Trustee Selection; Retaining Strings Without Getting "Strung-Up"

OR

"The Fancy Stuff Is Fun— But This Is What I Wrestle With Every Day"

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Trustee Selection; Retaining Strings Without Getting "Strung-Up"

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INTRODUCTION

This outline addresses tax and non-tax factors that should be considered in selection of a trustee or co-trustees for various types of trusts. Clients typically like to keep as much control as possible, and often want to place as much control in their trust beneficiaries as possible. This desire must be balanced against management, tax, and creditor issues that may result in significant advantages in placing restrictions on the control of the donor or trust beneficiaries. This outline address trustee selection against the backdrop of a client's desire to retain as many "strings" over the transfer as possible with causing the donor or beneficiaries to be "strung-up" by those other countervailing factors. As one court has expressed the issue, "the cost of holding onto the strings may prove to be a rope burn." Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st Cir. 1970).

I NON-TAX FACTORS

A. Legal Capacity.

1. General Statutory Requirements.

A trustee must have legal capacity, and if the trustee is a corporation, it must have the power to act as a trustee. TEXAS TRUST CODE § 112.008(a). A beneficiary or settlor may serve as trustee. TEXAS TRUST CODE § 112.008(b-c).

2. Requirements for Corporate Trustee.

Section 3 of the Texas Probate Code defines a "corporate fiduciary" as a financial institution as defined by Section 201.101 of the Finance Code, having trust powers, existing or doing business in Texas or another state, and being authorized by law to act under the order of any court of record without giving bond, as trustee, executor, or administrator. Under Section 201.101 of the Finance Code, a financial institution includes a bank or trust company chartered under laws of the United States or any state. For a list of activities that does not require obtaining a charter to engage in trust business, see Section 182.021 of the Texas Finance Code. A corporation formed under the Texas Business Corporation Act may not exercise the powers of a trust company. TEX. BUS. CORP. ACT art. 2.01B(4)(b); See TEX. FIN. CODE § 181.001 et. seq.

3.Requirements for a Foreign Corporate Fiduciary.

A foreign corporation or other entity chartered or domiciled in another jurisdiction as a trust company or depository institution with trust powers may act as a trustee in Texas only as provided by Section 105A of the Texas Probate Code. (As discussed below, this provision apparently is overridden by the Supremacy Clause as to financial institutions that are organized as National Associations.)

a. Reciprocity Requirement. A Texas court can appoint a corporate fiduciary from another state (a "foreign corporate fiduciary") as a fiduciary in Texas only if a Texas financial institution can be appointed under the laws of the state of the foreign fiduciary "to serve in like fiduciary capacity." TEX. PROB. CODE § 105A(a).

b. Filing Requirement. A foreign corporate fiduciary shall file with the Secretary of State of Texas (1) a copy of its charter, (2) an appointment of the Secretary of State as its resident agent for service of process, and (3) a designation of the agent who shall receive notices from the Secretary of State. TEX. PROB. CODE § 105A(b).

c. Not Doing Business. A foreign fiduciary who satisfies the requirements of Section 105A is not deemed to be doing business in Texas for purposes of Section 8.01 of the Texas Business Corporation Act.

d. National Associations. The Office of the Comptroller of the Currency takes the position that under the Supremacy Clause of the

U.S. Constitution a national association can serve in any state without meeting any state requirements, including the modest filing requirements. See e.g., OCC Interp. Ltr. No. 872 (Dec. 1999) and OCC Interp Ltr. No. 866 (Oct. 1999).

4. Charitable Corporation.

A charitable corporation may serve as the trustee of a trust (1) of which the charity is a beneficiary, or (2) benefiting another charitable organization. TEX. NON-PROFIT CORP. ACT ART. 1396-2.31(A) (2001). A charity meeting those requirements has immunity from any suit alleging that the corporation's role as trustee constitutes engaging in the trust business in a manner requiring a state charter. TEX. NON-PROFIT CORP. ACT ART. 1396-2.31(B) (2001).

B. Personal Attributes of Trustee.

The personal attributes of the trustee should be of paramount importance in the selection process. All too often, the tax factors predominate, but the planner must not lose sight of the personal attribute factors. The fact that the trust works for tax purposes will be of little benefit if a poorly selected trustee dissipates the trust assets through poor administration of the trust.

"Serving as an executor or trustee is neither an honor, nor a game for beginners to play. Acting as an executor or trustee requires technical skills, experience, and an ability to deal with the family members involved. Nevertheless, clients often choose an executor and the trustee without fairly evaluating the needs of the estate or trust against the named fiduciary's abilities to meet those needs." Schlesinger, Edward, Fifty-Two Questions to Ask Before Choosing Your Executor and Trustee, Successful Estate Planning Ideas and Method Service (1986).

Various personal attributes to be considered in selecting the trustee include sound judgment, impartiality (or desired partiality toward decedent's preferred beneficiaries), financial ability and responsibility, integrity and honesty, locality, permanence and continuity (particularly important for long-lived trusts), loyalty, trustworthiness, and experience as a trustee. Some of these attributes are explored in more detail.

1. Judgment; Experience.

Attorneys are all too familiar with situations where trust assets have been dissipated due to the inexperience of the trustee. A good trustee can provide sound business judgment to the beneficiaries.

2. Impartiality; Objectivity; Lack of Conflict of Interest.

The objectivity and lack of conflict of interest factor is very important in many family situations. Selecting an appropriate trustee can avoid conflict situations that may result in family tensions (or outright hostilities) that can never be repaired.

a. Beneficiaries Having Conflicting Interests. In situations where the beneficiaries have conflicting interests (the classic case being a split-family situation, where the settlor's spouse and children by a prior marriage are both involved as current or contingent beneficiaries.) One commentator suggests using an independent trustee in these types of situations:

"On our facts, the first thing that the estate planner should do is to convince the client to use the services of a truly independent trustee. In this respect, even though [certain approaches may] lessen the possibility of conflict between the client's children and their stepmother, to a certain extent the objective will be undermined by having a child act as trustee. Because opinions will differ, there still will be circumstances in which the son-trustee does not accede to the stepmother's requests, creating the possibility of a confrontation. This also might be the case if someone like a brother-in-law or other disinterested relative is appointed as trustee.

The use of an independent fiduciary—perhaps a corporate fiduciary such as a bank—removes the opinions, the underlying distrust, the misunderstandings, and most of all the personalities from the decision-making process. Consequently, there is a better chance of achieving the desired cooperation between the family members." Tiernan, Creating an

Amicable Estate Plan for the Decedent's Children and the Second Spouse, 94 J. TAX'N (Feb. 2001).

b. Avoiding Family Tension. Stephen Leimberg has summarized the various interpersonal relationships that can be affected by using a family member as trustee:

"How will the trustee react when faced with a choice that favors him at the expense of other beneficiaries—or favors others at this expense? What are the intra-family implications of those choices? For instance, will he alienate one family member by (even properly) denying a distribution, or ingratiate himself to another by being liberal in his policy of making distributions? Can he say no to one child and yes to another without causing a never-ending family feud? A trustee who is also a family member may be forced by conscience or by duty to make choices injurious to the harmony of family relationships.

Will the trustee (such as the grantor's spouse) be subject to the influence of one or more children (or a second spouse or lover) to make distributions that may not be in the best interest of other beneficiaries? Is the family member-trustee easily persuaded or likely to show favoritism? The remarriage of a spouse or child who is named as trustee may result in less than impartial decisions—especially where the trustee has been given discretionary powers over trust income or principal—even if the new spouse is not included in the class of possible recipients.

A child/trustee may take on the role of a parent to his or her remaining parent or siblings. This may be positive, but it also may result in an attempt to control the lives of family members through the family finances as if that person were a parent rather than a child.

An independent professional trustee is not subject to such problems. Since the choice between no and yes may be one of the most important duties of a trustee, this ability of a professional trustee to be objective and impartial should be given high preference in the decision-making process." S. Leimberg, The Tools and Techniques of Estate Planning 480 (11th ed. 1998).

3. Investment Sophistication; Track Record; Prudent Investor Act.

The investment sophistication of the trustee is important with respect to the investment growth of the trust. The trustee's experience in various types of investments should be considered. For example, does the trustee have experience in the increasingly important area of alternative investments (private equity, venture capital, and hedge funds) to increase returns while reducing overall portfolio volatility?

Under the Prudent Investor Act, which is being passed by many of the state legislatures (and will be considered by the Texas legislature in the 2003 session) the trustee must evaluate the investments in the context of the entire trust and the risk and return objectives of the trust. In addition, the trustee has a duty to diversify the trust assets. Some commentators observe that the Prudent Investor Rule may increase the level of sophistication required of trustees. See Heisler & Butler, Trust Administration ch. 5 (Ill. Inst. For Continuing Legal Educ. 1999).

4. Permanence and Availability.

Especially for long-term trusts, the long-term existence and availability of the trustee is important. Corporate trustees have the advantage of perpetual existence. The client should inquire, however, into the rate of turnover of the professional staff of the corporate trustee. Having someone available who can develop a long-term helpful relationship with the beneficiaries may be very important in many situations. "It is no big stretch to say that a warm, cooperative, *known* voice on the other end of the telephone line is probably more important to an elderly surviving spouse than an extra three percent of total return." Karisch, Protecting the Surviving Spouse, 38th ANNUAL SW LEGAL FDN. WILLS & PROB INST. 18 (May 1999).

Geographic availability of the trustee may also be important. Some individuals who are being considered as a possible trustee might be expected—over a long period of time—to move locations. Furthermore, beneficiaries may move

to new locales, and the ability of the trustee to respond to geographic moves of the beneficiary should be considered.

5. Sensitivity to Individual Beneficiaries' Needs.

One of the important duties of a trustee is to make appropriate distributions to the trust beneficiaries, often within some degree of discretion. Being able to understand the beneficiaries and their circumstances is important. Some clients choose to use co-trustees, one of whom has experience in providing the myriad of fiduciary services, and one of whom has a personal relationship with the beneficiaries. In that situation, the co-trustees could be given exclusive responsibility for the administration vs. distribution responsibilities. However, even in that case, the client may want to have the trustee consent to distributions (with the obvious input of the related co-trustee), to get the benefits of having an objective voice who can "shield" the related individual from unreasonable requests for distributions.

6. Accounting; Tax Planning; Record-Keeping.
"Corporate fiduciaries have a definite advantage over nonprofessional individual trustees when considering the myriad accounting procedures, tax compliance, and tax planning opportunities that must be handled by a trustee. The level of sophistication, expertise, and experience that should be applied over the lifetime of any trust is one that few nonprofessionals can provide. This means that most family members will simply be incapable of fully understanding all of the problems that must be avoided and the availability and implications of the tax and property law elections that must be weighed. Even knowledgeable attorneys and accountants do not have the requisite practical day-to-day experience unless they practice solely in this field.

It is possible and in many cases appropriate for a trustee to hire agents for advice and assistance. Most trustees will communicate regularly with outside attorneys and accountants. But planning policy and decisions must be made by the trustee; these are among the duties that cannot be delegated. . . . Will an untrained trustee know whom to call or if the advice received is both legally correct and practical? Will a nonprofessional understand the interplay between tax, trust, and property law well enough to interpret provisions in the trust and adequately inform beneficiaries about the tax and other legal effects of various choices?" S. Leimberg, The Tools and Techniques of Estate Planning 483 (11th ed. 1998).

The trust must maintain detailed records and reports typically are given to beneficiaries and the appropriate taxing authorities on a periodic basis. "This requires regular statements of the receipts, disbursements, and assets of the trust in an intelligible form, and careful long-term record storage." Id. At 484.

7. Fees.
Fees that will be charged by the trustee are a factor. However, the client should not be "penny-wise and pound-foolish."

"Relatives, beneficiaries, business associates, and close friends will often serve as trustee without charging a fee. The grantor should be careful to determine whether the individual will properly carry out his duties and give sufficient attention to the administration of the trust. One is easily lured away from his responsibilities by more lucrative endeavors. 'You get what you pay for.'" Malouf, Choosing a Trustee: Old Problems, New Problems, A Few Solutions, at 5, Presentation to Dallas Estate Planning Council (January 1991).

Fees are often the primary reason that a client elects to use family members or friends as trustees rather than a professional fiduciary. There are certainly many situations in which it is appropriate to use carefully selected individuals as trustees. However, the clients should consider the long-term effects on the trust and balance all of the personal attribute factors in weighing whether to use a corporate fiduciary despite the fee differences.

"Where the trust is likely to be of substantial size, administration of the trust may require special confidence and expertise beyond the ability of any individual, whether a relative,

friend or business colleague. For this and other reasons a corporate trustee is often selected. The use of a corporate fiduciary as an 'independent trustee' may be necessary to avoid adverse federal income or estate tax consequences. A corporate fiduciary presumably would bring special skills and competence to investment, tax and other matters of trust administration that would amply justify its commissions. Continuity is assured since the trusteeship would be unaffected by disability, death or other contingency by reasons of the corporate fiduciary's perpetual existence. Although an individual named as trustee might be willing to serve without compensation, this savings might be offset by the need to retain and compensate attorneys, accountants, investment advisors and other agents." G.G. Bogert, G.T. Bogert & A. Hess, BOGERT'S TRUSTS AND TRUSTEES. § 121 (2001).

C. Likelihood of Self-Dealing Transactions.
In many situations, the overall plan will call for a trustee to purchase assets from related parties or affiliates. This brings into play the independence and lack of conflict personal attributes discussed in section I.B.2. above. In addition, legal restrictions on the ability of the trustee to enter into certain self-dealing transactions may be imposed if the trustee is also personally involved in the transaction.

Many state statutes have restrictions on self-dealing transactions, but many of those restrictions may be waived in the trust instrument. The Texas Trust Code prohibits a loan of trust funds to a trustee, affiliate or relative of a trustee (§ 113.053), a purchase or sale of trust property by or to a trustee, affiliate or relative of the trustee (§ 113.053), a sale of property from one trust to another trust having the same trustee (§ 113.054), and a purchase of the trustee's securities (§ 113.055). The term "relative" includes a spouse, ancestor, descendant, brother or sister, or spouse of any of them. TEX. PROP. CODE § 111.004(13).

In many situations, the settlor may want to relieve the trustee of self-dealing prohibitions if permitted by local law. In Texas, the trust instrument may alter self-dealing prohibitions that would otherwise apply under the Code, except that a corporate trustee may not be relieved from the self-dealing provisions in Section 113.052 (loan of funds to trustee or specified related parties) or Section 113.053 (purchase or sale of property from or to trustee or specified related parties). TEX. PROP. CODE §§ 111.002(a) & 113.059. The Texas Trust Code also addresses a corporate trustee making a temporary or permanent deposit of funds with itself. TEX. PROP. CODE § 113.007 (temporary deposit pending reinvestment) & 113.057 (permanent investments). The Texas Trust Code specifically authorizes a corporate trustee to employ an affiliate to provide brokerage, investment, or other account services for the trust and to permit the affiliate to charge a commission for its services. The statute requires that the amount charged by the affiliated be disclosed and not exceed the customary amount that is charged by the affiliate for comparable services to others. TEX. PROP. CODE § 113.053(f).

