*, 112 T.C. 26 (1999), *acq.*, AOD 1999-006 (better known as the Fredericks of Hollywood estate) and similar cases in an effort to uncover these potential planning opportunities.

q. It is important to note that the mandatory income interest in the trust remains vulnerable to attack by a creditor. While the interest itself may be protected by use of a spendthrift provision, income distributed directly to the beneficiary is certainly at risk for attachment.

r. This strategy cannot work if the donee-spouse is not a US citizen as the transfer would not qualify for the marital deduction. See § 2523(f).

s. ***Caution***: If the property transferred to the trust has a situs outside of Florida that is located in a jurisdiction that has the Self-Settled Trust Doctrine, the law of that jurisdiction would most likely apply to such property held in the trust. In such a situation the asset protection features of this trust might not be available to the settlor following the donee-spouse's death.

t. Perhaps additional planning opportunities exist if the QTIP trust is designed to permit the donee spouse to assign his or her income interest in the trust. See *e.g.*,

PLR 201243004; and Bramwell and Kanaga, LISI Estate Planning Newsletter #2040 (December 20, 2012) at http://www.leimbergservices.com.

u. Based on the plain language of the statute, it should be possible to use this planning technique in the case of a same-sex couple who were married in a jurisdiction recognizing same sex marriage. See Rev. Rul. 2013-17; *United States v. Windsor*, 570 U.S. ____ (2013). For an excellent discussion of the issues relating to the Windsor case and Revenue Ruling 2013-17 see Karibjanian, "Revenue Ruling 2013-17 and IR-2013-72: The Service Responds to Windsor," LISI Estate Planning Newsletter #2137 (September 3, 2013) at http://www.LeimbergServices.com; Karibjanian, "Federal Law for Same-Sex Married Couples after Windsor: Equality for All or Only for Some?," LISI Estate Planning Newsletter #2118 (July 23, 2013) at http://www.LeimbergServices.com**;** Karibjanian, "Windsor and Perry: A Supreme Split Decision," LISI Estate Planning Newsletter # 2110, (June 26, 2013) at http://www.leimbergservices.com. But caution is warranted until more authority is available in this area. See *e.g.*, Section 27 of Article I of the Florida Constitution, which provides:

> Marriage defined.-
>
> Inasmuch as marriage is the legal union of only one man and one woman as husband and wife, no other legal union that is treated as marriage or the substantial equivalent thereof shall be valid or recognized.

See also Florida Statutes § 741.212, which provides:

> Marriages between persons of the same sex.-
>
> (1) Marriages between persons of the same sex entered into in any jurisdiction, whether within or outside the State of Florida, the United States, or any other jurisdiction, either domestic or foreign, or any other place or location, or relationships between persons of the same sex which are treated as marriages in any jurisdiction, whether within or outside the State of Florida, the United States, or any other jurisdiction, either domestic or foreign, or any other place or location, *are not recognized for any purpose in this state*. [Emphasis added.]
>
> (2) The state, its agencies, and its political subdivisions may not give effect to any public act, record, or judicial proceeding of any state, territory, possession, or tribe of the United States or of any other jurisdiction, either domestic or foreign, or any other place or location respecting either a marriage or relationship not recognized under subsection (1) or a claim arising from such a marriage or relationship.
>
> (3) *For purposes of interpreting any state statute or rule, the term "marriage" means only a legal union between one man and one woman as husband and wife, and the term "spouse" applies only to a member of such a union*. [Emphasis added.]

v. In the consolidated case of *Brenner v. Scott*, 999 F.Supp.2d 1278, 1286 N.D. Fla, (2014), the plaintiffs challenged the provisions of the Florida Constitution and

Florida Statutes banning same-sex marriage. Two of the plaintiffs in Brenner were an unmarried same-sex couple who were denied the issuance of a marriage license in Washington County, Florida. The other plaintiffs were individuals (and an association representing individuals) who were married in other jurisdictions and who sought recognition of their respective same-sex marriages in Florida. In each case, the plaintiffs moved for a preliminary injunction barring enforcement of the challenged provisions. A preliminary injunction was granted, holding that the Florida ban on same-sex marriage violated the due-process and equal-protection clauses of the Fourteenth Amendment. However, the court also issued a temporary stay on the injunction. The State of Florida requested further stays on the injunction from the Eleventh Circuit U.S. Court of Appeals and the Supreme Court of the United States; both requests to extend the stay were denied, and the stay on the injunction was set to expire on January 5, 2015. The Clerk of Court of Washington County filed an emergency motion on December 29, 2014 to clarify the preliminary injunction on the issue of whether the injunction required the Clerk to issue marriage licenses to all qualified same-sex applicants, or only to the two unmarried plaintiffs. On January 1, 2015, the court clarified the order announcing the issuance of the preliminary injunction to state that the Constitution of the United States required all Florida counties to issue marriage licenses to all qualified same-sex applicants. Thus, pending further developments at the federal level, effective as of January 5, 2015, qualified same-sex applicants may have marriage licenses issued in Florida, and same-sex marriages lawfully entered into elsewhere will be recognized in Florida. The ultimate outcome of these cases determined whether a same-sex couple would be able to obtain the creditor protection benefits of Florida Statues §736.0505(3). The issue seems moot at this time given the recent decisions of the Supreme Court and individuals in same sex marriage should be able to take advantage of the benefits provided by Florida Statutes §736.0505(3). See *United States v. Windsor*, 570 U.S. ____ (2013); *Obergefell v. Hodges*, 576 U.S. ___ (2015). See also *Huntsman v. Heavilin*, 16th Judicial Circuit, Monroe County, Florida, Case No. 2014-CA-305-K.; Gassman and Arango, LISI Estate Planning Newsletter #2236, (July 29, 2014) at http://www.leimbergservices.com; *In re the Marriage of Brassner*, 17th Judicial Circuit, Broward County, Florida, Case No. 13-012058 (37); *Pareto v. Ruvin*, 11th Judicial Circuit, Miami-Dade County, Florida, Case No. 14-1661 CA 24; *In re Estate of Bangor*, 15th Judicial Circuit, Palm Beach County, Florida, Case No. 502014CP001857XXXXMB.

