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Guest Article

PLR Addresses Irrevocable Trust Technique

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In a Private Letter Ruling (No. 200603040) issued on Jan. 20, the IRS concluded that the popular technique of making an irrevocable trust "intentionally defective" for income tax purposes by including a retained power to substitute property of equivalent value will not cause the trust property to be included in the taxpayer's estate.

As this issue is one the IRS has not frequently ruled on, the PLR offers interesting insight into its thinking on the matter. However, as practitioners know, PLRs cannot be actually relied upon by any taxpayers other than the ones requesting the ruling.

Facts Of The Case

The grantor in the case established an inter vivos, irrevocable trust, funded with cash and marketable securities. The trustee was not a descendant of the grantor and was not otherwise related or subordinate to the grantor within the meaning of Sect. 672(c) of the Internal Revenue Code.

The trust provided that during the grantor's life, the trustee had the discretion to distribute as much income and principal of the trust to the spouse and the grantor's issue as he or she wished. Another provision stated that at the grantor's death, the trustee was to distribute the trust property to the grantor's issue per stirpes. If none of the grantor's issue survived him, the trustee would retain the property in trust. If neither the grantor's spouse nor any issue of the grantor survived him, the trustee would distribute the trust property to a designated foundation.

The trust provided "Crummey" withdrawal powers for the spouse. Generally, she would have the right to withdraw an amount equal to the value of each contribution; provided, however, that in no event should the aggregate value of property subject to this withdrawal right exceed the amount of annual exclusion from gift tax prescribed under Sect. 2503(b).

The trust further provided that the grantor could acquire property constituting trust principal by

substituting other property of equivalent value, as measured at the time of substitution. This power to acquire trust property could only be exercised in a fiduciary capacity. (It's unclear why this would matter, since any substitution had to be for equivalent value.)

The grantor sought to exercise his power of substitution as follows: transfer X shares of B stock, from a publicly traded company, to the trust in exchange for Y shares of C stock (also from a publicly traded company), that was currently held in the trust. In addition, to the extent necessary, the grantor either would transfer to the trust, or withdraw from the trust, cash or cash equivalents in the amount necessary for the total value of the assets grantor was transferring to the trust to be equal to the total value of the assets being acquired from the trust.

Ruling Requests

The grantor requested rulings on four points:

- Would the retention of the power of substitution cause the property of the trust to be included in the grantor's gross estate?

- Would the exercise of the power of substitution constitute a gift to the trust by the grantor, for federal gift tax purposes?

- Is the trust a grantor trust under Sect. 671?

- Will either the grantor or the trust recognize any income or loss by reason of the exercise of the power of substitution?

Obviously, a key issue is whether the retained power to substitute property constituted a retained power under the Code. That is a question the IRS has previously refused to address. But in this ruling, relying on a 1975 U.S. Tax Court case, *Estate of Jordahl v. Commissioner* (65 T.C. 92) and based on the facts submitted by the taxpayer, the IRS stated "that the retention by Grantor of the power of substitution ... will not cause the property of Trust to be included in Grantor's gross estate under Sects. 2033, 2036(a), 2036(b), 2038 or 2039."

Interestingly, in its ruling the IRS made specific reference to the fact that the power to substitute could only be exercised in a "fiduciary capacity." Would the answer be different if that language was not in the trust? The ruling doesn't say.

This is an important issue, since many irrevocable trusts have relied on this power to create intentionally defective grantor trust status without specific reference to a fiduciary obligation. And if the IRS is relying on *Jordahl*, it should not matter if the trust requires substitution in a fiduciary capacity, because the Tax Court held that the decedent's reserved power to substitute other securities or property of equal value indicated that the substitution power was exercisable only in good faith and subject to fiduciary standards.

Gift Tax Issues

In general, Sect. 2501 imposes a tax on the transfer of property by gift. Section 2512 provides that a gift occurs where property is transferred for less than an adequate and full consideration in money or money's worth. If that occurs, the amount by which the value of the property exceeds the value of the consideration received is deemed to be a gift. However, under Treasury Regulations Sect. 25.2512-8, a transaction which is bona fide, at arm's length, and free from any donative intent will be considered to have been made for adequate and full consideration and thus is not a gift.

Here, the grantor planned to transfer shares of company B stock to the trust in exchange for shares of Company C stock held in the trust. The value of the B stock and the C stock was to be

determined in accordance with Sect. 25.2512-2(b)(1) of the Gift Tax Regulations, and cash would be exchanged to the extent necessary to ensure that the total value of the assets the grantor transfers to the trust would equal the total value of the assets acquired.

Based on these facts the IRS ruled "that the exercise by Grantor of the power of substitution, as described above, will not constitute a gift to Trust by Grantor for federal gift tax purposes."

Trust Owner?

Sections 673-678 of the Code specify the circumstances under which the grantor of a trust or a person other than the grantor will be treated as the owner of all or a portion of a trust for income tax purposes.

Here, the ruling states that because income and principal are payable to the spouse during the grantor's life, the grantor is treated as the owner of the entire trust under Sect. 677(a).

"Because Trust is a grantor trust under Sect. 677 with respect to Grantor, it is a grantor trust in its entirety with respect to Grantor notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under Sect. 678. Accordingly, all items of income, deductions, and credits against tax of Trust are included in computing the Grantor's taxable income and credits."

This part of the ruling is very important. It means that the trust can be a "wholly grantor trust" even if there are Crummey withdrawal powers. For trusts created to be grantor trusts by virtue of a Sect. 677 power, use of Crummey powers for the spouse are permitted. Unfortunately, the facts of this ruling are limited to the grantor trust status caused by Sect. 677 and to a Crummey power by a spouse. It does not address how Crummey powers would impact a trust deemed a grantor trust via a Sect. 675(4)(c) power to swap assets.

Income Or Loss?

The seminal ruling on the interaction of grantors and trusts and when the former are treated as owners under Sect. 673-678 is Revenue Ruling 85-13 (1985-1 C.B. 184.) That ruling held that if a grantor is treated as the owner of the entire trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes, and thus transactions between the grantor and the trust will be ignored for income tax purposes.

In this case, then, because the grantor is treated as the owner of the entire trust, the exchange of assets between the grantor and the trust will be disregarded for federal income tax purposes, and neither the grantor nor the trust will recognize any income or loss under Sect. 61 or Sect. 1001 as a result of the proposed exercise of the substitution power.

Conclusion

PLR 200603040 is interesting for those of us using intentionally defective trusts in our planning. If we use the spouse as a beneficiary, and thus create grantor trust status under Sect. 677, the ruling offers some added planning benefits (like the ability to include Crummey powers).

However, outside the context of a trust with a spouse, the ruling seems to have been intentionally vague. Indeed, the seminal issue - the impact of a right to exchange principal - seems to get lost in the ruling requests, and several key issues are unresolved.

For example, does it really matter if the trustee is independent? Why does that matter? Many of us create these irrevocable trusts for clients using family members as trustees, and also using the right to exchange principal as the tool to make the trust income tax defective, suggesting that the ruling's emphasis on an independent trustee is a matter of concern. I think it should not be, but it is interesting to see how it is noted and relied on.

Also, given the IRS' reliance on *Jordahl*, can we assume that we do not need to be concerned with the section of the trust saying the exercise of the right to exchange has to be in a fiduciary capacity? If *Jordahl* controls, and if exchanges can only be for full and adequate consideration, then who needs a fiduciary obligation?

Unfortunately, these issues are still unanswered.

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