In addition, restrictions are imposed on banks by the OCC, but Section 9.12 of Regulation 9 relieves a trustee from many self-dealing restrictions when the proposed action is "lawfully authorized by the instrument creating the relationship, or by court order or by local law."

Despite the statutory provisions allowing waiver of self-dealing prohibitions on the trustee, there are some suggestions in cases that there may be public policy concerns that would limit the ability of the settlor to relieve a trustee of liability for future self-dealing transactions. See Langford v. Shamburger, 417 S.W.2d 438, 444 & 447 (Tex. Civ. App.—Ft. Worth 1967, writ ref'd n.r.e.) (dictum that "it would be contrary to the public policy of this state to permit the language of a trust instrument to authorize self-dealing by a trustee"; on rehearing, the court stated that the language of a trust instrument specifically authorizing self-dealing "could present a serious question of public policy"). See also Interfirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882 (Tex. Civ. App.—Texarkana 1987, no writ).

D. Situs Selection Issues.

The situs of the trust may affect various important legal issues, including asset protection, state income taxation, and the application of the rule against perpetuities to the trust.

If the client wishes to create a "Dynasty Asset Protection Trust" (i.e., a trust that is not subject to the rule against perpetuities and that is generally not subject to creditors claims against the settlor of the trust), it may be necessary to require that at all times there be sufficient trustees resident in the state whose law is being used. Alaska, Delaware, Nevada and Rhode Island have enacted statutes, beginning in 1997, to allow self-settled dynasty trusts (not subject to the rule against perpetuities) that are generally not subject to creditors claims of the settlor. (Nevada will soon be voting on amending its constitution to repeal the Rule Against Perpetuities. See Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, AT 55 (March/April 2002).) Colorado and Missouri had previously enacted self-settled trust creditor protection statutes. These various states have differing provisions regarding trustee selection in order to take advantage of the state's laws. For example, Rhode Island requires that all trustees be a resident or authorized to do business in that state. R.I. GEN. LAWS § 18-9.2-2(8)(I) (1999). Alaska and Delaware require that one trustee be a resident in their states. Some of the jurisdictions require that at least some of the trust assets be located in or administered in the host jurisdiction. See Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, AT 56 (March/April 2002).

E. Power to Allocate Gains to Income Under Section 104.

Section 104 of the new Uniform Principal and Income Act, which was approved by the National Conference of Commissioners on Uniform State Laws in July 1997, and approved by the American Bar Association in January of 1998, is in the process of being adopted in many states. It will be considered by the Texas legislature in 2003. If a trust provides for the mandatory distribution of all income, and if a trustee makes the decision under section 104 to allocate some or all capital gains to income for a particular year, the decision directly impacts the amount to be distributed to the income beneficiary. Accordingly, section 104 of the Uniform Act and most of the states adopting the provision stipulate that the discretion may only be exercised by an independent trustee. See Wolf, Total Return Trusts—Meeting Human Needs and Investment Goals Through Modern Trust Design, at 23, ACTEC 2002 ANNUAL MEETING. The Texas statute that will be proposed in the 2003 legislature will not permit a beneficiary who is serving as a trustee to allocate gains to income under the statute.

F. Ability of Beneficiary to Force Distributions.

In some situations, a donor creates a trust to provide long-term management for the benefit of a spendthrift beneficiary. The donor should be aware that if standards for distributions are listed in the trust agreement, the beneficiary may go to court to force a trustee to make distributions within the prescribed standards. If a trust gives the trustee wide discretion in deciding to make distributions, without specified standards for exercising that discretion, the beneficiary will have a much more difficult time convincing a court to force the trustee to exercise its discretion in a particular manner. However, for tax reasons, wide discretion over distributions is usually only allowed for an independent trustee. If a major goal of the donor in a particular situation is to provide long-term management for spendthrift beneficiaries, using an independent trustee with wide discretion over distributions may be preferable.

II. DONOR TAX ISSUES

A. Gift Tax Issues.

1. Incomplete Gift—Structure Planning Based on Donor's Intent.

The transfer to a trust may or may not be a completed gift, based on the terms of the trust and the identity of the trustee. The trust terms and trustee selection must be planned after taking into consideration whether the donor wishes to make a complete gift for gift tax purposes.

If there is a completed gift initially, there could be immediate gift tax due, based on the size of the gift. However, if the gift is not complete initially, the assets--including subsequent appreciation--will still be included in the donor's estate under Sections 2036-2038 of the Code of 1986 (hereafter, references to "Sections" will be to sections of the Internal Revenue Code of 1986, as amended) for estate tax purposes until the gift has been completed. If the gift is "completed" sometime after the initial transfer, the gift tax will be calculated based on the value of the assets when the gift is subsequently completed.

Section 2511 of the Code applies the gift tax to "direct or indirect" gifts of all kinds of property whether in trust or otherwise. The regulations add that a gift may be complete even if, at the time it is made, "the identity of the donee may not … be known or ascertainable." Treas. Reg. § 25.2511-2(a). The regulations provide that various retained interests or powers by the donor will result in a transfer being an incomplete gift until the retained interest or power is relinquished. As a result, certain powers retained by the donor as a trustee, or in some situations as a co-trustee, will result in a transfer not being treated as a completed gift for gift tax purposes.

2. Retained Right to Receive Distributions.

a. Overview. A transfer is a completed gift only to the extent that the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another." Treas. Reg. § 25.2511-2(b). Regulation § 25.2511-2(c) states that a gift is incomplete to the extent that the donor reserves the power to revest the property in himself. This power can be indirect, such as through the power to force a trustee to make distributions to the donor under a trustee's power to make distributions that is limited by a fixed or ascertainable standard, which is enforceable by or on behalf of the donor. (The regulation refers to Regulation § 25.2511-1(g)(2) to determine what are "fixed or ascertainable standards.") Such a transfer "is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor." Treas. Reg. § 25.2511-2(b).

One case that considered the ascertainable standard exception for this purpose is Gramm v. Comm'r, 17 T.C. 1063 (1951). The court held that the discretion to make principal distributions to the settlor for "comfort, education, maintenance or support" did not constitute an ascertainable standard; so there was no completed gift. The court held that the transfer was not a completed gift because "there was no limitation as to the amount which could be withdrawn by the corporate trustee for the comfort, etc. of the decedent." (This analysis may seem contrary to the Regulation, which would suggest that there is a completed gift if there is not an ascertainable standard that the donor can enforce.)

If a trustee who is not the donor has absolute discretion over distributions to the donor and the donor's creditors cannot reach the transferred property, the gift is complete. Holz Estate v. Comm'r, 38 T.C. 37, 42 (1962), *acq*. 1962-2 C.B. 4; Rev. Rul. 76-103, 1976-1 C.B. 293 (gift not complete where trust permitted discretionary distributions to grantor and, under the controlling state law, the grantor's creditors could reach the entire trust property; gift would become complete if trustee moved situs of the trust to a state where the grantor's creditors cannot reach the trust assets). Several cases have specifically addressed that an incomplete gift results if creditors of the settlor/beneficiary can reach the trust assets. Outwin v. Comm'r, 76 T.C. 153 (1981); Hambleton v. Comm'r, 60 T.C. 558 (1973); Paolozzi v. Comm'r, 23 T.C. 182 (1954), *acq*. 1962-1 C.B. 4; but see Herzog v. Comm'r, 116 F.2d 591 (2d Cir. 1941) (gift complete despite creditor's ability to reach trust assets). The IRS has ruled privately that a gift to an "Alaska Trust" (which could not be reached by the donor's creditors) was a completed gift even though the trustee could in its discretion make distributions to the donor. Ltr. Rul. 9837007.

A private letter ruling has addressed a transfer under which the donor's spouse had a testamentary power of appointment to appoint

the trust property back to the donor. The ruling held that a transfer to an irrevocable trust for the donor's spouse was a completed gift even though the spouse had a special testamentary power of appointment to appoint the assets to a trust for the benefit of the donor, and even though the IRS found that an implied agreement existed between the spouses that the donee spouse would in fact execute a codicil to her will appointing the trust assets to a trust for the benefit of the donor. Pvt. Ltr. Rul. 9141027. (To be more conservative, the planner should having any express or implied agreement regarding the exercise of the power of appointment in such circumstances to avoid incomplete gift treatment.)

b. Summary of Application to Selection of Trustee To Avoid Having Transfer Treated as Incomplete Gift. **If any distributions may be made to or for the donor's benefit, there must be an independent trustee making the distribution decision, and there cannot be an ascertainable standard that allows the donor to compel a distribution. Furthermore, the donor cannot be a co-trustee participating in such decisions unless the other co-trustee has a substantial adverse interest in the disposition of the transferred property. Treas. Reg. § 25.2511-2(e). Even if there is an independent trustee or a co-trustee with an adverse interest, the trust should be located in a jurisdiction that recognizes spendthrift protection for self-settled trusts to assure that the retained discretionary interest does not cause the transfer to be treated as an incomplete gift because of the ability of the donor's creditors to reach the trust assets.**

3. Powers to Change Beneficial Interests.

a. Powers to Change Beneficial Enjoyment That Cause Incomplete Gift. A transfer is generally incomplete to the extent that the donor retains the power to change the interests of the beneficiaries among themselves. Treas. Reg. § 25.2511-2(c); Sanford Estate v. Comm'r, 308 U.S. 239 (1939). The following are examples of retained powers, which if held by the donor alone or in conjunction with another trustee who does not have a substantial adverse interest, will cause a transfer to be incomplete (unless the ascertainable exception applies, as described immediately below):

- The power to shift benefits from one beneficiary to another, such as through a "sprinkling" power;
- The power to add one or more beneficiaries of the trust;
- The power to remove one or more beneficiaries of the trust;
- The power to distribute or accumulate income, thus affecting the amount passing to another person who is the remainder beneficiary. Treas Reg. § 25.2511-2(c)

If the trustee has any of these powers either alone or in conjunction with a non-adverse party (and if the ascertainable standard exception does not apply), the trustee must be someone other than the donor, and the donor must not have the power to have himself or herself appointed as trustee.

b. Ascertainable Standard Exception. The regulations clarify that a power to change beneficial interests will not cause a transfer to be incomplete for gift tax purposes if the power is held in a fiduciary capacity and is subject to a "fixed and ascertainable standard." Treas. Reg. § 25.2511-2(c) & 25.2511-2(g). If there is a fixed and ascertainable standard, the beneficiaries would have legal rights to force distributions according to the standard, thus divesting the donor of dominion and control over the transferred property. The regulations cited above do not give examples of what constitutes an ascertainable standard, but an analogous regulation (addressing powers by a trustee who has a beneficial interest in trust property) does provide details, including the requirement that the standard be such that the trustee is "legally accountable" for exercise of the power. The analogous regulation states that a power to distribute for the "education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard." Treas. Reg. § 25.2511-1(g)(2).

There have been only a few cases addressing the ascertainable standard exception in connection with whether retained powers to change beneficial interests preclude treating a transfer as a completed gift. See McHugh v. U.S., 142 F. Supp. 927, 929 (Ct. Cl. 1956) ("to provide properly for the essential needs—such as food clothing, shelter and illness expenses" constituted ascertainable standard; transfer subject to such standard was a completed gift); Pyle v. U.S., 766 F.2d 1141 (7th Cir. 1985), *rev'g* 581 F. Supp. 252 ("necessary for her health, support, comfort and maintenance requirements" constituted ascertainable standard, based on an Illinois Supreme Court case holding that the word "comfort" created an ascertainable standard; transfer subject to such standard was a completed gift).

In light of the ascertainable standard exception, purely administrative powers retained by the donor should have no gift tax effect. See Dodge, 50-5th T.M., Transfers With Retained Interests and Powers 93 (2002); cf. Byrum v. Comm'r, 408 U.S. 125 (1972) (no estate tax effects under Section 2038 of administrative powers held in a fiduciary capacity).

c. Power to Affect Time or Manner of Enjoyment, But Not to Shift Among Beneficiaries. A gift is not considered incomplete merely because the donor reserves the power to change the manner or time of enjoyment, but not to shift benefits among beneficiaries. Treas. Reg. § 25.2511-2(d). Therefore, a retained power by the donor as trustee to distribute or accumulate income will not preclude a completed gift as long as there is only one beneficiary of the trust and all assets must eventually be distributed to the beneficiary or his estate.

d. Power Exercisable In Conjunction With Others. If the donor has the power to change beneficial interests only in conjunction with another person who has a "substantial adverse interest in the disposition of the transferred property or the income therefrom," the transfer will still be treated as a completed gift (unless the ascertainable standard exception applies.) Treas. Reg. § 25.2511-2(e). The regulations do not define a substantial adverse interest, but presumably the doctrines related to adverse parties for income tax purposes (I.R.C. § 672(a)) and powers of appointment (I.R.C. § 2041(b)(1)(C) & 2514(c)(3)) will apply. The interest of a beneficiary who is adversely affected by the decision to distribute or accumulate must be substantial in relation to the whole. See Paxton v. Comm'r, 57 T.C. 627 (1972), aff'd, 520 F.2d 923 (9th Cir. 1975) (3.8% interest not substantial); Paxton v. Comm'r, T.C. Memo. 1982-464 (1982) (9.9% interest not substantial); Comm'r v. Prouty, 115 F.2d 331 (1st Cir. 1940) (discretion to distribute or accumulate income for beneficiary for life, with remainder passing to the beneficiary's issue as appointed by beneficiary's will; beneficiary not hold a substantial adverse interest). The consent of a person who would otherwise have a substantial adverse interest will not be sufficient to preclude completed gift treatment if there is an agreement in advance regarding the person's consent to exercise of the power by the donor. Camp v. Comm'r, 195 F.2d 999 (1st Cir. 1952); Schwarzenbach v. Comm'r, 4 T.C. 179 (1945).

e. Contingent Powers. A donor is not deemed to retain a power that arises only upon a future contingency, even if the likelihood of the contingency can be calculated actuarially. Lasker v. Comm'r, 1 T.C. 208 (1942); TAM 8546001; PLR 8727031. For example, the mere possibility that the donor may become a trustee in the future (but outside the control of the donor) will not result in the donor being treated as holding the powers of the trustee for purposes of determining whether the transfer is a completed gift. Goldstein v. Comm'r, 37 T.C. 897 (1962), *acq.*, 1964-1 C.B. (Part 1) 4; Rev. Rul. 54-537, 1954-2 C.B. 316 (contingency in donor's control, by removing the trustee and appointing himself as successor).

f. Summary of Application to Selection of Trustee To Avoid Having Transfer Treated as Incomplete Gift. **This paragraph summarizes powers that the donor can have (or not have) and still make a completed gift. If the donor is the trustee, the trustee cannot have the discretion to shift benefits among beneficiaries, unless the discretion is limited**

by a "fixed or ascertainable standard." If the donor is a co-trustee or must consent to discretionary distributions that may shift benefits among beneficiaries, the other person must have a substantial adverse interest with respect to the discretion over the disposition of the transferred property. In that circumstance, the third party cannot have an express or implicit agreement regarding consent to the donor's exercise of the discretionary power. The donor may be a possible future trustee, as long as the donor cannot control his substitution as trustee (such as through a power to remove and appoint himself as successor trustee.) The donor may serve as trustee if the trustee's only discretion is to accelerate or delay distributions to a single beneficiary, with no ability to shift benefits in any way to any other persons.

