

CHAPTER FIVE - IRREVOCABLE TRUSTS

Planning structure & objectives in using irrevocable trusts:

Lifetime asset transfer to an irrevocable trust.

- 1) Save estate tax, but (over \$5.340 million) gift tax, at 40% rate during 2014, §2502(a)).
- 2) Transfer asset management responsibility.
- 3) Reduce potential exposure to creditors' claims (if the transfer is consistent with creditor's rights laws, i.e., local law).

Local Trust Law Requirements

p.2

- 1) Creation of a trust under local trust law
 - What type of structure?
 - Irrevocable (how assure this status?)
- 2) Transfer of assets into the trust on an irrevocable basis. How accomplished?
- 3) What are the rights of the beneficiaries after transfers of assets into this trust have been completed?

Federal Tax Planning - Basic Objectives p.3

- 1) Minimize gift tax on transfers, e.g.,
 - (a) exclusions (including credit equivalent; during 2014 – \$5.34 million), and
 - (b) valuation discounts
- 2) Reduce federal income tax by spreading taxable income among multiple taxpayers (note: Must avoid application of grantor trust rules)
- 3) Eliminate subsequent estate tax exposure for the transferred assets.

Estate Tax Inclusion Risks to Trust Grantor

§§2036, 2037 & 2038; cf. §2035

P.4

- 1) Grantor retains beneficial interests.
- 2) Grantor retains powers concerning:
(a) income, & (b) corpus distributions from the trust to other beneficiaries.
- 3) Certain administrative powers retained.

Cf., tax importance of these powers if they are held by an “independent trustee.”

How create a “supertrust”? P.7.

Beneficial Enjoyment by the Trust Grantor p.7

Code §2036(a)(1) – a retained life interest causes gross estate inclusion for the transferor.

What is the amount of inclusion in the gross estate when a retained life interest?

What relevance/applicability of the “reciprocal trust doctrine” – i.e., the Grace case? P.8

How prove a “cross-trust” situation? What if the trust documents are signed at essentially the same time? And equivalent value? And equivalent terms?

Situations where a “Retained Interest” Exists

What rights of the trust grantor’s creditors when the property is transferred into a trust by grantor & discretionary power to distribute to the grantor? See TAM 199917001, p.13.

Is this a state law issue re creditor’s rights?

Cf., impact of support obligations (*next slide*)

See 2009 Texas Property Code provisions, p. 13, re satisfaction of support obligations (but no cutback for the trust grantor).

Discretion to distribute to grantor? RR 76-103.

Trusts for Minor Children

Independent Trustees

What if distributions are made to (or for) grantor's minor children – what if a legal obligation to support these children?

Chrysler case, p.22, re HSEM distribution power, but “as the Trustees shall deem advisable.” Held: no estate tax inclusion; cf., Code §677(b) re income tax effect.

What is a “support obligation” in this context?

Note “private trust company” issue, p. 25.

Note “equity trusts”, etc. approach (p.27).

Equity Trusts

p.27

Objectives when implementing an “equity trust”:

- 1) Income tax
- 2) Gift tax
- 3) Estate tax
- 4) Creditors rights

Note: “substance vs. form”

Real issue for the professional advisor: how to unwind these (irrevocable) arrangements?

Notice 97-24, p. 30 – abusive trust arrangements.

Beneficial Powers Retained by Grantor p.36

Code §§2036(a)(2) and 2038.

What choices for trust income/corpus
distribution provisions:

- 1) Mandatory distributions.
- 2) Discretionary distributions.
- 3) Distribution standard: health, support, education and maintenance (HSEM).

Cf., independent trustee vs. the grantor as the trustee – who can have which powers?

Lober case p.37

Estate Tax Considerations

Power to accelerate or decelerate distributions?

Lober case – concerns capacity of the grantor-trustee to accelerate principal distributions.

Is this a power to alter, amend or revoke? Yes.

What if a power to change beneficiaries? p.39

Completed gifts for gift tax purposes? P.39

Yes, if one beneficiary; Reg. §25.2511-2(c)&(d).

Income tax result? See Code §674(b)(5)&(6).

P.39

Effect of “Ascertainable Standard” Provision?

Rev. Rul. 73-143 (p. 40), i.e., does an “ascertainable standard” exist (where the grantor acts as trustee) so as to limit estate tax inclusion exposure?

Daughter’s trust – “support and education” – no inclusion (i.e., an “ascertainable standard”).

Son’s trust – distributions as “advisable” – required estate tax inclusion. Why?

How determine what is an “ascertainable standard”?

Family Trust Company

p.41 (footnote)

What is a “family trust company”?

How organize?

Who controls?

What are its purposes?

Does a risk of retained tax adverse powers exist? How mitigate this risk? Use “firewalls”?

Old Colony Trust Co.

p.42

Trust grantor as the trustee

- Article 4 – income distribution discretion.
- Article 7 – administrative powers clause (note the prior State Street Trust Co. case).

Possible §2036(a)(2) & §2038(a)(1) & gross estate inclusion?

Can the powers clause be used to shift economic benefits between the life tenant and the remaindermen? What relevance of local probate court supervision in this context?

Administrative Powers Clauses – Examples, p.44

Estate tax impact of:

- 1) Classification of an extraordinary corporate dividend as “corpus” or “income.”
- 2) Creation of a depreciation or a depletion “reserve” concerning wasting property
- 3) Power to distribute high tax basis property to one beneficiary and low tax basis property to another beneficiary; cf., §1041 (divorce).
- 4) Power to substitute property of equal value – Rev. Rul. 2008-22, p.45 What fiduciary responsibility here?

Estate of Wall

p.45 (& Vak Estate)

Independent trustee; trustee has discretionary power re distributions.

However: Trust grantor has power to remove a corporate trustee and to replace original trustee with another corporate trustee – Held: not a retained §2036(a)(2) or §2038 power.

Should the retained power to change trustees be important for estate tax purposes? When?

Note IRS position in Rev. Rul. 79-353 and, later, in Rev. Rul. 95-58, p. 53

Cf., power of grantor to be a substitute trustee.

Closely-held Business & §2036(b) p.55

Note the Byram case – U.S. Supt. Ct. holds that retention of (controlling?) voting power over corporate shares held by a trust is not a §2036(a)(1) power. Response: §2036(b).

When is inclusion (for purposes of §2036(a)(1)) required under §2036(b)?

Note PLR 199938005, p.55, re transfer of closely held stock into a partnership and the transferor was the GP of partnership. How preclude this result by agreement?

Three-Year Pre-death Transfer Rule §2035(a)(2)

Example: Terminate a prohibited power.

Inclusion in gross estate where: p.59

- (1) The transfer involved a trust within three years of death, and**
- (2) Assets would have been included for estate tax purposes under one of the “retained interest” provisions.**

What is the tax/financial impact of this gross estate inclusionary provision?

Grantor Trust Income Tax Rules

Subpart E (of Subchapter J), §§671-678 (re income inclusion for income tax purposes), including:

- §674(b)(5) – exception for power to withhold corpus distributions
- §674(b)(6) – exception for power to withhold income distribution

Tax planning possibility: inclusion for income tax purposes, but not for estate tax purposes (i.e., a “defective trust” or “IDGT”).

Note: Obama legislative proposal.

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