

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #921

Date: 25-Jan-06
From: Steve Leimberg's Estate Planning Newsletter
Subject: **PLR 200603040 Retained Power To Substitute Property Does NOT Cause Estate Inclusion**

An IDGT is generally designed to remove assets from the grantor's gross estate for federal estate tax purposes but be treated as the grantor's alter ego for income tax purposes - so that transactions between the grantor and the trust are "non-events" for income tax purposes. The trust is "defective" because grantor income tax rules apply to the trust - even though the trust's assets remain outside of the grantor's estate for estate tax purposes.

One of the puzzlements of planning is to how to thread this needle; how to get the best of all possible worlds - without the tax problems.

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But in this commentary, Jeff brings LISI members good news that impacts on the use of these Intentionally Defective Grantor Trusts (IDGTs) - and a warning.

EXECUTIVE SUMMARY:

In PLR 200603040, 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:

1. cause the property of Trust to be included in Grantor's gross estate under Code Sections 2033, 2036(a), 2036(b), 2038 or 2039.
2. constitute a gift to the Trust by Grantor, for federal gift tax purposes.

The PLR also holds that:

1. the Trust is a grantor trust under Code Section 671 in its entirety with respect to Grantor.
2. neither Grantor nor the Trust will recognize any income or loss by reason of the Grantor's exercise of the power of substitution.

FACTS

The Grantor established an inter vivos irrevocable trust funded with cash and marketable securities.

1. The trust provided that the Trustee is not a descendant of Grantor and is not otherwise related or subordinate to Grantor within the meaning of Code Section 672(c).

(Commentator's Query: Why should the fact that the Trustee was neither a

descendant of nor subordinate to Grantor matter?)

2. Article 1, Section 1.1 of Trust provides that during Grantor's life, the trustee may distribute as much income and principal of Trust to Spouse and Grantor's issue as the trustee determines.

3. Article 1, Section 1.2 provides that, at the Grantor's death, the trustee shall distribute the trust property to Grantor's issue per stirpes. If none of Grantor's issue survives Grantor, the trustee will retain the trust property in further trust in accordance with section 1.1. If neither Grantor's spouse nor any issue of Grantor survives Grantor, the trustee shall distribute the trust property to a Foundation.

4. Article II provides "Crummey" withdrawal powers for the spouse. Generally, the trust gives the Spouse the right to withdraw an amount equal to the value of each contribution; provided, however, that in no event shall the aggregate value of property subject to this withdrawal right exceed the amount of annual exclusion from gift tax prescribed under section 2503(b) then available to the Grantor with respect to Grantor's spouse for each such calendar year. Upon the receipt of a contribution subject to this right, the trustee shall give Spouse notice of Spouse's right to withdraw. The right to withdraw with regard to a contribution terminates upon the later of 30 days after the receipt of such notice and December 31st of such calendar.

5. In accordance with Article VI, Sections 6.1 and 6.3, Trustee has the power to invest, dispose of and otherwise deal with property in Trust, in his sole and absolute discretion, without the approval or consent of any other person.

6. Article VII, Section 7.7 of Trust provides that Grantor may acquire any or all property constituting Trust principal by substitution of other property of equivalent value to the property acquired, measured at the time of substitution. The instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity.

For purposes of the section, action in a fiduciary capacity is defined as action that is undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law.

[Commentator's Query: Why should it matter if the substitution is subject to a fiduciary capacity since any substitution must be for equivalent value?]

7. Grantor proposes to exercise his power of substitution under Section 7.7, as follows:

Grantor will transfer X shares of B stock, a publicly traded company to Trust in exchange for Y shares of C stock (also a publicly traded company), that is currently held in Trust.

In addition, to the extent necessary, Grantor either will transfer to Trust, or withdraw from Trust, cash or cash equivalents in an amount necessary such that the total value of the assets Grantor is transferring to Trust will be equal to the total value of the assets Grantor is acquiring from the Trust incident to the substitution. It is represented that the value of the B stock and the C stock subject to the exchange, will be determined in accordance with section

25.2512-2(b)(1) of the Gift Tax Regulations.