B. Estate Tax Issues.

1. Who is the "Grantor"?
Sections 2036 and 2038 may estate inclusion where certain interests or powers are retained by the grantor of a trust. Therefore, determining who is the "grantor" for this purpose is important. Generally, the person who makes an actual transfer, for state law purposes, to the trust is considered a grantor for this purpose. Heasty v. U.S., 239 F. Supp. 345 (D. Kan. 1965), *aff'd*, 370 F.2d 525 (10th Cir. 1966). There are several exceptions, in which transfers made by others will be attributed to a grantor. See generally Stephens, Maxfield, Lind & Calfree, Federal Estate & Gift Tax'n ¶ 4.08[7] (2001); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M.. at 112-138 (2002).

a. Reciprocal Trust Doctrine. If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated", the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court said that the principal factor in determining whether trusts are sufficiently interrelated is "whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary." Id. If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. Estate of Levy v. Comm'r, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not).

The Grace case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. Estate of Bischoff v. Comm'r, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); Exchange Bank & Trust Co. of Florida v. U.S., 694 F.2d 1261 (Fed. Cir. 1984); but see Estate of Grace v. Comm'r, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. Estate of Cole v. Comm'r, 140 F.2d 636 (8th Cir. 1944).

b. Indirect Transfers. Various indirect transfers may be attributed to a grantor. For example, if A transfers cash to B, with the understanding that B will transfer property to a trust for A's benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. Estate of Shafer v. Comm'r, 749 F.2d 1216 (6th Cir. 1984). As another example, if a husband owes funds to his wife from a prior loan, but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust. Estate of Marshall v. Comm'r, 51 T.C. 696 (1969), *nonacq*. 1969-2 C.B. xxvi. Cf. Treas. Reg. 25.2511-1(h)(2,3,9) (examples of indirect transfers for gift purposes).

2. Retained Beneficial Interest in Donor.

a. Statutory Provision--Section 2036(a)(1). The gross estate includes the value of all property to the extent the decedent:

- Has made a transfer other than a bona fide sale for a full and adequate consideration;

- Under which he has "retained" the possession or enjoyment of, or the right to the income from the property;

- For his life or for any period ascertainable without reference to his death (example: income quarterly for life but income in the quarter of his death will not be paid) or for any period which does not in fact end before his death (example: retain income for five years and donor dies within that five year period).

b. Only Donative Transfers Are Subject to Section 2036. Transfers for full and adequate consideration are not subject to Section 2036. If one donor creates a trust and another person sells assets to that trust for full and adequate consideration, the person who sold assets to the trust will not be subject to section 2036, regardless who serves as trustee of the trust.

c. Types of Retained Interests That Cause Estate Inclusion.

(1) Right to Use of Property or Income. A direction that the donor has the right to actual use of trust property or trust income clearly comes within the meaning of the statute, regardless of who is serving as trustee. If there is a retained right to receive only a portion of the income, only that corresponding part of the trust is included in the estate. Treas. Reg. § 2036-1(a)(last paragraph).

(a) Implied Understanding. The statute also applies if there is an implied understanding that the settlor will be allowed to use or receive income from the transferred property. Treas. Reg. § 2036-1(a) (last sentence). For example, section 2036 was applied on the basis of an implied agreement where the trustee merely had the discretion to make distributions to the settlor and others, but in fact distributed all of the income to the settlor for his lifetime. Estate of Skinner v. U.S., 316 F.2d 517 (3d Cir. 1973) See Estate of Paxton v. Comm'r, 86 T.C. 785 (1986) (donor transferred almost all assets to trust). The IRS has made the implied understanding argument in a multitude of cases, with varying results. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 160-169 (2002); Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001).

(b) Continued Use of Residence. Estate inclusion under Section 2036 has been argued in many cases involving continued use of a transferred residence by the donor. The cases have generally tended to require more than just continued possession of a residence in order to find that an agreement existed at the time of the transfer. See Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001). In fact, the IRS concedes that continued co-occupancy for interspousal transfers will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 78-409, 1978-2 C.B. 234. Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. Estate of Wineman v. Comm'r, T.C. Memo. 2000-193 (2000).

(c) Payment of Rent by Donor. If the donor retains use of the transferred property under a lease agreement that provides for fair rent, it is not clear whether Section 2036 applies. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 162-163 (2002); Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor's estate. However, the trend of the cases is not to apply section 2036 where adequate rental is paid for the use of the property. E.g., Estate of Barlow v. Comm'r, 55

T.C. 666 (1971); Estate of Giselman v. Comm'r, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. E.g., Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value avoids application of Section 2036. See Tech. Adv. Memo. 9146002 (Barlow distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. E.g., Estate of Du Pont v. Comm'r, 63 T.C. 746 (1975).

(2) Payment of Grantor's Debts. The grantor is treated as having retained the "use, possession, right to income, or other enjoyment" of property to the extent that such interest is to directed to be applied toward the discharge of legal obligations of the decedent (regardless who is the trustee). Treas. Reg. § 2036-1(b)(2); Hooper v. Comm'r, 41 B.T.A. 114 (1940).

(3) Support of Dependents. If the trust directs the trustee to make payments in support of the grantor's dependents, Section 2036(a)(1) applies. Treas. Reg. § 2036-1(b)(2). However, if the trust merely directs the payment of income to a person whom the donor is obligated to support, Section 2036(a)(1) does not apply if the grantor's support obligation would continue, because the income distribution in that situation would not benefit the grantor. See Colonial-American Nat'l Bank v. U.S., 243 F.2d 3112 (4th Cir. 1957). For example, the IRS has ruled that a trust requirement that required the trustee to consider the beneficiary's other resources would avoid Section 2036(a)(1) if the other resources included the support obligation of the grantor. Ltr. Rul 8504011. Similarly, if a trust requires that all income be distributed to a grantor's dependent, but states that the beneficiary "should" use the income for his maintenance and support, Section 2036(a)(1) is not triggered unless local law provides that receipt of the income by the beneficiary discharges the donor's legal support obligation. Wishard r. U.S., 143 F.2d 704 (7th Cir. 1944).

Even if a trust provides for distributions in support of the grantor's dependent, once the grantor no longer has the obligation to support the trust beneficiary (such as when the dependent reaches the age of majority), Section 2036 would cease to apply. The retained right would not have continued for a period that does not in fact end before the grantor's death. Estate of Pardee v. Comm'r, 49 T.C. 140 (1967).

d. Settlor as Totally Discretionary Beneficiary. Two different phrases/words in the statute suggest that naming the grantor as a beneficiary in the trustee's discretion might not trigger Section 2036. First, the statute refers to the grantor keeping a "right to" income. Second, the statute requires that the grantor "retain" the income interest. As to the first argument, the legislative history indicates that the substitution of the phrase "right to the income" in 1932 was meant to broaden, not restrict the reach of Section 2036(a)(1) and to extend it to cases where the grantor had the right to income but did not actually receive it. See Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 56 (2002). The second argument does lend a credible argument that a totally discretionary interest might not be subject to Section 2036(a)(1). Professor Dodge lists four exceptions to the "general rule that discretionary trusts for the settlor are not included under §2036(a))(1)":

- Where there was an agreement or understanding that the transferor would receive the income. Such an agreement may sometimes be inferred from the fact that the transferor in fact received (all of) the income. (See section II.B.2.c.(1)(a) of this outline, above.)

- Where, under the law of creditor's rights, the settlor's creditors can reach the trust income to pay the transferor's debt. (See Section II.B.2.d.(1) of this outline, immediately below.)

- Where the settlor is herself trustee of such a discretionary trust. (See Section II.B.2.f. of this outline, below.)

- Where the trustee's discretion is limited by a standard that can be enforced by the settlor-beneficiary. See Blunt v. Kelly, 131 F.2d 632 (3d. Cir. 1941) ("support, care or benefit"); Estate of John J. Toeller, 165 F.2d 665 (7th Cir.1946) ("misfortune or sickness"); Estate of Boardman v. Comm'r, 20 T.C. 871 (1953), *acq*. 1954-1 C.B. 3 (trust provided distributions for grantor "as the trustee deems necessary for her comfort, support and/or happiness"; held that these standards—especially "happiness"—gave grantor an enforceable right to demand income distributions and caused inclusion under Section 2036); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 57 (2002).

(1) Includible if Settlor's Creditors Can Reach Trust Assets. . If the donor's creditors can reach the trust assets, because of the potential discretion to distribute assets to the donor, Section 2036(a)(1) would apply. UNIF. TRUST CODE §505 (2000) (settlor's creditors can reach whatever "can be distributed to or for the settlor's benefit"); RESTATEMENT (THIRD) OF TRUSTS § 60, Comment f (if settlor is discretionary beneficiary, creditors can reach maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor"); Rev. Rul. 77-378, 1977-2 C.B. 347 (gift complete, even though trust assets were distributable to settlor in trustee's complete discretion, where donor's creditors could not reach trust assets); Rev. Rul. 76-103, 1976-1 C.B. 293 (gift incomplete, where trust assets were distributable to settlor in trustee's complete discretion and where donor's creditor could reach trust assets; also trust assets included in donor's estate under § 2038 because of donor's control to terminate the trust by relegating the grantor's creditors to the entire trust property); Estate of Uhl v. Comm'r, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); Outwin v. Comm'r, 76 T.C. 153 (1981) (trustee could make distributions to settlor in its absolute and uncontrolled discretion, but only with consent of settlor's spouse; gift incomplete because settlor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the creditor's gross estate under Sections 2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because settlor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of nonbeneficiaries).

(2) "Alaska Trusts". Some states (Alaska was the first) have amended their trust and creditor laws to provide that creditors cannot reach trust assets merely because the trustee may, in its discretion, make distributions to the settlor, if certain procedural requirements are satisfied. Alaska, Delaware, Nevada, and Rhode Island now have such laws, and Colorado and Missouri have had similar laws for some years. See section I.D. of this outline. A trust that meets those requirements could safely permit someone to take steps to include the donor as a beneficiary upon the occurrence of an estate tax trigger. However, it is not clear that a person living in another state, who creates a trust governed by the laws of one of those states, would necessarily be exempted from creditors claims in the state of domicile.

(3) Grantor Trust Under Section 674(a). Income tax effects of trustee selection are covered in a later section of this outline. However, be aware that if the grantor is a potential beneficiary, the trust will be a grantor trust, unless the consent of an adverse party is required before a distribution may be made to the grantor. I.R.C. §674(a). The mere possibility that income may distributed in satisfaction of the grantor's legal obligation of support does not cause grantor trust treatment—

the income is taxed to the grantor only to the extent that income is actually distributed in satisfaction of the grantor's support obligation (other than to the grantor's spouse.) I.R.C. § 674(b).

e. Transfer to Spouse With a Potential of Having Spouse Appoint the Assets Back to Grantor. If the grantor gives property in trust for his spouse (or anyone else), and gives the beneficiary of the trust an inter vivos or testamentary power of appointment to appoint the trust assets to anyone, including the grantor (but not to the beneficiary, his estate, his creditors, or the creditors of his estate), does the grantor have to include the assets in his estate under Section 2036(a)(1) because of the possibility of receiving the assets back from the trust? (The gift effects of this transfer will also be addressed in light of the unique nature of this type of transfer.)

(1) Completed Gift for Gift Tax Purposes. Despite the fact that the property may eventually be returned to the donor, the transfer is a completed gift, because the donor has so parted with dominion and control as to leave him in no power to change its disposition whether for his own benefit or for the benefit of another. Reg. § 25.2511-2(b). Also, the donor has retained no power to revest beneficial title to the property in himself, which also makes a gift incomplete. Reg. § 25.2511-2(c). Letter Ruling 9141027 held that a transfer to an irrevocable trust for the donor's spouse was a completed gift even though the spouse had a special testamentary power of appointment to appoint the assets to a trust for the benefit of the donor, and even though the IRS found that an implied agreement existed between the spouses that the donee spouse would in fact execute a codicil to her will appointing the trust assets to a trust for the benefit of the donor. However, to assure that the initial transfer is treated as a completed gift, there should be no express or implied agreement regarding the exercise of the power of appointment.

Furthermore, if a creditor of the donor could reach the trust assets, the gift would be incomplete. Until the power of appointment is exercised appointing some interest in the property to the creditor, a creditor arguably would have no rights in the trust property. However, if the spouse holds an inter vivos power of appointment and if the donor's creditor is also a creditor of the spouse, underlying state law may afford creditors rights to the property, since the spouse would have the current power to appoint the property in a manner that would satisfy the donor's and spouse's creditors. To avoid this argument, the spouse should not hold an inter vivos power of appointment, or at least should be restricted from the appointing the property in a manner that would have the effect of satisfying the spouse's creditors.

(2) Application of Section 2702. If the gift is complete, does §2702 apply in valuing the gift? Section 2702 should not apply, because the spouse will not have held an interest in the transferred property, both before and after the transfer. Ltr. Rul. 9141027.

(3) Inclusion in Spouse's Estate. Whether the trust is included in the spouse's estate depends on whether, under traditional planning principles, the spouse has a power over the trust that is taxable under Section 2041. Two letter rulings in 1991 addressed situations in which the donee-spouse had a power of appointment to appoint the trust property back to the donor. In Letter Ruling 9140068, the transfer was to an inter vivos QTIP trust, and the trust assets were includible in the donee spouse's estate under Section 2044. In Letter Ruling 9141027, the transfer was to a trust that was not included in the spouse's estate. Letter Ruling 9128005 involved an outright transfer from husband to wife, where the wife, on the same day as the gift, executed a codicil leaving the property back to a trust for the husband if she predeceased him. The property was obviously included in her gross estate.

(4) Inclusion in Donor's Estate. The main issue is whether the trust assets are included in the donor's gross estate, (1) if the donor predeceases the spouse, or (2) if the spouse predeceases and in fact appoints the trust property to a trust for the benefit of the donor.

