Recent ruling affects powers to remove and replace trustees

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Yielding to the pressure of recent court decisions(1), on August 4, 1995, the IRS issued Rev. Rul. 95-58. That Revenue Ruling rejects the position the IRS adopted in Rev. Rul. 79-353 (1979-2 CB 325) and Rev. Rul. 81-51 (1981-1 CB 458). In the old Revenue Rulings, the IRS required settlor's to include in their gross estates irrevocable trust assets where (i) the settlor retained a power to remove and replace the trustees of the trusts, and (ii) discretionary distributions or accumulations of income and principal were not limited by an ascertainable standard. Rev. Rul. 95-58 also rejects the IRS's position in Private Letter Ruling ("PLR") 8916032, which extended the logic of Rev. Rul. 79-353 to include in the gross estates of beneficiaries any trusts over which they have the power to remove and replace the corporate trustees. Thus, Rev. Rul. 95-58 provides new opportunities for clients to create irrevocable trusts with broad discretionary distribution standards while retaining for themselves or providing to beneficiaries a power to remove and replace independent trustees (either corporate or individual, but not related or subordinate to the settlor(2)) without causing inclusion of the trust assets in the clients' or the beneficiaries'

Appointing a Trustee

OFTEN CLIENTS WHO create irrevocable trusts choose to appoint corporate (or non-corporate but independent) trustees to avail themselves of the professional management a corporate trustee provides, or to incorporate broad discretionary powers of distribution (not limited by an ascertainable standard) without causing adverse estate or gift tax consequences. At the same time, many of those clients prefer to retain the authority to change the trustees in case they are unhappy with the services of the trustees or in case a beneficiary moves to a remote location where the trustees have no offices or no contact with the beneficiary. Under the IRS's former position, if a client created an irrevocable trust with broad trustee discretion to make distributions, the client's retention of an unrestricted power to remove and replace the trustees (even if they were independent) caused the entire trust to be included in the client's estate. Moreover, if the client provided a beneficiary an unrestricted right to remove and replace the trustees (even if they were independent) then the entire trust was included in the estate of the beneficiary.

The IRS's new position published in Rev. Rul. 95-58 helps our clients. Now, they may (i) create trusts with broad discretion, (ii) appoint independent trustees, and (iii) retain for themselves or provide to a beneficiary the right to remove and replace the trustees -- provided the replacements must always be independent.

Legal Background

PURSUANT TO THE TERMS of Secs. 2036 and 2038 of the IRC of 1986, as amended (the "Code"), if a settlor retains a power to affect the enjoyment of property placed in an irrevocable trust, then the trust principal will be included in the settlor's estate.

Sec. 2036(a) provides 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 (except in case of a bonafide 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 ... (2) the right, either or alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Sec. 2038 provides (for transfers after June 22, 1936) that:

(The gross estate of a decedent) shall include the value of all property ... (t)o 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, 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 (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the three year period

ending on the date of the decedent's death.

Two issues are not contested. First, if your client wants to create an irrevocable trust, which provides the trustee significant powers to distribute or accumulate the income and the principal of that trust, unlimited by an ascertainable standard, then the trust principal would be includable in your client's gross estate under Secs. 2036 and/or 2038 of the Code if your client were a trustee of the trust even if the client were not a beneficiary of the trust. Second, if the client reserves the power to remove the trustee and appoint herself as the successor trustee, then the Treasury Regulations require the trust property to be included in the client's estate, even if she did not actually remove the trustee.(3)

What has been hotly contested since 1979 was the IRS' extension of the logic of Secs. 2036, 2038 and the Regulations thereunder in Rev. Rul. 79-353. In that ruling, the IRS stated that if a settlor creates an irrevocable trust nominating a corporate trustee and granting broad discretionary powers to accumulate or distribute income and principal, unlimited by an ascertainable standard, and the settlor also retains an unrestricted right to remove the corporate trustee and appoint another corporate trustee, then the trustee's powers will be attributed to the settlor causing the principal of the trust to be included in the settlor's estate.(4) Citing various cases, the IRS asserted in Rev. Rul. 79-353 that the settlor's reservation of the unlimited power to remove and substitute the corporate trustee (even though the settlor could not appoint herself trustee) was equivalent to the reservation of the trustee's powers by the settlor herself.(5) The IRS argued that the settlor could compel the trustee to act as the settlor directed, or could remove a reluctant trustee and "shop around" for another which would act as the settlor instructed. The threat of removal itself, the IRS argued, afforded the settlor control over the trustee's discretion.