w. For an excellent discussion of post-divorce income tax issues and strategies to address those issues during a divorce, see Nelson & Franklin, "*Inter Vivos* QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce," LISI Estate Planning Newsletter #2244, (Sept. 15, 2014) at http://www.leimbergservices.com.

F. Tax Reimbursement Provisions.

Drafting irrevocable trusts as "**wholly-owned grantor trusts**" for federal income tax purposes is a common technique used by estate planners to enhance the benefits of such trusts by effectively permitting tax-free gifts when the grantor pays income taxes attributable to trust assets. Still, it may be desirable to grant the trustee a discretionary power to pay such taxes or reimburse the settlor. Although not found in the UTC, the FTC ensures that such discretionary power will not subject an irrevocable trust to the claims of creditors under the general rule established in F.S. § 736.0505(1)(b). F.S. § 736.0505(1)(c). This provision provides in relevant part:

> the assets of an *irrevocable* trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax.

As a result of this provision the state legislature may have unwittingly added Florida to the list of asset protection states. Normally such a decision is made with substantially more consideration. Issues related to this provision include:

a. **There is no time limit on reimbursement**. Thus, in theory a trustee can accrue a reimbursement account for several decades and reimburse the settlor for a tax liability incurred many years in the past. While policy arguments can be made to permit reimbursement for a tax liability incurred within the statute of limitations for a tax return, permitting reimbursement for tax liability incurred beyond that point is ridiculous unless the state has made a conscientious decision to become an asset protection trust jurisdiction. This certainly has not occurred in this instance.

b. As a result of the issue identified in the foregoing paragraph (a), Florida has unwittingly added a new exemption to its laws. Practitioners are certainly obligated to discuss the use of this potentially substantial exemption with their clients.

c. The provision could have been drafted to prevent abuse by mandating the formula for determining the maximum amount that the trustee could distribute to the settlor. Some methods of constructing such a formula might have been to mandate that the trustee can pay up to:

i. the highest marginal rate of tax. Thus, the income generated by the assets in the trust is assumed to be taxed at the highest rate applicable to the settlor.

ii. its proportional share of the tax liability. Thus, all income generated by the assets in the trust is assumed to be taxed at the settlor's average tax rate.

iii. the lowest possible tax rate applicable. Thus, the settlor's remaining income from sources other than the assets in the trust is assumed to be taxed at the higher rates applicable to the settlor.

d. Although potentially difficult under certain circumstances, the provision could have prevented abuse by directing that any tax payments be made directly to the appropriate taxing authority rather than reimbursing the settlor for such amounts. Of course, one could argue that such a provision would be too restrictive.

e. Is the payment by the settlor of the settlor's tax liability subject to the fraudulent transfer statute? The funds could one day be returned to the settlor pursuant to a discretionary distribution. At first blush it would seem that such payment should not be a fraudulent transfer, however, inequitable results will be caused to a creditor because of this

provision if the fraudulent transfer statute is not applicable. How will the bankruptcy law (discussed *infra*) treat this provision?

f. Can distributions be made from the reimbursement account ***for the benefit of*** the grantor rather than having to be distributed directly to him. The statute provides no guidance in this respect.

g. Is the trustee permitted to offset the tax benefits that accrue to the settlor as a result of grantor trust status, such as deductions and tax credits, against the reimbursement account? ***Query***: Trust ("**T**") contains a discretionary tax reimbursement provision. T holds interests in limited liability companies that own substantial real estate investments. T was established and funded by A and T is a wholly owned grantor trust as to A. In calendar year *x* T's real estate generates $2,000,000 of taxable income and it also generates $1,000,0000 of depreciation. In the same year A has $2,000,000 of taxable income. Assume a thirty-five percent (35%) income tax rate applies. A includes the $2,000,000 of taxable income from T on his personal income tax return with his $2,000,000 of personal taxable income. He also includes the $1,000,000 of deduction provided by the depreciation on the assets held in T. Assume the trustee does not reimburse T for any income tax liability in year *x*. How much should be allocated to the reimbursement account? The answer is unknown. The statute does not appear to mandate the $1,000,000 of depreciation be used to offset the trust income specifically. It would seem logical to assume that it should, however, the answer remains unclear.