Section 2036(a)(1) includes in a decedent's gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise, under which the decedent has *retained* for the decedent's life or for any period which does not in fact end before the decedent's death the possession or enjoyment of, or the right to the income from the property. Has the donor *retained* an interest in the trust, if the spouse must later exercise the power to leave the assets back to the donor? Regulation § 20.2036-1(a) provides that an interest or a right is treated as being *retained* or reserved if at the time of the transfer there was an *understanding, express or implied*, that the interest or right would later be conferred.

The regulations address such a contingency with respect to Sections 2038 and 2036(a)(2), dealing with powers that the donor could regain upon the occurrence of contingencies, but does not address the effect of such a contingency under Section 2036(a)(1), which is the relevant section. Reg. §§ 20.2038-1(a)(3) & 20.2036-1(b)(3).

In two letter rulings in 1991, where transferred property would be included in the spouse's estate, the IRS ruled that the assets would not be in the donor's estate. In one ruling, the donee-wife died first and appointed the assets to a trust for the donor-husband, under a will executed on the same day as the date of the original gift of property to the wife. Ltr. Rul. 9128005. In another, the ruling stated that the donee-wife of an inter vivos QTIP would, on the same day the trust was funded, execute a codicil to her appointing the assets to a trust for the donor-husband. That ruling concluded that the trust assets would not be in the donor's estate, whether he died before donee-wife, or whether she died first after appointing the assets to a trust for his benefit. The ruling reasoned that the original donor-husband is not considered the transferor of the Subtrust for his benefit, so Sections 2036 or 2038 are inapplicable. Ltr. Rul. 9140069. Even though the ruling postulated that the codicil exercising the power of appointment would be signed on the same day that the gift was originally made to the QTIP trust, the IRS did not even discuss whether an implied agreement existed. Perhaps the IRS was satisfied that the asset was included in the estate of one of the spouses.

In another 1991 ruling, where the original transfer was made to a trust that was <u>not</u> included in the spouse's estate for estate tax purposes, the IRS concluded that the trust assets would be included in the gross estate of the donor because the spouse intended to exercise the power of appointment to leave the assets to a trust for the donor's benefit. Ltr. Rul. 9141027. In that ruling, the donor-husband proposed transferring assets to an irrevocable trust for his wife's benefit, and the donee-wife proposed exercising her testamentary power of appointment (by a will executed on the same day the original transfer is made to the trust) to appoint the property, under a standard marital deduction formula approach, to a bypass trust for the benefit of the original donor-husband. The IRS concluded, based on these facts, that an implied agreement existed that the transferred property would later be transferred for the donor's use and benefit.

"<u>A</u> [the original donor] and <u>B</u> [the original donee] agreed that if <u>A</u> transfers property to the Spousal Trust for the benefit of <u>B</u>, <u>B</u> will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which <u>A</u> may be a beneficiary. This implied agreement between <u>A</u> and <u>B</u> results in <u>A</u> retaining benefits of property that he plans to transfer. It is not necessary that <u>A</u> has definite right to the property. In view of the facts presented, *the possibility that <u>A</u> may reacquire* an interest in previously transferred property after <u>B</u> dies constitutes a retained interest in the transferred property. Therefore, the value of the Spousal Trust will be includible in <u>A</u>'s gross estate under section 20.2036-1(a) of the regulations." (emphasis added).

Under the facts of the ruling, finding an implied agreement to appoint the property back to the donor seems clear, based on the representation that the donee spouse planned to exercise the power of appointment by signing a revised will on the very day that the gift was made to the

trust. The italicized words in the ruling suggest that the mere existence of the power caused the estate inclusion problem for the original donor, and not the actual exercise of the power of appointment.

Various other possible restrictions would help bolster the argument that the spouse's power of appointment would not cause an estate inclusion problem for the donor. The actual exercise of the power, or even more conservatively, the manner in which the power of appointment could be exercised in favor of the donor-spouse, could be limited in the following possible ways. The appointment for the donor could be limited to payments for the health, support and maintenance of the donor. (Observe, however, that there are no cases suggesting an ascertainable standard exception for Section 2036(a)(1) like there are for Sections 2036(a)(2) and 2038.) Additionally, the permissible trust could require that distributions could be made to the grantor only after other income and assets of the donor had been exhausted, so that A's creditors could not reach the property. See Covey, Current Developments, 1992 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 115.8.

If case law subsequently becomes clear that the mere existence of the power causes estate inclusion problems for the original donor, the donee-spouse could release the power of appointment, but the release would have to occur more than 3 years before the donor's death under section 2035.

(5) Summary. Giving the donee-spouse a testamentary power of appointment to appoint the assets back to the donor or to a trust for the benefit of the donor should not create inclusion problems for the donor as long as there is no express or implied agreement that the spouse would exercise the power of appointment for the donor. Do not have the spouse sign a new will exercising the power of appointment for some period of time. Make sure that the spouses understand that there really is no preconceived plan of whether the power of appointment will be exercised, but that it is just included to provide helpful flexibility. Other restrictions, discussed above, that could be added would help bolster a non inclusion argument, but should not be necessary.

f. Effect of Trustee Selection on Retained Right to Income.

(1) Grantor as Trustee. If the grantor is the trustee with the power to make distributions of income to himself, to make payments in satisfaction of his obligations, or in satisfaction of his support obligations, Section 2036(a)(1) applies. That is the case even if there are no directions to make distributions for the "support" of the grantor's dependents but merely the discretion to make distributions to dependents. See Helfrich Estate v. Comm'r, 143 F.2d 43 (7th Cir. 1944); Ltr. Rul 9122005. The same rule applies if the decedent reserved the power to name himself as the trustee. Estate of McTighe v. Comm'r, 36 T.C.M. 1655 (1977) (estate inclusion under Section 2036 where decedent reserved the power to substitute himself as trustee and the trustee retained the right to apply the trust income to satisfy his obligation to support the beneficiary).

What if the grantor can name himself as trustee only if an event outside his control occurs (for example, when a vacancy occurs)? That would clearly still cause inclusion if the issue is a power to control enjoyment of the property under Section 2036(a)(2), but the answer is not totally clear under Section 2036(a)(1). There is a regulation to Section 2036(a)(2) making clear that the contingent power to become trustee is problematic (Treas. Reg. § 20.2036-1(b)(3)), but there is no similar statement in the regulation to Section 2036(a)(1). The primary issue is the retention issue—has the grantor retained the right when he has no control over whether it arises—and that issue should be the same for subsections (a)(1) and (a)(2) of Section 2036. See Estate of Farrell v. U.S., 553 F.2d 637 (Ct. Cl. 1977) (analysis of situation involving Section 2036(a)(2), but analysis repeatedly referred just to Section 2036(a), without making a distinction for (a)(1) and (a)(2)).

(2) Third Party as Trustee—General Rule. As discussed above, if the trust directs that

income be distributed to the grantor, be applied to discharge the grantor's debts, or to provide for the support of the grantor's dependents, Section 2036(a)(1) is triggered, regardless of who is serving as trustee. However, if the trust instrument gives the trustee discretion in making such distributions, Section 2036(a)(1) may be avoided if there is a third-party trustee.

(3) Third Party as Trustee—Discretion to Make Payments for Support of Grantor's Dependents. If the trust instrument directs distributions under standards (such as "comfort" or "welfare") other than support or maintenance of the dependent, Section 2036(a)(1) is not triggered if there is a third party trustee. Rev. Rul 77-60, 1977-1 C.B. 282. For example, in Gokey v. Comm'r, 72 T.C. 721 (1979), a trust for the donor's child's "support, care, welfare, and education" was held to be included in the estate under Section 2036(a)(1), under the reasoning that under local law, the last three terms referred to the child's accustomed standard of living, and merely restated the concept of support. Furthermore, if payments for support are left up to the trustee's discretion, Section 2036(a)(1) should not apply, because no one can compel the distributions and the grantor has therefore not "retained" the right to the distributions. Commissioner v. Douglas, 143 F.2d 961 (3d Cir. 1944); Chrysler Estate v. Comm'r, 44 T.C. 55 (1965), *acq. in result*, 1970-2 C.B. xix, *rev'd on other issues*, 361 F.2d 508 (2d Cir. 1966). Even a close relative as trustee can have the discretion to make distributions for support of the grantor's dependents without triggering Section 2036(a)(1). Mitchell Estate v. Comm'r, 55 T.C. 576 (1970), *acq*, 1971-1 C.B. 2. However, the trustee's discretion must extend to whether distributions for support should be made at all, and not merely as to when or how much should be distributed. See Richards v. Comm'r, 375 F.2d 997 (10th Cir. 1967) (distributions for settlor's wife's support and maintenance "at such times as the trustee in its sole discretion shall determine"; assets includible under Section 2036);Ltr. Rul. 8504011.

(4) Third Party as Trustee—Discretion to Make Income Distributions to Grantor. If there are enforceable standards, which the grantor could enforce to require income distributions, Section 2036 applies even if there is an independent trustee. Even if the trustee has total discretion to make distributions to the grantor, the trust assets will still be includible under Section 2036 if the grantor's creditors can reach the trust assets under applicable state law. If the trust is established in a manner that the grantor's creditors cannot reach the trust assets (i.e., it is created in a state that allows self-settled spendthrift trusts, such as Alaska, Delaware, Nevada, and Rhode Island, AND if the state of the grantor's domicile will recognize such spendthrift protection as to creditors claims arising in the state of domicile), Section 2036(a)(1) probably will not apply to the trust. However, even in that case, the IRS may, in a last ditch effort, argue for estate inclusion in extreme cases where the third party is controlled by the grantor's domination, or where there is an implied agreement or understanding.

(5) Nature of Relationship of Third Party Trustee to Grantor.

(a) Close Relationship of Grantor to Trustee. A variety of cases have recognized that a grantor did not retain a power held by a trustee, "just because the trustee is the settlor's wife, young daughter, or golfing companion, or because the trustee tends to follow the settlor's wishes in exercising discretion." Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 159 (2002). An example is Estate of Beckwith v. Comm'r, 55 T.C. 242 (1970). In that case, the IRS contended that a variety of factors enabled the grantor to control the flow of income from the trust, including "close business relationships between the settlor and the individual trustees." The court rejected that position. 55 T.C. at 248-249.

(b) De Facto Control. A few cases, in extreme circumstances, have suggested that a grantor is treated as holding powers of a third party trustee where the grantor actually controlled the trustee's actions. See Estate of Klauber v. Comm'r, 34 T.C. 968 (1960) (reviewed)(dictum); see also Tech Adv. Memo. 9043074 (grantor controlled institutional

trustee). However, courts have generally been reluctant to attribute powers of a trustee to the grantor. In an early case, the court refused to include assets in the settlor's estate where the trustee in its discretion could make distributions to the settlor's minor child, specifically rejecting notion that a court should presume that a trustee would do what the settlor asked of him:

"The Commissioner's argument that these trustees would be likely to do what he asked of them about assigning income for the support of a minor child departs from the 'practical' and 'realistic' approach we are asked, in the same argument, to take. We have no notion what the trustees would have done had such a request been made. It is apparent, from the terms of the instrument, that the settlor could not direct or control the matter, once the trust settlement had become effective." Comm'r v. Douglass Estate, 143 F.2d 961 (3rd Cir. 1944).

In Estate of Goodwyn v. Comm'r, 32 T.C.M. 740 (1973), the court reasoned that the trustee is obligated to adhere to fiduciary duties regardless how close the relationship of the trustee and the grantor, and as long as the trustee's actions are consistent with those duties, the courts will not attribute the trustee's powers to the grantor. If the trust allows distributions in the total discretion of the trustee, it will be difficult to show a violation of the trustee's fiduciary duties. See McCabe v. U.S., 475 F.2d 1142 (Ct. Cl. 1973) (no estate inclusion even though trustee ignored interests of beneficiaries other than settlor). "In sum, the de facto control issue may be essentially dead." Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 159 (2002).

(c) Implied Agreement or Understanding. See section II.B.2.c.(1)(a) of this outline.

(6) Summary of Trustee Selection Issues With Respect to Retained Beneficial Interests in Donor. The grantor cannot serve as trustee if there is any possible retained beneficial interest in the donor, or else the trust will be included in the donor's estate. Similarly, the donor cannot have the power to name himself as successor trustee (even if he could become a successor trustee only if a contingency occurs that is outside his control.)

As to support of dependents, if a third party trustee serves, the trust could authorize distributions to dependents of the donor as long as there is not a standard for distribution tied to support or maintenance of the donor's dependents. (The more conservative approach is to always prohibit any distributions from a trust that would satisfy the donor's legal obligation of support, regardless of who is the trustee.)

If there is any possibility for distributing assets to the donor at some point in the future, there must be a third party trustee to have any hope of excluding the trust assets from the donor's estate. Even then, the trust must give the trustee complete discretion in making distributions to the grantor, the trust must be established in a jurisdiction that allows "self-settled trusts," and the jurisdiction of the donor's domicile must recognize the spendthrift protection of the self-settled trust.

A few older cases questioned whether a trustee who has a close relationship to the donor, and who always follows the donor's directions, can avoid estate inclusion problems under Section 2036(a)(1). However, most cases have refused to apply a "de facto" control analysis. Regardless of who is the trustee, there must be no agreement or understanding with the trustee regarding how the trust assets will be distributed.

3. Retained Dispositive Powers in Donor.

a. Statutory Provision--Section 2036(a)(2). The gross estate includes the value of all property to the extent the decedent:

- Has made a transfer other than a bona fide sale for a full and adequate consideration,
- Under which he has "retained" the right either alone or in conjunction with any person
- To designate the persons who shall possess or enjoy the property or the income from the property

- For his life or for any period ascertainable without reference to his death or for any period which does not in fact end before his death.

b. Statutory Provision—Section 2038. The gross estate includes the value of all property to the extent the decedent:

- Has made a transfer other than a bona fide sale for a full and adequate consideration

- Under which the decedent had at the date of his death (regardless of when or from what source the decedent acquired a power)

- The power (in whatever capacity exercisable), either by the decedent alone or in conjunction with any person

- To alter, amend, revoke, or terminate enjoyment of the property,

- Or where such power is relinquished during the 3-year period ending on the date of his death.

c. Dispositive Powers that Trigger Application.

(1) Sprinkling Power. The power to shift income or trust property among beneficiaries causes inclusion under either Section. Estate of McManus v. Comm'r, 172 F.2d 697 (6th Cir. 1949) (predecessor to Section 2036(a)(2)); Estate of Craft v. Comm'r, 608 F.2d 240 (5th Cir. 1980) (Section 2038 inclusion where decedent had power to change beneficiaries and change their respective shares). A power to add beneficiaries would cause inclusion. But see Rev. Rul. 80-255, 1980-2 C.B. 272 (decedent's ability to have more children and add beneficiaries is not a power to change beneficial interests under Section 2038). A power exercisable to change the beneficiaries only in the decedent's will causes inclusion. Adriance v. Higgins, 113 F.2d 1013 (2d Cir. 1940) (predecessor to Section 2038); Marshall v. U.S. 338 F. Supp 1321 (D. Md. 1971).