Rev. Rul. 81-51 clarified Rev. Rul 79-353. In Rev. Rul. 81-51, the IRS indicated that the estate inclusion rules did not apply to transfers to or additions to trusts created and irrevocable prior to October 29, 1973 -- the date of the publication of Rev. Rul. 79-353.

After Rev. Ruls. 79-353 and 81-51, the IRS further extended the scope of its reasoning to include removal powers held by beneficiaries. In PLR 8916032, the IRS required the assets of an irrevocable trust created by a third party to be included in the beneficiary's estate since the beneficiary had the right to remove the trustee without cause and replace the trustee with a third party (even though the beneficiary could not appoint herself, and because the trustee's power to distribute the principal of the trust was not limited to an ascertainable standard. Thus, the IRS contended, beneficiaries with unrestricted removal powers to whom the trustee has discretion to distribute principal, not restricted by an ascertainable standard, will be deemed to hold a general power of appointment over the trust under Sec. 2041 of the code.(6)

The entire landscape of the law regarding the includability of trust assets was affected by the Wall and Vak cases. Those decisions placed the IRS's: position in doubt.

The Wall Case

IN THE WALL DECISION, the tax court directly confronted the IRS's logic in Rev. Rul. 73-353 and rejected the IRS's approach. Mrs. Wall created three irrevocable trusts on December 19, 1979, reserving the right to remove the corporate trustee and appoint a successor corporate trustee on written notice. Mrs. Wall had no power to appoint herself as trustee of any of the three trusts. In fact, First Wisconsin Trust Company served as trustee from the date of appointment to her death.

The dispositive provisions of the trusts gave the corporate trustee the power to distribute the principal and income of the trusts in its sole discretion for the benefit of the beneficiaries. There was no argument that the dispositive provisions failed to contain a limitation on the power to distribute based upon an ascertainable standard.(7)

While auditing Mrs. Wall's estate tax return, relying upon Rev. Rul. 79-353, the IRS determined that the value of the three trusts must be included in Mrs. Wall's estate. The Personal Representative of the estate, filed suit in the Tax Court.

In its arguments to the Tax Court, the IRS relied upon the same case previously cited to support Rev. Rul. 79-353.(8) On the other hand, the estate systematically distinguished the precedents the IRS alleged as supporting Rev. Rul. 79-353.(9) Then the estate cited the Beckwith and Byrum cases in support of its position.(10) It argued by analogy to the holdings in those cases that retaining a right to change trustees did not cause trust property to be includable in Mrs. Wall's estate.

In reaching its decision, the Tax Court found neither the estate's cases nor the IRS's cases to be controlling. After distinguishing the cases supplied by the IRS as well as those offered by the estate, the Tax Court faced the precedential value of Rev. Rul. 79-353 and stated: "Revenue Ruling 79-353 does directly address the issue before us, but as already demonstrated, the conclusion it reached is not supported by cogent argument nor by cited cases supporting the conclusion reached."(11) Thus, the Tax Court found no binding precedent in the law and reviewed ab initio the

fundamental question of the includability of the principal of the trusts due to the retained right to change corporate trustees.

The court concluded that under established principles of trust law, it would be a violation of fiduciary duty for a trustee to administer the trusts by acquiescing in the wishes of the settlor if such were not in the beneficiaries' best interests. To take actions which the trustee would not otherwise have taken regarding distribution or accumulation of income or principal and the timing of the beneficial enjoyment of any of the trust property because of a power of the settlor to remove the corporate trustee would constitute maladministration. The Tax Court found no basis to infer that any corporate fiduciary would risk a law suit by the beneficiaries to satisfy the whims of the settlor. The court then cited general legal theories regarding the duty of trustees to administer trusts in the sole interest of the beneficiaries, to act impartially in so doing, and not to exercise their powers for the benefit of anyone other than the beneficiaries.

To reach its ultimate conclusion, the Tax Court determined that the provisions of Secs. 2036 and 2038 of the Code were not violated in this case; the settlor had not retained a power to designate the persons who possess or enjoy the trust property nor a power to alter, amend or revoke the enjoyment of the trust property. Therefore, the Tax Court found in favor of the estate and overruled Rev. Rul. 79-353, stating that the underlying assumptions of the Revenue Ruling violated the established principles of law governing the administration of trusts.