[Commentator's Query: Can we assume that the proposed transaction was income tax motivated – for example, designed to take assets with a low income tax basis out of the trust and substitute assets with a high basis?]

THE FOUR RULING REQUESTS

The Grantor requested the following four rulings:

1. 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 Code Sections 2033, 2036(a), 2036(b), 2038 or 2039.
2. The exercise by Grantor of the power of substitution as proposed will not constitute a gift to the Trust by Grantor, for federal gift tax purposes.
3. Trust is a grantor trust under § 671 in its entirety with respect to Grantor.
4. Neither Grantor nor Trust will recognize any income or loss by reason of the exercise of the power of substitution.

COMMENT:

NO ESTATE TAX INCLUSION

Ruling Request 1

Code Section 2033 requires inclusion in the gross estate of the value of all property owned by the decedent at the time of his/her death.

Section 2036(a) and (b) include in the estate property transferred by decedent but over which he retained certain rights to control and enjoy the income or principal for life or for a period that does not end before his death.

Section 2038 includes the value of all property transferred during lifetime subject to the decedent's right to alter or amend, revoke, or terminate the gift.

Section 2039 includes in the estate any lifetime contractual annuities that pass to a beneficiary upon the decedent's death.

In this Ruling, obviously the key issue was whether the decedent's retained power to substitute property of equal value constituted a retained power under any of the code sections cited above.

Although that is a question the IRS has previously refused to address, in this Ruling the IRS addressed the issue and answered in the affirmative for the taxpayer. Relying on the Estate of Jordahl, and based on the facts submitted in the ruling request, the IRS stated

"that the retention by Grantor of the power of substitution, as described above, will not cause the property of Trust to be included in Grantor's gross estate under §§ 2033, 2036(a), 2036(b), 2038 or 2039."

Interestingly, in the ruling, the IRS made specific reference to Article VII, Section 7.7 of the Trust stating the power to substitute could only be exercised in a "fiduciary capacity." But what if that language was not in the trust? The ruling does not clarify. This is an important issue, as I assume many irrevocable trusts have relied on this power to create intentionally defective grantor trust status without specific reference to a fiduciary obligation.

However, if the IRS was relying on Jordahl, then it should not matter if the trust requires substitution in a fiduciary capacity or not. In Jordahl, the 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.

NO TAXABLE GIFT

Ruling Request 2

Code 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. In that case, the amount by which the value of the property given exceeds the value of the consideration received is deemed to be a gift. However, under Treasury Regulations § 25.2512-8, a transaction which is bona fide, at arm's length, and free from any donative intent will be considered as made for adequate and full consideration and thus not a gift.

In the Ruling Request, the Grantor will transfer shares of company B stock to Trust in exchange for shares of Company C stock that are held in the Trust.

The value of the B stock and the C stock will be determined in accordance with Reg. Sec. 25.2512-2(b)(1), and cash will be exchanged to the extent necessary to ensure that the total value of the assets Grantor transfers to the Trust will equal the total value of the assets Grantor acquires from the Trust. In other words the value of what is given must be equal to the value of what is received.

Based on the facts presented, 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."

WHOLLY GRANTOR TRUST - EVEN IF TRUST CONTAINS CRUMMEY POWERS!

Ruling Request 3

Sections 673 through 678 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.

The power directly impacted by the requested ruling is found in Code Section 675(4)(c), the power to reacquire trust principal by substituting other property of an equivalent value. However, another power impacted by the facts of this

ruling, is the power to distribute income or principal to the Grantor's spouse, which is addressed by Code Section 677(a).

Further, as a result of the Crummey power to withdraw, Section 678(a) is also impacted by the terms of the ruling request. Section 678 causes the non-grantor of the trust to be taxed on the trust income (treated as its owner) if such non-grantor has a power to vest principal in himself, or has previously released such a power – such as the lapse of a Crummey withdrawal power.