(2) Power to Accumulate. The power to affect only the timing of distributions, and not the beneficiaries who receive distributions, clearly triggers inclusion under Section 2038. Lober v. U.S., 346 U.S. 335 (1953); Estate of Alexander v. Comm'r, 81 T.C. 767 (1983) (retained power to accumulate income for distribution every five years caused inclusion, even though all income eventually had to be distributed to the income beneficiary). The regulations under Section 2038 state explicitly that "Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected." Treas. Reg. § 2038-1(a). The regulation illustrates this with an example where grantor has the power to accumulate income or distribute it to A and to distribute corpus to A, even though the remainder is vested in A or his estate. (In the example described in the regulation, it appears that only the value of the remainder interest would be includible under Section 2038, and not the value of the income interest. The grantor would not have the power to change when A receives the income. He would have to wait until the income is earned in any event before he could receive it. See Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 100 (2002).) A power to accumulate or distribute income causes inclusion under Section 2036(a)(2) where the income beneficiary is different from the remainder beneficiary, because accumulating income may shift the recipient from the income beneficiary to the remainderman. U.S. v. O'Malley, 383 U.S. 627 (1966), *rev'g* 340 F.2d 930 (7th Cir. 1964). If the income beneficiary and the remaindermen are the same (if the assets pass to the income beneficiary's estate or if the income beneficiary holds a general power of appointment), neither the statutory language of Section 2036(a)(2) nor the regulations address whether Section 2036(a)(2) applies. However, cases have nevertheless held that Section 2036(a)(2) applies even in that situation. Leopold v. U.S., 510 F.2d 617 (9th Cir. 1974); McDermott v. Comm'r, 222 F.2d 665 (7th Cir. 1955); Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955); Ritter v. U.S., 297 F. Supp. 1259 (S.D. W. Va. 1968). (Applying section 2036(a)(2) in this situation is not just

theoretical. Under section 2036(a)(2), the entire trust property is included, whereas under section 2038 only the property affected by a power is included in the estate. See section II.B.3.e.(1) of this outline below.)

(3) Power to Invade Corpus. A power to invade corpus is a power to alter enjoyment under Section 2038. Estate of Yawkey v. Comm'r, 12 T.C. 1164 (1949). The power to terminate a trust by acceleration of the corpus distribution causes inclusion under Section 2038. Lober v. U.S., 346 U.S. 335 (1953); Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970). Similarly, under Section 2036(a)(2), an unlimited power to invade corpus for the income beneficiary or other beneficiary is subject to Section 2036(a)(2). See Commissioner v. Holmes, 326 U.S. 480 (1946).

(4) Power to Revoke. Unlike most states, Texas law provides that every trust is revocable unless it explicitly states that it is irrevocable. TEX. PROP. CODE §112.051. Accordingly, a trust established under Texas law must explicitly state that it is irrevocable, or else the trust assets will be included in the estate under Section 2038. Estate of Hill v. Comm'r, 64 T.C. 867 (1975), *acq.* 1976-2 C.B. 2; Tech Adv. Memo. 9032002.

d. Similarities In Application of Sections 2036(a)(2) and 2038.

(1) Triggering Powers. As discussed in the preceding section, the powers that trigger the two sections are very similar, with a great deal of overlap.

(2) Joint Powers. Even though the decedent holds the power jointly with another person, inclusion results under both sections. Unlike the treatment of powers of beneficiaries under Section 2041, or the gift tax treatment of powers held by grantors, whether the person who holds the joint power has an adverse interest is irrelevant under Sections 2036(a)(2) and 2038. E.g., Treas Reg. §20.2036-1(b)(3) ("whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest").

(3) Joint Power Holder Can Override Grantor's Decision. Even if the joint power holders can override the grantor's decision (such as where a majority vote controls), both Sections still apply. See Estate of Yawkey v. Comm'r, 12 T.C. 1164 (1949).

(4) Veto Power. Whether the grantor can act with the consent of another, or whether another person can act with the consent of the grantor makes no difference. Even if the grantor is not the trustee, but merely holds a veto power over actions of the trustee, both Sections would apply if the veto power affects a decision that triggers the Sections. See Rev. Rul. 70-513, 1970-2 C.B. 194 (only the value of the remainder interest is includible in decedent's gross estate where the enjoyment of the son's life estate was not subject to change through exercise of decedent's reserved power to consent to or veto the trustees' power to terminate the trust); Rev. Rul. 55-683, 1955-2 C.B. 603 (predecessor to Section 2038 applied where grantor's wife could modify or revoke the trust only with the consent of the grantor). The court in Estate of Carrie Grossman v. Commissioner, 27 T.C. 707 (1957), noted that "it is irrelevant whether the decedent's participation initiates the termination, or, as here, is in the nature of a consent after others have set the machinery in motion, it being sufficient under the statute merely that she act 'in conjunction' with the others * * *," citing Thorp's Estate v. Commissioner, 164 F.2d 966 (1947), cert. denied 333 U.S. 843; and Du Charme's Estate v. Commissioner, 164 F.2d 959 (1947). Rev. Rul. 70-513, 1970-2 C.B. 194. The fact that the decedent does not take an active part in the trust management or administration does not matter. Biscoe v. U.S., 148 F. Supp. 224, 225 (D. Mass. 1957). The IRS agrees with the position that veto powers invoke Sections 2036 and 2038. E.g., Ltr. Rul. 8038014

(5) Disability of Grantor Disregarded. Under both sections, the inability of the grantor to exercise the problematic powers because of incompetency or other disability is disregarded. Tech. Adv. Memo. 8623004. This is similar to the rule under Section 2041 as to powers held by

disabled beneficiaries. E.g., Pennsylvania Bank & Trust Co. v. U.S., 597 F.2d 382 (3d Cir. 1979); Fish v. U.S., 432 F.2d 1278 (9th Cir. 1970).

(6) Capacity in Which Power Is Held Is Irrelevant. Under both sections, estate inclusion results whether the power is held in an individual or a fiduciary capacity. As an example, if the grantor makes a transfer to a private foundation, and has the ability to control disposition of the donated funds as a director of the foundation, estate inclusion results. Rifkind v. U.S., 84-2 U.S.T.C. 13,577, 5 Cl. Ct. 362 (1984) (inclusion under Section 2036(a)(2)).

(7) Full Consideration Transaction Excluded. Both sections apply only to the extent that the grantor has made a transfer other than a "bona fide sale for an adequate and full consideration."

e. Differences Between Section 2036(a)(2) and 2038. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 97-98 (2002).

(1) Retention of Power Over Income Only; Amount of Inclusion. A retention of power over distributing or accumulating income alone is enough to cause inclusion of the entire trust property under Section 2036(a)(2). However, under Section 2038, only the actual property over which a power is held is included in the estate. Therefore, a power over only income would require inclusion of only the income interest under Section 2038. Similarly, a power over only the remainder interest would require inclusion of just the remainder interest and not the income interest under Section 2038. Rev. Rul. 70-513, 1970-2 C.B. 194.

(2) Retained Power vs, Power Held At Death For Whatever Reason. Under Section 2036(a)(2), only powers "retained" by the decedent cause inclusion. Under Section 2038, it is sufficient that the decedent holds the power at death, regardless of "at what time or from what source the decedent acquired his power." Treas. Reg. § 20.2038-1(a). For example, if a decedent did not retain the power to control distributions, but acquired the power only through appointment as trustee by another person, Section 2038 would apply.

(3) Contingent Power. Under Section 2036(a)(2), "whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime)" is irrelevant. Treas. Reg. § 20.2036-1(b)(3). In Revenue Ruling 73-21, the decedent reserved the power to name a successor trustee (which, under state law, included himself) upon the death, resignation or removal of the trustee. The Ruling concludes that Section 2036(a)(2) applied even though a vacancy had not occurred by the time of the decedent's death. Rev. Rul. 73-21, 1973-1 C.B. 405. At least one case has disagreed with the government's position, holding that a contingent power to determine who enjoys property or the income from property is not subject to Section 2036(a)(2), based on an interpretation of the predecessor statute in the 1939 Code. Estate of Kasch v. Comm'r, 30 T.C. 102 (1958). However, most cases have supported the IRS's position regarding contingent powers under Section 2036(a)(2). E.g., Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977).

In contrast, under Section 2038, the power must actually be possessed at death. "Section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's life)." Treas. Reg. §20.2038-1(b).

The contingency rule under Section 2036(a)(2) creates a trap—estate inclusion can result if there is the possibility that the grantor might at some point be appointed as the successor trustee if a vacancy occurs, even if the grantor does not hold the power to fire a trustee and appoint himself. Estate of Gilchrist v. Comm'r, 630 F.2d 340 (5th Cir. 1980) (power of grantor to appoint himself as trustee if vacancy occurs).

f. Exception for Powers Held By Third Party Trustee. Powers held by a third party rather than by the grantor will not cause estate inclusion. As discussed in section II.B.2.f.(5)(a) of this outline, the IRS's "de facto" control argument has not been well received by the courts. However, the grantor must be careful not to have an agreement or understanding regarding the trustee's decisions. Also, the reciprocal trust doctrine might apply to uncross powers held by trustees of "interrelated trusts." See section II.B.1.a. of this outline.

g. Ascertainable Standard Exception. If the distribution powers held by the grantor are limited by a determinable external standard, enforceable in a court of equity, the grantor arguably does not have any power to alter the distributions from the terms of the trust, because the standard sufficiently limits the grantor's discretion. However, there is no explicit ascertainable standard exception in the statutory provisions or regulations to Sections 2036 and 2038. (Regulations under various other sections give guidance on what standards would constitute ascertainable standard or a definite external standard. Treas. Reg. §§ 20.2041-1(c)(2), 25.2511-1(g)(2), and 1.674(b)-1(b)(5)(i).)

The seminal case establishing the ascertainable standard exception for a donor controlled power over disposition is Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947). In that case, the grantor retained the power as trustee to make distributions to enable to beneficiary to keep himself and his family in comfort "in accordance with the station in life to which he belongs." The court held that power would not cause inclusion under the predecessor to Section 2038. Since that time, many courts have ruled on whether particular standards are sufficient to avoid inclusion under Section 2036 and 2038. Standards relating to "health education, support and maintenance" are invariably held to avoid estate inclusion, by analogy to the standards exception in Section 2041. E.g., Estate of Weir v. Comm'r , 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4 ("the education, maintenance and support"' and "in the manner appropriate to her station in life").

The courts have been lenient in recognizing standards as being ascertainable for purposes of Section 2036 and 2038, as long as some definite standard (other than amorphous terms such as "pleasure," "well-being," or "happiness") are used. Darin Digby, of San Antonio, Texas, has provided the following outstanding compilation of cases that have recognized standards as being ascertainable. Digby, Drafting Donor-Trustee Irrevocable Trusts Without Adverse Income, Gift or Estate Tax Consequences to the Donor and Drafting Defective Grantor Trusts, STATE BAR OF TEXAS 6th ANN. ADV. DRAFTING: ESTATE PL. & PROB. COURSE, at H-5 (1995). Blunt v. Kelly, 131 F.2d 632 (3d. Cir. 1941) ("support, care or benefit"); Estate of John J. Toeller, 165 F.2d 665 (7th Cir.1946) ("misfortune or sickness"); Industrial Trust Co v. Comm'r, 165 F.2d 142 (1st Cir 1947), *aff'g in part and rev'g in part*, 7 T.C. 756 (1946) ("in case of sickness or other emergency"); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), *rev'g*, 63 F. Supp 834 (income—"benefit, support, maintenance or education"; corpus—"suffer prolonged illness or be overtaken by financial misfortune which trustees deemed extraordinary"); Estate of Wilson v. Comm'r, 187 F.2d 145 (3d Cir 1951), *aff'g*, 13 T.C. 869 ("in case of need for educational purposes or because of illness or for any other good reason"); State Street Trust Co. v. U.S., 263 F.2d 635 (1st Cir. 1959), *aff'g*, 160 F. Supp 877 (D.C. Mass.); ("comfortable maintenance and/or support"; United States v. Powell, 307 F.2d 821 (10th Cir. 1962) ("maintenance, welfare, comfort, education or happiness"); Estate of Ford v. Comm'r, 450 F.2d 878, *aff'g,* 53 T.C. 114 (1969) ("illness, infirmity … or support, maintenance, education, welfare and happiness"); Leopold v. U.S., 510 F.2d 617 (9th Cir. 1975) ("support, education, maintenance and general welfare"); United States v. Powell, 307 F.2d 821 (10th Cir. 1962) ("maintenance, welfare, comfort, or happiness"); Pardee v. Comm'r, 49 T.C. 140 (1967) ("education, maintenance, medical expenses, or other needs … occasioned by emergency"); Seasongood v. U.S., 331 F. Supp. 486 (S.D. Ohio 1971) ("as [beneficiary] may require"); Estate of Klafter v. Comm'r, 32 T.C.M. 1088 (1973) (income—"to

maintain [beneficiary's] standard of living in the style to which she has been accustomed;" corpus—"support, maintenance, health, education and comfortable living"); Estate of Gokey v. Comm'r, 72 T.C. 721 (1979) (children—"support, care, welfare and education;" spouse—"care, comfort, support or welfare").

The following, including a compilation of cases by Mr. Digby, summarizes cases where the stated standard was too broad, and where estate inclusion resulted under Section 2036 or 2038. Old Colony Trust Co. v. U.,S., 423 F.2d 601 (1st Cir. 1970) ("changed circumstances" standard was acceptable, but "for his best interests" standard" was not); Hurd v. Comm'r, 160 F.2d 610 (1st Cir. 1947) ("the circumstances so require"); Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960) ("a special emergency"); Estate of Yawkey v. Comm'r, 12 T.C. 1164 (1949) ("best interests");Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970) ("for the benefit of"); Estate of Bell v. Comm'r, 66 T.C. 729 (1976) ("for purposes of providing ['beneficiary'] with funds for a home, business … or for any other purpose believed by the Trustee to be for [beneficiary's] benefit …"); Estate of Carpenter v. U.S., 80-1 U.S.T.C. ¶13,339 (Wis.) ("trustees are authorized but not required" "in the sole discretion of the Trustees"). Cf. Merchants Nat'l Bank v. Comm'r, 320 U.S. 256, 64 S. Ct 108 (1943) ("happiness" not an ascertainable standard for purposes of allowing charitable deduction); Industrial Trust Co. v. Comm'r, 151 F.2d 592 (1st Cir. 1945), *cert. denied*, 327 U.S. 788 ("pleasure" not an ascertainable standard for purposes of charitable deduction).