The Vak Decision

IN ESTATE OF VAK, the settlor created a trust with broad discretionary distribution powers -- including the settlor as a permissible beneficiary. The settlor appointed individual trustees and retained a power to remove the trustees and replace them with other independent trustees. Three years after the creation of the trust, it was amended to remove the settlor as a permissible beneficiary and to eliminate his power to remove and replace the trustees.

In that case, the IRS argued the transfer to the trust was an incomplete gift until the date when the settlor relinquished his right to remove and replace the trustees. On the other hand, the estate argued the gift was complete upon the initial funding of the trust.

The Eighth Circuit Court agreed with the estate and concluded that the funding of the trust constituted a completed gift. The court based its conclusion upon its decision that the settlor's retention of the right to remove and replace the trustees did not constitute a retention of dominion and control over the trust.

Rev. Rul. 35-58

HAVING LOST ITS ARGUMENTS twice in court, the IRS re-examined Rev. Rul 79-353 and its subsequent rulings and PLRs. The result of this re-examination was the issuance of Rev. Rul. 95-58. Rev. Rul. 95-58 revoked the old rulings. The IRS now agrees not to include trusts in the estates of settlors or beneficiaries merely due to a right to remove or replace independent trustees, so long as the right to replace the trustees is limited to other independent trustees. Under those circumstances, even if the trustee discretion is broader than an ascertainable standard, the IRS will not assert indudability under Secs. 2036, 2038 and/or 2041 of the Code.

Until Rev. Rul. 95-58, clients desiring to create irrevocable trusts but wishing to include broad discretionary powers to make distributions -- broader than an ascertainable standard -- could not retain the power to change independent trustees. Moreover, clients could not permit beneficiaries to do so. As previously discussed, there are many valid reasons why clients might choose to avail themselves of the broader discretionary distribution powers available by the use of independent trustees; however, there are also important reasons why such clients may also wish to retain the power to change those trustees. For example, if the corporate trustee appointed were "taken over" by or merged into another institution, the client may not be satisfied with the acquiring institution. Or, if one of the beneficiaries were to move from the city, state or even the country in which the trust was established, the client may want to appoint a new trustee familiar with the location to which the beneficiary has moved or closer in proximity to the beneficiary to better monitor the beneficiary.

Particularly for clients creating irrevocable life insurance trusts, Crummey trusts and/or credit shelter trusts, the IRS' position in Rev. Rul. 73-353 has been troublesome. However, with the IRS's new position published in Rev. Rul. 95-58, powers to remove and appoint independent trustees for irrevocable trusts may be broadened in the future. Ultimately, the Wall decision's sweeping rejection of the IRS's position in Rev. Rul. 73-353 caused the IRS to reconsider that position, acquiesce in Wall, withdraw Ret. Rul. 79-353, and withdraw the subsequent Revenue Rulings and PLRs founded thereon. The IRS's new position in Rev. Rul. 95-58 is beneficial to many clients, and estate planners should consider the circumstances where powers to remove and replace independent trustees should be incorporated into their clients' documents. All future drafting should consider inclusion of such powers of removal and replacement, unless the settlor is not interested in retaining such powers and does not trust a beneficiary with such powers.

End Notes

1. Estate of all vs. Commissioner, 101 T.C. 300 (1993); and Estate of Vak vs. Commissioner, 973 F.2d 1409 (8th Cir. 1992), rev. T.C. Memo 1991-503

2. For purposes of Rev. Rul. 95-58 the term "independent trustee" means a corporate or individual trustee who is not related to or subordinate to the person having the power to remove and replace the trustee as those terms are used within the meaning of Sec. 672(c) of the Code. Sec. 672(c) broadly defines the class of "related or subordinate parties" to include: the settlor's spouse (if living with settlor), parents, descendants, siblings, employees, subordinates in a corporation in which the settlor is an executive and a corporation significantly controlled by the settlor. All references in this Article to "independent" trustees shall conform to that definition.

3. Treas. Reg. Sec. 20.2036-1(b)(3), and 20.2038(a)(3).

4. Rev. Rul. 79-353 (1979-2 C.B. 325).

5. In support of its decision in Rev. Rul. 79-353, the IRS cited the following cases: state of Farrell vs. United States, 213 CT. CL. 622, 553 P.2d 637 (1977); Mathty us. United States, 491 F.2d 481 (3d Cir. 1974); Van Beuren vs. McLoughlin, 262 F.2d 315 (1st Cir. 1958); Loughridge's Estate vs. Commissioner, 183 P.2d 294 (10th Cir. 1950), affg. in part, revg. in part 11 T.C. 968, (1948); and Corning us. Commissioner, 24 T.C. 907 (1955), affd. per curiam 239 F.2d 646 (1st Cir. 1958).