h. The provision applies even though the grantor trust may be designed to receive gifts that are incomplete for federal gift tax purposes. This can lead to serious abuse of the statute.

i. ***Caution***: A tax reimbursement provision is not appropriate for use in every type of grantor trust. For instance, such a provision should never be used in a general power of appointment marital trust (see §2523(e)), a QTIP trust (see §§2056(b)(7) and 2523(f)), a § 2642(c) trust or a §2503(c) trust. Additionally, if it is necessary for a trust to qualify as a skip person for GST tax purposes, a tax reimbursement provision should not be included in the trust agreement. See § 2613.

For a further discussion of tax reimbursement clauses, see Durkin, "Understanding Tax Payment/Reimbursement Clauses for Sales to Intentionally Defective Grantor Trusts," 29 Probate & Property 45 (Sept./Oct. 2015).

j. In PLR 201647001, the grantors created an irrevocable trust for the benefit of their children. The trust was a grantor trust meaning all items of income, deductions, loss, and credit of the trust was reflected on the grantors' Form 1040 (U.S. Individual Income Tax Return). Due to unforeseen and unanticipated circumstances, payment by the grantors of the income taxes on the trust's income became unduly burdensome. As such, the grantors sought a trust modification primarily to add a tax reimbursement clause. Several other administrative changes were sought, including: (i) modification of the rule against perpetuities to clarify that the modifications could not extend the term of any trust created under the trust; (ii) modifications to clarify trustee powers; (iii) modifications to the trustee succession provisions; (iv) modifications

to the trustee removal provisions; (v) provisions for an initial and successor investment trustee; (vi) modifications to add provisions regarding the indemnification of trustees, exoneration of the trustees in certain circumstances, limitations on trustee liability, and employment of professionals; and (vii) modifications to provisions which qualify the trust as a grantor trust, including the substitution power.

The taxpayers sought rulings indicating that there were no adverse estate, gift and generation-skipping transfer tax consequences, specifically:

1. Whether the modifications would cause the property of the trust to be included in the gross estate of either grantor for federal estate tax purposes.

2. Whether the modifications would cause the property of the trust to be included in the gross estate of Child 1, Child 2, or Child 3 for federal estate tax purposes.

3. Whether the modifications would cause the property of the trust to be treated as a deemed transfer of any property of trust by the grantors for federal gift tax purposes.

4. Whether the modifications would cause the property of the trust to be treated as a deemed transfer of any property of trust by Child 1, Child 2, or Child 3 for federal gift tax purposes.

5. Whether the modifications would cause the trust, as modified, to lose its zero inclusion ratios for generation-skipping transfer tax purposes under chapter 13.

6. Whether the modifications would be treated as a transfer of any property of trust by the grantors or any beneficiary for purposes of Section 1001 of the Code.

In Ruling #1, the taxpayers received guidance that the following additions would not make the trust property includible in the gross estate of either grantor: (i) retaining the power to remove and replace the Trustees, including the Independent Trustee; (ii) certain modifications termed "administrative" in nature; (iii) modifying the trust to provide that the substitution power shall comply in all respects with Rev. Rul. 2008-22; and (iv) allowing a trustee who is not related or subordinate to either grantor within the meaning of Section 672(c) of the Code to reimburse either grantor with respect to the income tax liability actually incurred by the grantor attributable to trust items.

In Ruling #2, the taxpayers received guidance that the proposed modifications to the trust did not result in transfers by any of the children to trust. Ruling #2 indicated that the right of each of the children to remove any trustee and appoint a successor trustee not related or subordinate to such child within the meaning of Section 672(c) of the Code did not result in any child holding a general power of appointment within the meaning of Section 2041 of the Code.

In Rulings #3 and #4, the taxpayers received guidance that the proposed modifications to the trust would not be treated as a deemed transfer of any property of trust by either the grantors or children for federal gift tax purposes.

In Ruling #5, the taxpayers received guidance that the proposed modifications to the trust would not cause the trust, as modified, to lose its zero inclusion ratio for GST tax purposes under chapter 13. Ruling #5 noted that the proposed modifications to trust did not constitute the release, exercise, or lapse of powers of appointment for purposes of Sections 2041 and 2514 of the Code. Additionally, the administrative modifications to the trust did not shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the trust. Accordingly, the proposed modifications did not constitute constructive additions to the trust. The modifications were effected in accordance with state law and pertained to the administration of the trust.

In Ruling #6, the taxpayers received guidance that the proposed modifications of the trust would not be treated as a transfer of any property of trust by the grantors or beneficiaries for purposes of Section 1001 of the Code. There was no exchange (reciprocal transfer) of trust property merely on account of the grant of additional powers to the trustee since the grantors were treated for federal income tax purposes as owners of the entire trust before and after the proposed modification. The fact that the beneficiaries will have the same beneficial interests in the trust after the modifications as they had prior to the modifications to the trust was noted.