The analysis must extend beyond just looking to see if "magic" unacceptable words are used in the description of standards. An excellent discussion of this principle is provided by a Tax Court case that was affirmed by the Second Circuit Court of Appeals. Estate of Ford v. Comm'r, 53 T.C. 114 (1969), *nonacq*. 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971). In that case, the instrument included the following clause regarding distributions:

"If any time or from time to time it shall appear to the satisfaction of the Trustee that the said [beneficiary] *shall be in need of funds* in excess of the income which may then be available for his benefit from the trust estate and from any other source or sources of which the Trustee has knowledge, for the purpose of defraying expenses occasioned by illness, infirmity or disability, either mental or physical, or for his *support, maintenance, education, welfare and happiness*, then the Trustee may relieve or contribute toward the relief of any such need by paying to him or using and applying for his benefit such sum or sums out of the principal of the trust estate as the Trustee deems to be reasonable and proper under the circumstances. *The Trustee, in considering at any time whether or not to make any disbursements of principal under the terms hereof, shall consider primarily the welfare of the said [beneficiary]*, and shall not unduly conserve the principal for later distribution to him or to others having contingent remainder interests." 53 T.C. 114, at 120-21 (emphasis added).

The court acknowledged that "the word 'happiness' standing alone, or in conjunction with language exhorting the trustee to administer the trust liberally for the benefit of one beneficiary over another, does not provide an ascertainable standard enforceable in a court of equity." 53 T.C. at 125. However, the court observed that the invasion provision contains a clause advising the trustee that he should "consider primarily the welfare" of the beneficiary. In addition, the invasion power is prefaced with the clause that it applies when the trustee is satisfied that the income beneficiary is "in need" of funds in excess of the income which may then be available, and that invasion is permitted to "relieve or contribute toward the relief of any such need." The instrument placed a fiduciary responsibility on the trustee to determine "need" before he could invade principal for any of the prescribed reasons.

In response to the IRS's argument that the term "happiness" afforded unbridled discretion to the grantor-trustee, the court responded:

"To the contrary, we do not accord this single word such as talismanic effect. A word, such as 'happiness,' must be construed in the context in which it appears 'because its meaning may be affected by the words it accompanies.' Estate of Marvin L. Pardee, 49 T.C. 140, 144 (1967). Viewing the invasion provision in its entirety, we conclude that its emphasis on 'need' delimits 'happiness' as well as the other enumerated terms, and provides an external, objective standard enforceable against the grantor-trustee in a court of equity. United States v. Powell, 307 F.2d 821, 826-828 (C.A. 10, 1962). It is well settled that where the trust instrument contains such a standard, the grantor- trustee is not deemed to have retained sufficient dispositive discretion to activate the operative provisions of either section 2036 or section 2038. Jennings v. Smith, 161 F.2d 74, 77-78 (C.A. 2, 1947). Estate of C. Dudley Wilson, 13 T.C. 869, 872-873 (1949), affirmed per curiam 187 F.2d 145 (C.A. 3, 1951); and Delancey v. United States, 264 F.Supp. 904, 907 (W.D. Ark. 1967). Moreover, an examination of the applicable State law reveals that an aggrieved beneficiary could indeed enforce his rights against an imprudent or wrongdoing trustee. …

…

Thus, although we deem the question to be a close one, we conclude that the grantor-trustee herein did not have untrammeled discretion to invade corpus at his own whim or that of the income beneficiary. Consequently, the presence of the invasion power in the trust indenture does not in our view operate to trigger the provisions of sections 2036(a)(2) and/or 2038(a)(1)." 53 T.C. at 126-27.

This extended discussion of the Ford decision is included to emphasize that the ascertainable standard issue will be resolved in the context of the overall provisions for distributions in the trust instrument.

h. Summary of Planning for Ascertainable Standard Exception. **To be conservative in the planning process, if the trust instrument reserves for the grantor any dispositive powers, the instrument should apply a strict "health, education, support and maintenance" standard. Using any other words is taking a risk that the IRS might question whether Sections 2036 or 2038 should apply. E.g., Rev. Rul. 73-143, 1973-1 C.B. 407 (power to make payments early "in case of need for education purposes or because of illness or for any other good reason" is not an ascertainable standard). Even though the courts have generally recognized other reasonable standards as being ascertainable, why place yourself in the position of having to argue with the IRS and possibly face an adverse court decision?**

i. Effect of Adding That Trustee Makes Decision "In His Sole Discretion". Various cases have held that adding that if a trustee may decide in his sole or uncontrolled discretion whether the stated standards have been satisfied does not change the result. E.g., Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) ("in their absolute discretion"); State Street Trust Co. v. U.S., 160 F. Supp 877 (D. Mass 1958) (power to invade capital for the "comfortable maintenance and/or support" of each beneficiary, in the trustee's "'sole and uncontrolled discretion"), aff'd, 263 F.2d (1st Cir. 1959); Estate of Budd v. Comm'r, 49 T.C. 468 (1968) ("suitable support, education and maintenance of any such beneficiary, the Trustee may, in his uncontrolled discretion, apply …"). In Estate of Budd, the IRS argued that adding the modifier "in his uncontrolled discretion" rendered the standard as not being ascertainable. The Tax Court disagreed, under the reasoning that even though "a court of equity ordinarily will not substitute its discretion for that of the trustee, nevertheless, even where the power is granted in terms of the 'sole' or 'uncontrolled' discretion of the trustee, it will review his action to determine whether in light of the standards fixed by the trust instrument, such discretion has been honestly exercised." Cf. Treas. Reg. § 25.2511-1(g)(2)("the fact that the governing instrument is phrased in discretionary terms is not itself an indication that no such standard exists"). However, some commentators have pointed out that adding such a modifier, where the grantor has retained a power over distributions, is dangerous and generally should be avoided. See

Kasner, Why One Should Never Rely on A Private Letter Ruling, TAX NOTES, 742 (August 5, 1996) (commenting on Letter Ruling 9625031 in which the IRS held that trusts were not included under Section 2036 and 2038 where the trustees—including the grantor—had the right to pay the beneficiary "in their discretions" for his health, support, maintenance, and education). Indeed, the IRS did raise the argument, albeit unsuccessfully, in Estate of Budd.

j. Summary of Trustee Selection Issues With Respect to Grantor Powers Over Dispositive Provisions. **If the grantor has the power, either as trustee or otherwise, to add beneficiaries, change the disposition among beneficiaries, accumulate or distribute income, invade corpus, or revoke the trust, Sections 2036 and/or 2038 will apply. (Under Section 2038, it is not necessary that the grantor "retain" the power; Section 2038 applies if the grantor holds the power at his death, regardless of how the grantor acquired the power.) Estate inclusion also occurs if the grantor has the right to appoint himself as trustee, either currently or (under Section 2036, but not Section 2038) upon the occurrence of a future contingency even if the contingency is out of the grantor's control (such as a vacancy in the office of trustee.) The Sections apply whether the grantor serves alone or as a co-trustee, or if the grantor just has a veto power, or may act only subject to another person's veto power. The Sections apply if the grantor keeps the dispositive power in any capacity (for example, as director of a private foundation that receives a gift from the grantor), not just as trustee.**

Estate inclusion will not occur if the dispositive power is subject to an ascertainable standard (despite the absence of an ascertainable standard exception in the statues or regulations under Section 2036 and 2038.) A wide variety of standards have been approved by courts, but if the grantor holds (or may in the future hold) any dispositive powers, the conservative course of action would be to use a pure "health, education, support and maintenance" standard, without further embellishment. For example, to be conservative, if the grantor might possibly acquire dispositive powers, do not provide that the trustee may make dispositive decisions under the standard in the trustee's sole or uncontrolled discretion. If a third party trustee has powers that would trigger estate inclusion if held by the grantor, the grantor should not have the unlimited power to remove and replace the trustee. (See Section III.B.5.g. & h. of this outline.

4. Retained Administrative and Management Powers.

a. Administrative Powers Can Affect Distributions. Certain administrative decisions may have the effect of shifting benefits from one beneficiary to another. For example, the power to allocate receipts and disbursements between income and principal can affect the amounts distributed to income beneficiaries and remaindermen. Similarly, a trustee's investment powers to invest in high-growth non-income producing assets may shift benefits from the income beneficiary to the remaindermen. Courts have long recognized that "standard" administrative powers would not invoke the predecessors of Section 2036 and 2038. E.g., Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). However, the IRS has argued (with some success in early cases) that various broad administrative powers would cause estate inclusion under Sections 2036 and 2038. E.g., State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a "very close" case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply).

b. Key Issue: Is Exercise of Power Subject to Review By Court? As the courts have sifted through these types of cases, the emerging principle is that a grantor's broad management powers will not invoke Section 2036 or 2038 as long as the grantor's actions are subject to review by a court of equity (for example, if the exercise of the power is subject to fiduciary standards.) See Dodge, 50-5th T.M., Transfers

With Retained Interests and Powers 101 (2002). For example, the court that ruled in favor of the IRS in the State Street case changed its position in 1970, specifically overruling the result in State Street, and adopting a position under Massachusetts law that no amount of administrative discretion prevents judicial supervision of the trustee. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970). In Old Colony, a provision that the trustees could "do all things in relation to the Trust Fund which the Donor could do if living" did not cause Sections 2036 or 2038 to apply. See also United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (trustee-grantor had power to invest assets as he deemed "most advisable for the benefit of the trust estate"; held that trustee's acts were subject to review by court of equity and did not invoke the predecessor to Section 2038). Some courts have even held that a grantor's non-trustee powers were reserved in a fiduciary capacity, thus invoking the general rule that administrative powers subject to court review do not trigger application of Section 2036 or 2038. Estate of King v. Comm'r, 37 T.C. 973 (1962), *nonacq*. 1963-1 C.B. 5

The absence of a fiduciary duty was the determining factor in finding that a grantor who retained controls over Illinois land trusts was subject to Sections 2036(a)(2) and 2038. Estate of Bowgren v. Comm'r, 105 F.3d 1156 (7th Cir. 1997) (decedent had no duty to seek agreement of other beneficiaries to deal with their interests and had no fiduciary duty to the donee who received an assignment of an interest in a land trust).

c. Supreme Court's Pronouncement in Byrum. The Supreme Court held that retained rights to vote the transferred stock of a closely held corporation does not constitute a Section 2036(a)(2) power over the property. U.S. v. Byrum, 408 U.S. 125 (1972).

The Court reasoned, first, that management powers generally are not powers subject to Section 2036(a)(2). The very strong language of the Supreme Court is quoted at length:

"At the outset we observe that this Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets. On the contrary, since our decision in Reinecke v. Northern Trust Co., 278 U.S. 339, 73 L Ed 410, 49 S. Ct. 123, 66 ALR 397 (1929), it has been recognized that a settlor's retention of broad powers of management does not necessarily subject an inter vivos trust to the federal estate tax. Although there was no statutory analogue to § 2036(a)(2) when Northern Trust was decided, several lower court decisions decided after the enactment of the predecessor of § 2036(a)(2) have upheld the settlor's right to exercise managerial powers without incurring estate tax liability. In Estate of King v. Commissioner, 37 T.C. 973 (1962), a settlor reserved the power to direct the trustee in the management and investment of trust assets. The Government argued that the settlor was thereby empowered to cause investments to be made in such a manner as to control significantly the flow of income into the trust. The Tax Court rejected this argument, and held for the taxpayer. Although the court recognized that the settlor had reserved "wide latitude in the exercise of his discretion as to the types of investments to be made," id. at 980, it did not find this control over the flow of income to be equivalent to the power to designate who shall enjoy the income from the transferred property.

Essentially the power retained by Byrum is the same managerial power retained by the settlers in Northern Trust and in King. Although neither case controls this one – Northern Trust, because it was not decided under § 2036(a)(2) or a predecessor; and King, because it is a lower court opinion—the existence of such precedents carries weight. The holding of management without adverse estate tax consequences, may have been relied upon in the drafting of hundreds of inter vivos trusts. The modifications of this principle now sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been "controlling" stockholders of a closely held corporation. Courts properly have been reluctant to depart from an interpretation of tax law that has been

generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct that results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning." 408 U.S. at 132-35.

Second, the Court held that Mr. Byrum did not have a retained "right" as described in Section 2036(a)(2), because of the fiduciary duty that Mr. Byrum owed to the corporation:

"It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O'Malley. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation. However great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereof." 408 U.S. at 136-138.

An interesting (but perverted) position urged by the IRS in one private ruling is that the fiduciary duty doctrine of the Byrum case only applies if there are minority adverse interests who might question decisions made by the fiduciary. The IRS's view was that "interests of family members, employees, agents or other related or non-adverse persons do not represent minority interests, since whatever legal rights they may be perceived to have under Byrum are apt not to be exercised. Conversely, the presence of a single truly adverse minority interest would make the Byrum rationale applicable." Ltr. Rul. 8038014. No case has supported that narrow reading of Byrum.

d. Broad Powers to Allocate Between Income and Principal Even broad authority to allocate receipts and disbursements between income and principal will not trigger Sections 2036 or 2038. E.g., Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st. Cir. 1970); Estate of Budd v. Comm'r, 49 T.C. 468 (1968). In Estate of Ford v. Commissioner, the trust authorized trustee "to apportion between principal and income of the trust estate any loss or expenditure in connection with the trust estate, which in his opinion should be apportioned, and in such manner as he may deem advantageous and equitable." Estate of Ford v. Comm'r, 53 T.C. 114, 120 (1969), *nonacq*. 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971). The IRS argued that the administrative and management powers gave the fiduciary uncontrolled discretion. It stressed particularly the power to allocate receipts, losses, and expenditures of the trust between income and principal. The court dismissed this argument, observing that this
"provision is commonly included in trust instruments 'to give the trustee some discretion so that he would not be required to seek court guidance in making doubtful allocations.' … The trustee herein is directed to exercise this power in an 'advantageous and equitable' manner. Of course, should he abuse his discretion by classifying an obvious item of principal as income, he would be subject to equity court review." 53 T.C. at 128.