6. Private Letter Rul. 8916032; see also, Private Letter Ruls. 9113026, 9303018 and 928015; see also, Berall, Hayes and Walsh, "TC Okays Grantor's Power to Replace Independent Trustee," Estate Planning March/April 1994) at 69.

7. Estate of Wall vs. Commissioner, supra note 1.

8. See note 5, supra.

9. First, the estate argued the in Corning the taxpayer was not prevented from appointing a corporation in which he was the sole shareholder and director as the successor trustee, and therefore he de facto still maintained the requisite power to appoint himself. Such was not possible under the facts of Rev. Rul. 79-353, or in Wall. Second, the estate argued that Corning was based on income tax provisions, not estate tax. Income tax rules and estate tax rules are not to be construed in pari materia, the estate argued. Next, the estate asserted that Van Buren only supported the decision of Rev. Rul. is353 by way of dictum. The estate argued that statements made in dictum should not be deemed binding precedent.

10. Estate of Beckwith us. Commissioner, 55 T.C. 242 (1970); and Byrum vs. United States, 311 F.Supp. 892 (S.D. Ohio 1970), affd. 440 F.2d 949 (6 Cir. 1971), affd. 408 U.S. 125 (1972).

11. Estate of Wall, supra note 1.

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Abstract (Document Summary)

The recently published Rev. Rul. 95-58 has reversed the IRS's 16-year-long position regarding the consequences for trust settlors and beneficiaries of rights to remove and replace trustees. The estate industry should be conscious of the new opportunities available that would make creating irrevocable trusts and designating professional fiduciaries palatable to clients. Ultimately, familiarity with Rev. Rul. 95-58 will make trust administrators better planners and will benefit clients.

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Sec. 2038 provides (for transfers after June 22, 1936) that:

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The dispositive provisions of the trusts gave the corporate trustee the power to distribute the principal and income of the trusts in its sole discretion for the benefit of the beneficiaries. There was no argument that the dispositive provisions failed to contain a limitation on the power to distribute based upon an ascertainable standard.(7)

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The court concluded that under established principles of trust law, it would be a violation of fiduciary duty for a trustee to administer the trusts by acquiescing in the wishes of the settlor if such were not in the beneficiaries' best interests. To take actions which the trustee would not otherwise have taken regarding distribution or accumulation of income or principal and the timing of the beneficial enjoyment of any of the trust property because of a power of the settlor to remove the corporate trustee would constitute maladministration. The Tax Court found no basis to infer that any corporate fiduciary would risk a law suit by the beneficiaries to satisfy the whims of the settlor. The court then cited general legal theories regarding the duty of trustees to administer trusts in the sole interest of the beneficiaries, to act impartially in so doing, and not to exercise their powers for the benefit of anyone other than the beneficiaries.

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Rev. Rul. 35-58

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7. Estate of Wall vs. Commissioner, supra note 1.

8. See note 5, supra.

9. First, the estate argued the in Corning the taxpayer was not prevented from appointing a corporation in which he was the sole shareholder and director as the successor trustee, and therefore he de facto still maintained the requisite power to appoint himself. Such was not possible under the facts of Rev. Rul. 79-353, or in Wall. Second, the estate argued that Corning was based on income tax provisions, not estate tax. Income tax rules and estate tax rules are not to be construed in pari materia, the estate argued. Next, the estate asserted that Van Buren only supported the decision of Rev. Rul. is353 by way of dictum. The estate argued that statements made in dictum should not be deemed binding precedent.

10. Estate of Beckwith us. Commissioner, 55 T.C. 242 (1970); and Byrum vs. United States, 311 F.Supp. 892 (S.D. Ohio 1970), affd. 440 F.2d 949 (6 Cir. 1971), affd. 408 U.S. 125 (1972).

11. Estate of Wall, supra note 1.

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Abstract (Document Summary)

The recently published Rev. Rul. 95-58 has reversed the IRS's 16-year-long position regarding the consequences for trust settlors and beneficiaries of rights to remove and replace trustees. The estate industry should be conscious of the new opportunities available that would make creating irrevocable trusts and designating professional fiduciaries palatable to clients. Ultimately, familiarity with Rev. Rul. 95-58 will make trust administrators better planners and will benefit clients.

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