Section 678(b) provides that Section 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom § 679 applies) is otherwise treated as the owner under the provisions of subpart E other than § 678.

The issue of the impact of a Crummey power in "changing" the grantor trust status has been one of significant debate in the journals regarding how to structure "intentionally defective" trusts. (See **Keith Schiller's** Commentary in LISI Estate Planning Newsletter # 768). Generally, it has been assumed that having a Crummey power in the trust might cause it not to be considered a grantor trust (at least in part) and thus causing issues in sales or other transactions with the trust.

In general, the Ruling states that the Crummey power of the Spouse results in Spouse being treated as the owner of the portion of Trust subject to her withdrawal power, unless the Grantor is treated as the owner, as provided in § 678(b).

The ruling then notes that income and principal are payable to the Spouse during the Grantor's life.

So the Grantor is treated as the owner of the ENTIRE Trust under § 677(a). And the ruling concludes:

"Because Trust is a grantor trust under § 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 § 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 Section 677 power, use of Crummey powers for the spouse are permitted.

Unfortunately, as the facts of this Ruling are limited to the grantor trust status caused by Section 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 Section 675(4)(c) power to swap assets.

POWER OF SUBSTITUTION WILL NOT TRIGGER INCOME OR LOSS

Ruling Request 4

The seminal Ruling on the interaction of grantors and trusts over which they are treated as owner under Sections 673-678 is Rev. Rul. 85-13. Rev. Rul 85-13 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 the facts of this Ruling request, then, because Grantor is treated as the owner of the entire Trust, the exchange of assets between Grantor and Trust will be disregarded for federal income tax purposes, and thus neither the Grantor nor the Trust will recognize any income or loss under Code Section 61 or Section 1001 as a result of the proposed exercise of the substitution power.

CAUTIONS:

This ruling provides insight into issues the IRS seldom has ruled on. So it provides practitioners with a rare glimpse into the IRS' thinking on the matter. But be careful out there! Only the taxpayer requesting a private letter ruling can rely on it.

PLR 200603040 is still an interesting and important read 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 Code Section 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 of the Ruling – the impact of a right to exchange principal – seems to get lost in the ruling requests, and several key issues the ruling considers are unresolved.

For example, does it really matter if the trustee is independent? If so, 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. So does the part of the ruling harping on an independent trustee create a concern?

I think it should not, but it is interesting how it is noted and relied on.

Also, given the IRS' reliance on Jordahl in the ruling, 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 had to be in a fiduciary capacity? If Jordahl is relied on, and if exchanges can only be for full and adequate consideration, then why would a fiduciary obligation be a necessary provision?

Unfortunately, these issues were not answered in what is otherwise an interesting and worthy PLR to review.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jeff Baskies

Edited by Steve Leimberg

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CITES:

PLR 200603040 ; Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1 ; Rev. Rul. 85-13, 1985-1 C.B. 184. More information on Intentionally Defective Grantor Trusts can be found in **Tools and Techniques of Estate Planning** (800.543.0874) ; **The Cutting Edge** (610.924.0515) ; **The Book of Trusts - IV** (610.924.0515) ; **Tax Planning for Family Wealth Transfers** (800.950.1216) ; **Estate Planning and Wealth Preservation** (800.950.1216).

You can find LISI Commentaries on IDGTs or the grantor trust issues in IDGTs by **Larry Katzenstein** in Estate Planning Newsletter # 697 , **Bob Keebler** in Employee Benefits and Retirement Planning Newsletter # 258, **Steve Akers** in Estate Planning Newsletter # 738, and **Bruce Steiner** in Estate Planning Newsletter # 560 . See also "Using Beneficiary Guarantees in Defective Grantor Trusts" by **Milford B. Hatcher, Jr.** and **Edward M. Manigault**, *Journal of Taxation*, March 2000.