Nevertheless, if the trust instrument permitted an unrestrained power to allocate capital gains to either to principal or income without the possibility of court review, Sections 2036 and 2038 could apply. Stephens, Maxfield, Lind &

Calfree, Federal Est. & Gift Tax'n, ¶ 4.10[4][c] (2001).

e. Broad Investment Authority. Various cases recognize that authorizing the trustee to invest in investments that would not otherwise be permissible under state law or to sell or exchange trust assets does not invoke Sections 2036 or 2038. E.g., United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Ford v. Comm'r, 53 T.C. 114 (1969), *nonacq*. 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971) ("the power to invest in honlegals' (i.e., investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust"); Estate of Budd v. Comm'r, 49 T.C. 468, 475 (1968) (authority to retain or invest in securities or property that may not be of a character permitted for trustees' investment under applicable State law).

f. "All Powers As I Would Have If Trust Not Executed". A rather common catch-all administrative power is to say that the trustee can exercise any powers that the settlor could have exercised over the property if it had not been transferred to the trust. This type of common catch-all provision has been found not to trigger application of Sections 2036 or 2038. Old Colony Trust C. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970) (reasoning that such language does not protect trustees from accountability to the court for exercise of the power).

g. Substitution Powers. A power of the grantor to substitute assets of equivalent value does not cause Section 2036 or 2038 to apply where it is held in a fiduciary capacity. State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a "very close" case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply). Despite the State Street decision (where the court barely found the predecessor to Section 2036 to apply when the donor, albeit as a fiduciary, could exchange assets with the trust *without regard to values*), the IRS again argued that a substitution power *for equal value* held by the grantor-trustee constituted a power to alter amend or revoke the instrument in Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975). The court disagreed, reasoning that any property substituted should be 'of equal value' to property replaced, so the grantor was thereby prohibited from depleting the trust corpus. The court viewed that as being no different than the case where a settlor retains the power to direct investments. The IRS subsequently acquiesced in the case. 1977-2 C.B. 1.

What if the grantor retains a substitution power in a *nonfiduciary* capacity (to cause the trust to be a grantor trust under Section 675(4)(C))? In Jordahl, the grantor who held the substitution power was a trustee, and held the power in a fiduciary capacity. However, the court's reasoning suggests that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity: "Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust." 65 T.C. at 97. The IRS has issued various private letter rulings agreeing with this conclusion. See section II.C.3.e. of this outline.

h. Management Powers Over Partnership. The principles of Byrum v. U.S., 408 U.S. 125 (1972), should mean that the powers of a transferor-general partner of a limited partnership should not cause transfers of limited partnership interests to be included in the estate under Section 2036(a)(2). The IRS recognized in Technical Advice Memorandum 9131006 and in Letter Ruling 9515007 that a parent may make gifts of interests in a limited partnership, and retain investment and distribution authority over partnership assets as the general partner without causing the partnership assets to be included in his or her estate as a transfer with the retained power to control beneficial enjoyment. In those rulings, the IRS observed that the donor-general partner "occupied a fiduciary

position with respect to the other partners and could not distribute or withhold distributions, or otherwise manage the partnership for purposes unrelated to the conduct of the partnership business." Obviously, if the donor could hold that power directly as a general partner, the donor could also serve as trustee of a trust and hold that power as trustee without violating Section 2036(a)(2) or 2038.

Section 2036(b), enacted in response to the Byrum case, applies only to stock of a controlled corporation. There are no rulings where the IRS has taken the position that Section 2036(b) applies to transfers of partnership interests—since the statute specifically references stock of corporations.

i. Effect of Exculpatory Clause Limiting Trustee's Personal Liability. As discussed above, the fact that a court of equity has the power to review administrative and management decisions of the trustee is the overriding principle that removes administrative and management powers from the reach of Section 2036(a)(2) or 2038. Does the existence of a broad exculpatory clause in the instrument change that result? It should not, because under state law, it is not possible to give a trustee complete exculpation from liability for its decisions. E.g., InterFirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882, 888 (Tex. App.—Texarkana 1987, no writ) (exculpatory clause does not protect a trustee who used the trustee position to obtain an advantage by action inconsistent with the trustee's duties and detrimental to the trust, or who takes actions in bad faith or acts "intentionally adverse or with reckless indifference to the interest of the beneficiary"). Cases interpreting Sections 2036 and 2038 have agreed. E.g., Old Colony Trust Co. v. U.S., 423 F.2d 601, 602 (1st Cir. 1970) (IRS argued that exculpatory clause triggered Sections 2036 and 2038; court disagreed observing that exculpatory clause "has no bearing on the question in this case because it does not affect the meaning, extent or nature of the trustees' duties and powers").

j. Effect of Guarantees.

(1) Guaranty By Trustee. If the trustee has the authority to guarantee a personal obligation of the settlor or other individual, could that administrative power cause Section 2036 or 2038 to apply? The general principle regarding administrative powers that are exercisable subject to fiduciary standards for the benefit of the trust should control this situation. Texas courts have emphasized the fiduciary duties of trustees in analyzing whether a trustee even has the authority to issue a guaranty. See Three Bears, Inc. v. Transamerican Leasing Co., 574 S.W.2d 193, 197 (Tex. Civ. App.—El Paso 1978), *aff'd in part and rev'd in part on other gr*, 586 S.W.2d 472 (Tex. 1979).

(2) Guaranty by Donor. If an individual guaranties a trust indebtedness, the question that arises is whether that individual makes a gift to the trust. In Letter Ruling 9113009, the IRS suggested that a guaranty by an individual for the benefit of another is a transfer, but the IRS indicated that it was not taking a position as to how the gift should be valued. That ruling came under intense criticism, and was withdrawn by Letter Ruling 9409018. An analogous issue is that an S corporation shareholder receives no basis from the guarantee of a corporate loan since nothing is "paid" by merely giving the guaranty. Another analogy is that an insured's loan to a trust to pay premiums does not create an incident of ownership, where the policy is not used as security for the loan. Ltr, Rul. 9809032. If the loan is not an incident of ownership, a guarantee of a loan should not be an incident of ownership either. There are no further rulings or cases that have addressed whether guarantees constitute gifts.

k. Administrative Powers That CANNOT Be Retained by Grantor. The prior subsections have addressed various administrative powers that do not cause inclusion under Sections 2036 or 2038. There are two situations where administrative powers cannot be retained by the grantor. (In addition, certain controls over the appointment of trustees, such as removal powers, may have adverse consequences. They are addressed in section II.B.5. of this outline.)

(1) Voting Powers. The IRS argued in the past that retaining voting powers over stock that is transferred to a trust constitutes a power causing inclusion under Section 2036(a)(2). The Supreme Court ultimately rejected this argument in U.S. v. Byrum, 408 U.S. 125 (1972). (The Byrum case is discussed in detail in section II.B.4.c. of this outline.) In response, the IRS (nine years later) withdrew an earlier ruling that stated that a power to control dividends by the right to vote nontransferred stock constituted a Section 2036(a)(2) power. Rev. Rul. 81-15, 1981-1 C.B. 457, *rev'g*, Rev. Rul. 67-54, 1967-1 C.B. 269.

In 1976, Congress passed the "anti-Byrum" amendment, enacting the predecessor to Section 2036(b). That Section provides that a grantor's retention of the power to vote shares in a "controlled corporation" is deemed to be the retention of the enjoyment of the property for purposes of Section 2036(a)(1). Interestingly, this legislative response to the issue leaves undisturbed the Byrum holding as to Section 2036(a)(2).

Section 2036(b) imposes two requirements: (1) there must be a controlled corporation, and (2) the decedent must have retained voting rights.

As to the first requirement, a corporation is a "controlled corporation" if at any time after the transfer of stock and during the three year period ending on the date of the decedent's death, the decedent owned (taking into account the attribution rules of Section 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock. I.R.C. § 2036(b)(2).

As to the second requirement, the grantor must retain the right to vote (directly or indirectly) the stock that is transferred. The right to vote nontransferred stock does not count, and the grantor may give non-voting stock and retain even all of the voting stock of the corporation. Prop. Reg. § 20.2036-2(a). Proposed regulations (that have been outstanding for years) take the position that the grantor retains the right to vote, for this purpose, if the power is merely exercisable in a fiduciary capacity as trustee or co-trustee, or where the grantor may appoint himself as trustee. Prop. Reg. § 20.2036-2(c). There is a right to vote "indirectly" if there is any agreement, either express or implied, as to how the shareholder will or will not vote the stock. Id. However, the mere fact that persons whose ownership of stock would be attributed to the grantor under Section 318 have the right to vote stock will not be treated as a retention of voting power by the grantor. Id.

In addition, the IRS takes the position that if stock of a controlled corporation is transferred to a partnership of which the grantor is a general partner and has the right to vote the stock as general partner, Section 2036(b) applies. That is the case even if the voting rights are subject to the fiduciary duties of a general partner. Tech. Adv. Memo. 199938005. Some commentators disagree with the conclusion, because under state law a partner has no direct or indirect rights with respect to the property of the partnership. Under this argument, the insured-transferor who is the general partner "has no individual right to vote that stock. Only the partnership has the right to vote that stock." Eastland, The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES, at p.114 (2002).

Observe that Section 2036(b) has its own three-year rule, rather than just using the three-year rule in Section 2035. The difference is that the Section 2036(b) provision applies if the grantor held the power to vote at any time within three years prior to death, whereas Section 2035 does not apply as long as the relinquishment of any problematic power occurs automatically under the agreement without any volition on the part of the grantor. Accordingly, any right that the grantor has as trustee (or otherwise) to vote stock in a controlled corporation must be relinquished at least three years before the grantor dies, or else estate inclusion will result under Section 2036(b). For example, if the grantor of a GRAT is the trustee during the initial term of the GRAT, the grantor would

have to survive at least three years after relinquishing any voting power over controlled corporation stock. Therefore, if stock of a controlled corporation is being contributed to a GRAT, (1) the grantor either should not serve as trustee at all, (2) the grantor should resign as trustee or in some other manner give up the right to vote the stock at least three years before the GRAT terminates, or (3) there must be a co-trustee who would hold all of the voting power with respect to stock of any controlled corporation and the grantor must be precluded from ever holding any power to vote such stock.

(2) Incidents of Ownership Over Life Insurance. Section 2042 provides that life insurance proceeds are included in the insured's estate if (i) the proceeds are payable to or for the benefit of the insured's estate, or (ii) if the insured, at his death, possessed any incidents of ownership in the policy, exercisable either alone or in conjunction with any other person. The term "incidents of ownership" has been interpreted very broadly, and includes just about any power over the policy, including the following powers: to change the beneficiary; to surrender or cancel the policy; to assign the policy; or to pledge the policy for a loan or obtain a loan on the policy from the insurer. Treas. Regs. § 20.2042-1(c)(2). In addition, incidents of ownership include the power to elect a settlement option, In Re Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973), or to veto the owner's right to assign the policy or designate policy beneficiaries, Rev. Rul. 75-70, 1975-1 C.B. 301. However, the insured's merely making a loan to a trust to enable it to pay premiums is not an incident of ownership in the policy as long as it is not used as collateral for the loan. Ltr. Rul. 9809032.

Any such powers held by the insured in a fiduciary capacity will be treated as if the insured held the incidents of ownership for purposes of Section 2042. Treas. Reg. § 20.2042-1(c)(4); Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), *cert denied*, 427 U.S. 977 (1976); Freuhauf v. Comm'r, 427 F.2d 80 (6th Cir. 1970); but see Bloch v. Comm'r, 78 T.C. 850 (1982). Under Revenue Ruling 84-179, an insured who holds powers over a policy in a fiduciary capacity will avoid Section 2042 only if all of the following are satisfied: (i) the powers are held only in a fiduciary capacity, (ii) the powers are not exercisable for the insured's personal benefit, (iii) the insured did not transfer the policy to the trust and did not transfer to the trust from personal assets any of the consideration for purchasing or maintaining the policy by the trust, and (iv) the insured did not obtain his trustee powers through some prearranged plan in which the insured participated. The last two requirements would not be satisfied where the insured transfers an insurance policy to a trust and serves as the trustee or became trustee through some prearranged plan.

Even if the insured is not the initial trustee, if the insured can appoint himself as trustee, the insured will be treated as holding incidents of ownership in the policy. Furthermore, if the insured just has the power to remove and appoint a replacement trustee, the insured may be treated as holding any incidents of ownership held by the trustee. The general effects of trustee removal powers are addressed in section II.B.5.g. of this outline. The effects of removal powers for purposes of Section 2042 are discussed in this section II.B.5.h. of this outline.

l. Summary of Trustee Selection Issues With Respect to Administrative Powers. **Administrative or management powers of the trustee will generally not cause inclusion under Section 2036 or 2038, even if the grantor is the trustee or has the power to become trustee. The cases have reached this conclusion by relying on the authority of a court to review the trustee's actions under its fiduciary duty; therefore the trustee does not have unfettered control. Accordingly, if the grantor is or may become the trustee, be wary of including language giving extremely broad management powers that are purportedly to be exercised solely in the trustee's discretion without any court control. (That type of language is probably not enforceable anyway, but why push the envelope?) Similarly, be wary of using extremely broad exculpatory provisions if the grantor is or may become the trustee.**

Two powers that the grantor cannot have without adverse tax consequences are (1) the right to vote stock of a "controlled corporation" that the grantor contributes to the trust, and (2) any incidents of ownership over life insurance policies on the grantor's life. As an example, if the grantor of a GRAT serves as trustee during the initial term, he should not have the power to vote stock if "controlled corporation" stock is conveyed to the GRAT—because the grantor would have to survive at least three years after ceasing to serve as trustee (with the power to vote) before the assets would be excluded from the grantor's estate for estate tax purposes.

