

CHAPTER FIVE - IRREVOCAABLE TRUSTS

Planning structure & objectives in using irrevocable trusts created during lifetime:

Lifetime asset transfer to an irrevocable trust.

- 1) Save estate tax, but (over \$11.2 million) gift tax, at 40% rate during 2018, §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 (equitable) rights of the beneficiaries after the transfers of the 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 2018 – \$11.2 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.4-5

- 1) Grantor retains beneficial interests.
 - 2) Grantor retains beneficial powers concerning:
(a) income, & (b) corpus distributions from trust to other beneficiaries.
 - 3) Certain administrative powers retained.
- Cf., tax importance of these powers if they are held by an “independent trustee.” Chart, p. 7.
- 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.9

How prove a “cross-trust” situation? What if the trust documents are signed at essentially the same time? And, have equivalent value? And, have 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? P. 13.

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

Uniform Trust Code, § 505(a)(2), p. 13.

See 2009 Texas Property Code provisions, §113.029(b)(2), p. 26, re satisfaction of support obligations (no discretionary distributions permitted for grantor’s debts).

Situations where a “Retained Interest” exists

Discretion to distribute to grantor?

Rev. Rul. 76-103, p. 13:

independent trustee

Absolute discretion to distribute income and principal to the grantor.

Property subject to claims of creditors.

Therefore, NOT COMPLETE for gift tax purposes (and includible in gross estate?).

Cont., situations where a “Retained Interest” Exists

See TAM 199917001, p.14. Inclusion in gross estate since access of grantor’s creditors.

P. 22. Trust grantor’s legal obligation (determined under state law) to support one’s spouse which can be funded from trust created by grantor?

Same treatment if trust established by grantor to support grantor’s minor children?

See next slide re discretionary trust/independent trustees.

Trusts for Minor Children Independent Trustees

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

Chrysler case, p.23, re HSEM distribution power, but “as the Trustees shall deem advisable.” Held: no estate tax inclusion.

See Tx. Estates Code, § §113.029(b)(2), p. 26.

Cf., Code §677(b) re income tax effect. P. 27.

What is a “support obligation” in this context?

Family Office or Private Trust Company p.27

Can a “private trust company” or “family office” be used to circumvent the estate tax inclusion rules?

See Notice 2008-63, p. 27 (& fn 32, p. 38 re grantor as beneficiary).

Trust grantor can have no rights to participate in trust management decisions.

“Equity Trusts”

p.27

Objectives when implementing an “equity trust”:

- 1) Income tax – Rev. Rul. 75-257**
- 2) Gift tax – Rev. Rul. 75-260 (no gift)**
- 3) Estate tax - Rev. Rul 75-259, p. 27.**
- 4) Creditors rights**

Note: “substance vs. form”

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

Notice 97-24, p. 31 – abusive trust arrangements.

“Top Ten Tax Scams for 2016” - abusive trusts

Beneficial Powers Retained by Grantor p.33

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., (a) independent trustee vs. (b) the grantor
as the trustee – who can have which powers?**

Lober case p.34

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 (except for afterborn/after-adopted children)? p.36

Completed gifts for gift tax purposes? P.36

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

Income tax result? See §674(b)(5)&(6). P.36

Effect of “Ascertainable Standard” Provision?

Rev. Rul. 73-143 (p. 37), i.e., does an “ascertainable standard” exist (where grantor acts as trustee) to limit estate tax inclusion?

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 an “ascertainable standard”?

Cf., Chrysler case & §2036(a)(1) re support.

Family Trust Company p.38 (footnote)

What is a “family trust company” or “private 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”?

Proposed IRS ruling has not been issued.

Old Colony Trust Co.

p.39

Trust grantor as the trustee

- **Article 4 – income distribution discretion.**
- **Article 7 – administrative powers clause (note the prior State Street Trust Co. case in 1st Cir.).**

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 to control the trustee's decision-making? State law issue?

Administrative Powers Clauses – Examples, p.41

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.42. What fiduciary responsibility is pertinent here?**

Avoiding Gift Tax Exposure

p.42

PLR 201729009 – an incomplete non-grantor trust when retained trust administration power.

Objective: Avoiding income tax applicability and not be a gift for gift tax purposes.

For gift tax – grantor’s consent power required for trustees to distribute corpus and income, or Grantor directs distributions to children, etc. for HESM purposes.

Held: Not a gift for gift tax purposes (as to various components of the gift).

Estate of Wall (& Vak Est)

Re: Estate Tax p.44

Independent trustee; trustee has discretionary power re income & corpus distributions.

However: Trust grantor has power to remove a corporate trustee and to replace original trustee with another corporate trustee.

Held: not 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, 16 years later, revised in Rev. Rul. 95-58 (p. 52).

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

Closely-held Business & §2036(b) p.53

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: Code §2036(b).

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

Note PLR 199938005, p.54, re transfer of closely held stock into a partnership and the transferor was the GP of partnership. How preclude this result by an agreement among the partners?

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

Example: Terminate a prohibited power.

Inclusion in gross estate where: p.57

- (1) The transfer involved a trust within three years prior to death, and**
- (2) Assets would have been included for estate tax purposes under one of the “retained interest” provisions (i.e., §§2036-2038).**

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

Grantor Trust Income Tax Rules

p.58

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

- §674(b)(5) – exception for retained power to withhold corpus distributions
- §674(b)(6) – exception for retained 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”).

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