5. Trustee Removal and Appointment Powers.

a. Power to Appoint Self at Any Time. The grantor will be treated as holding any dispositive or management powers held by the trustee if the grantor can appoint himself as the trustee at any time. Treas. Reg. § 20.2036-1(b)(3) (power to remove trustee and appoint himself); Estate of McTighe v. Comm'r, 36 T.C.M. 1655 (1977) (power to substitute self as trustee and power of trustee to make distributions in satisfaction of grantor's support obligations).

b. Contingent Power to Appoint Self as Successor Trustee. If the grantor has a contingent power to appoint himself as trustee upon the occurrence of an event that is out of his control (such as a prior trustee ceasing to serve due to his death or resignation), Section 2038 does not apply, but Section 2036(a) does apply. Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977) (trustees, under provisions of irrevocable trust, had right to designate persons who would possess trust property and income; settlor could designate herself as trustee if vacancy occurred in office of trustee during her life, and settlor had opportunity to appoint two successor trustees before her death; held, right of trustee to designate beneficiaries would be attributed to settlor); Estate of Alexander v. Comm'r, 81 T.C. 757 (1983); Rev. Rul. 73-21, 1973-1 C.B. 405; See Treas. Reg. § 20.2036-1(b)((3). (At least one case has disagreed with this position, but most have agreed with it. See section II.B.3.e.(3) of this outline.)

c. Power to Appoint Self as Co-Trustee. Sections 2036 and 2038 apply to powers held jointly with someone else. Therefore, the ability to add one's self as a co-trustee would be just as damaging as being able to become sole trustee—unless the trust instrument reserved the problematic power just for the co-trustee other than the grantor. See section II.B.3.d.(2) of this outline.

d. Veto Power. A corollary to the co-trustee rule is that a power reserved by the grantor to veto actions of the trustee will cause the grantor to be treated as holding the powers of the trustee over which the veto power may be exercised. See section II.B.3.d.(4) of this outline.

e. Power to Appoint a Series of Successor Trustees. Is the power to appoint a series of trustees in effect a power to "amend" the trust that would be subject to Section 2038? No case has directly addressed that argument, although that type of power has been present in a variety of reported cases that have addressed Section 2036 and 2038. E.g., Estate of Budd v. Comm'r, 49 T.C. 468 (1968) ("power to appoint a successor trustee or trustees by instrument in writing lodged with said successor trustee or trustees, and specifying the date or event upon which the appointment of such successor trustee or trustees shall take effect").

f. Power to Add Co-Trustees (Not Including Self). If the grantor merely has the power to add co-trustees, the grantor generally should not be treated as holding the powers of the trustees, as long as he cannot appoint himself. Durst v. U.S., 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, and there was no estate inclusion). Nevertheless, there is concern that if the grantor can keep adding co-trustees indefinitely, the grantor could control the trustees' decision by just appointing trustees who would agree with his position. Even in that situation, there would

still be the argument that the grantor has no real power at all, because anyone he appoints is subject to fiduciary standards and control of the courts, unless an express or implied agreement could be shown. See Estate of Vak v. Comm'r, 973 F.2d 1409 (8th Cir. 1992) (transfer constituted completed gift; court rejected IRS's argument that donor "had the power to replace trustees with individuals who would do his bidding"); Estate of Wall v. Comm'r, 101 T.C. 300, 312 (1993) ("a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take") (See section II.B.2.c.(1)(a) of this outline regarding the implied agreement principle.).

g. Power to Remove and Replace Trustee—Sections 2036 and 2038. If the grantor could remove the trustee and appoint himself, it has long been clear that the grantor is treated as holding the powers of the trustee for purposes of Sections 2036 and 2038. See section II.B.5.a of this outline, above. There is a long history of disagreement as the tax effect of the grantor's power to remove the trustee and appoint someone other than the grantor as successor trustee. Since 1995, there is now a very clear objective safe harbor, but a brief review of the history of this issue may help provide perspective (and help to analyze situations where the safe harbor is not met.)

In a 1977 revenue ruling, the IRS ruled on a situation in which the decedent held the power to appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process. The IRS ruled that Section 2036 did not apply because "the decedent's power to appoint a successor corporate trustee in the event of resignation or removal of the original trustee did not amount to a power to remove the original trustee that, in effect, would have endowed the decedent with the trustee's discretionary control over trust income." Rev. Rul. 77-182, 1977-1 C.B. 273.

The IRS followed that with the now infamous Revenue Ruling 79-353, 1979-2 C.B. 325, which takes the position that the right to remove a corporate trustee without cause and appoint a successor corporate trustee caused estate inclusion under Sections 2036 and 2038. The IRS posited that this removal and appointment power was an "extremely potent power," even though the decedent was forced to appoint a successor corporate trustee. After receiving considerable criticism of the ruling, the IRS relented somewhat in 1981, and agreed that Revenue Ruling 79-353 would apply only to transfers after the date of the 1979 ruling. Rev. Rul. 81-151, 1981-1 C.B. 458.

The first court case to address the IRS's position in Revenue Ruling 79-353 was Estate of Vak, which held that the grantor's unlimited power to remove the trustee and appoint a successor independent trustee (who was not a related or subordinate party under Section 672(c)) did not prevent the grantor from making a completed gift when the transfer to the trust was made. The case summarily rejected the IRS's position that "Mr. Vak had the power to replace the trustees with individuals who would do his bidding." Estate of Vak v. Comm'r, 973 F.2d 1409 (8th Cir. 1992).

The IRS next urged its position under Sections 2036 and 2038 regarding removal powers in Estate of Wall. That case presented facts very similar to the facts of Revenue Ruling 79-353. Estate of Wall v. Comm'r, 101 T.C. 300 (1993). The IRS's position was "that even a corporate trustee will be compelled to follow the bidding of a settlor who has the power to remove the trustee; otherwise the settlor will be able to find another corporate trustee which will act as the settlor wishes. In other words, says respondent, under these circumstances the settlor has the de facto power to exercise the powers vested in the trustee." 101 T.C. at 311. The Tax Court rejected this argument. The relied primarily on the fiduciary duty of any trustee that might be appointed by the grantor:

"[U]under established principles of the law governing trusts, a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the settlor, prior to appointment, as to how

fiduciary powers should be exercised over the distribution of income and principal. The trustee has a duty to administer the trust in the sole interest of the beneficiary, to act impartially if there are multiple beneficiaries, and to exercise powers exclusively for the benefit of the beneficiaries.

…

In the absence of some compelling reason to do so, which respondent has not shown, we are not inclined to infer any kind of fraudulent side agreement between Mrs. Wall and First Wisconsin as to how the administration of these trusts would be manipulated by Mrs. Wall. Instead, since the language of the trust indentures provides maximum flexibility as to distributions of income and principal, the trustee would be expected to look to the circumstances of the beneficiaries to whom sole allegiance is owed, and not to Mrs. Wall, in order to determine the timing and amount of discretionary distributions." 101 T.C. at 312-313

The IRS concluded by relying on the Supreme Court's analysis of Section 2036 in U.S. v. Byrum, 408 U.S. 125 (1972), to concluded that the grantor did not retain an ascertainable and enforceable power to affect the beneficial enjoyment of the trust property. 101 T.C. at 313.

Following its losses in Estate of Vak and Estate of Will, the IRS changed its position in Revenue Ruling 95-58, 1995-2 C.B.-1. The ruling revokes Revenue Ruling 79-353 and Revenue Ruling 81-51. In addition, it modified Revenue Ruling 77-182 "to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent would not have retained a trustee's discretionary control over trust income." In effect, the ruling allows a safe harbor based on the facts of the Vak case. The safe harbor is that Sections 2036 and 2038 will not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was "not related or subordinate to the decedent" within the meaning of Section 672(c). (Interestingly, this position is consistent with the removal provisions in the income tax regulations for grantor trusts. Treas. Reg. § 1.674(d)-2.)

Thus, the grantor can retain an unlimited right to remove the trustee, and there is no requirement that a successor corporate trustee be appointed. However, the IRS does add the requirement that, to come within the safe harbor, the successor trustees must not be a "related or subordinate party."

In many situations, the grantor will want to have a removal power and have the power to appoint someone other than the grantor, but the grantor may want to keep the ability to name relatives or others who would not come within the safe harbor. The grantor will need to weigh the desire for the retained flexibility vs. the comfort of coming within the safe harbor of Revenue Ruling 95-58. If the grantor decides to keep the more expansive ability to appoint relatives as successor trustees, the grantor would rely on the broad language in Estate of Wall relying primarily on the fiduciary duty of any trustee who might be appointed.

h. Power to Remove and Replace Trustee—Section 2042. Revenue Ruling 79-353, 1979-2 C.B. 325 held that retaining the ability to remove a trustee gave the grantor all of the powers of the trustee for purposes of Sections 2036 and 2038, but did not address Section 2042.

Technical Advice Memo 8922003 held, in reliance on Revenue Ruling 79-353, 1979-2 C.B. 325, that the ability of the insured to remove the trustee *without cause* and appoint someone other than the insured as successor trustee resulted in the insured holding incidents of ownership.

Revenue Ruling 95-58, 1995-2 C.B. 1, revoked Revenue Ruling 79-353 (which addressed Sections 2036 and 2038) and provided that those Sections would not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was "not related or subordinate to the decedent" within the meaning of Section 672(c).

The revocation of Revenue Ruling 79-353 seems to imply that the extension of its rationale to Section 2042 in TAM 8922003 is no longer valid. Furthermore, Letter Ruling 9832039 cited Revenue Ruling 95-58's revocation of Revenue Ruling 79-353 to support its conclusion that the power to remove a trustee *for cause* did not trigger Section 2042. (However, the citation to Revenue Ruling 95-58 was not necessary because the power to remove a trustee *for cause* was probably not an incident of ownership even prior to Revenue Ruling 95-58.) See Janson, Life Insurance Potpourri—Recent Developments and Private Split Dollar Plans, 34TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 401.5.C. (2000).

The IRS has not addressed the effect of a removal power *without cause* for purposes of Section 2042, but it would probably be treated the same as for Sections 2036 and 2038 under Revenue Ruling 95-58. See Covey, Recent Developments in Transfer Taxes and Income Taxation of Trusts and Estates, 35TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 120 (2001) (suggesting that the IRS likely will not take a harsher position under Section 2042 than under Sections 2036 and 2038, observing that the IRS has taken same position in PLR 9746007 regarding the effect of removal powers on a beneficiary under Section 2041).

i. Disability of Grantor. The disability of the grantor will have no impact on powers that may be held by the grantor with respect to any of the prior subsections regarding trustee appointment powers. See section II.B.3.d.(5) of this outline.

j. Summary of Selection of Trustee Issues Regarding Trustee Removal and Appointment Powers. **If the trustee holds powers that would cause estate inclusion if the grantor held the powers directly, the following restrictions apply regarding appointment procedures to avoid estate inclusion by reason of the appointment powers. The grantor cannot have the power to appoint himself--even a power contingent upon the occurrence of future conditions outside his control. Also, the grantor cannot serve as a co-trustee or have a power to veto actions by the trustee. The grantor can, however, keep the power to appoint a successor or series of successor trustees in the future (apparently) or to add co-trustees. The grantor can keep the power to remove and replace the trustee (with someone other than the grantor) as long as the successor is someone who is not related or subordinate to the grantor. If the grantor wants to have the ability to remove and appoint a successor (other than himself) is who a related party, the parties would have to rely on the reasoning of Vak and Wall that any successor trustee would be subject to fiduciary duties, but that procedure would not be within the safe harbor that is clearly recognized by the IRS.**

6. Special Trusts.

a. Minor's Trusts Under Section 2503(c). If the grantor serves as trustee of a minor's trust created under Section 2503(c) (to qualify for the gift tax annual exclusion), the trust assets will be included in the grantor's estate for under Sections 2036 and 2038 if he dies while serving before the termination of the trust. See Alexander v. Comm'r, 81 T.C. 757 (1983); Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970). Under Section 2503(c), there can be no "substantial restrictions" on the trustee's exercise of the discretionary power to make distributions for the minor beneficiary. Treas. Reg. § 25.2503-4(b)(1). A discretionary power to make distributions for "support, education, care, comfort and welfare" will qualify under Section 2503(c). Rev. Rul. 67-70, 1967-2 C.B. 349. Even that standard, however, is probably too expansive to satisfy the ascertainable standard exception under Section 2036 and 2038 (as discussed in Section II.B.3.g. of this outline). (In addition, estate inclusion would result if the grantor resigns as trustee within three years of his death. I.R.C. § 2035(a).)

Accordingly, the grantor should not serve as trustee or co-trustee (or have the power to appoint himself as trustee or co-trustee) of a Section 2503(c) trust. In addition, the grantor's

spouse generally should not be the trustee either. If the spouse dies before the trust terminates, the assets may be included in the spouse's estate, because she would have the power to make distributions in satisfaction of her legal obligation of support. Treas. Reg. § 20.2041-1(c)(1). Furthermore, when the child becomes of majority age, so that the spouse no longer owes a legal obligation of support, the IRS may argue that a lapse of the spouse's general power of appointment occurs, thus resulting in a gift from the spouse to the trust. See generally Zaritsky, Tax Planning for Family Wealth Transactions, ¶ 4.05[1][a].

The trustee's discretionary power over distributions in a Section 2503(c) trust is not a grantor trust power. See I.R.C. § 674(b)(7).

b. Special Needs Trust. A "special needs trust," designed to provide benefits for a disabled beneficiary that would not disallow governmental benefits, must provide complete discretion to the trustee in making distributions. Obviously, the grantor cannot be the trustee or co-trustee (or have the power to appoint himself as trustee or co-trustee.)

c. Qualified Domestic Trust. Bequests of other transfers at the death of a spouse to a surviving spouse who is not a citizen of the United States will qualify for the estate tax marital deduction only if the transfer is made to a qualified domestic trust. I.R.C. 2056A. One of the statutory requirements is that the trust instrument require that one trustee of the trust be an individual citizen of the United States of a domestic corporation. I.R.C. § 2056A(a)(1)(A). In the addition, the regulations add various requirements that must be satisfied depending on the size of the trust. If the trust is over $20 million in value, the trust must meet one of three additional requirements. Treas. Reg. § 20.2056A-2(d)(1)(i). The easiest of those three requirements is to have at least one co-trustee that is a domestic bank or the United States branch of a foreign bank (in which event there must be another co-trustee (individual or a domestic corporation) that is a United States citizen. Treas. Reg. § 20.2056A-2(d)(1)(i)(A). (An additional option is available if the QDOT has assets under $2.0 million, namely that the trust instrument provide that no more than 35% of the fair market value of the trust assets, determined annually, may be invested in real property that is located outside the United States, Treas. Reg. § 20.2056A-2(d)(1)(ii).)

d. S Corporation. Only certain types of trusts can qualify as shareholders of an S corporation. These include (1) a grantor trust, (2) a "Section 678" trust requiring that all income be taxable to a trust beneficiary, (3) a Qualified Subchapter S Trust, ("QSST") or (4) an electing small business trust. ("ESBT"). I.R.C. § 1361(c)(2)(A). If a trust is not a grantor trust (as to the grantor under Section 671-677 or as to the beneficiary under Section 678), it is often preferable for the trust to qualify as a QSST, due to the complexity of administering ESBTs and the requirement that all S corporation income attributable to an ESBT will automatically be taxed at the trust's highest marginal rates. I.R.C. § 641(c). One of the requirements of a QSST is that there be only one current income beneficiary, and that corpus distributions may only be made to the current income beneficiary. I.R.C. §1361(d)(3)(A)(i-ii). Another requirement is that all of the income must be distributed currently to the income beneficiary. I.R.C. § 1361(d)(3)(B).

If a trust instrument allows distributions to more than one beneficiary, and if the grantor anticipates that the trust may at some point own or acquire stock in an S corporation, the trust instrument may include a provision permitting the trustee to divide the trust into separate trusts for the beneficiaries, so that there is a separate single-beneficiary trust for each beneficiary; the S corporation stock would be distributed to those separate trusts. Furthermore, the special S corporation authority will typically provide that if such separate trusts are created for each income beneficiary, there will be a mandatory income requirement with respect to those separate trusts (so that the trust will not be at risk for losing S corporation status for all of the shareholders of the S corporation by inadvertently failing to distribute all of the trust's accounting income during the year). If that type of provision is included, and if the

grantor is the trustee or co-trustee (or may become the trustee or a co-trustee), the authority to acquire stock of an S corporation and to divide a sprinkle trust into separate trusts and to convert a discretionary income provision into a mandatory income provision may cause estate inclusion for the grantor under Sections 2036 and 2038.

e. Charitable Remainder Trust. Subject to several limitations, a grantor may serve as the trustee of a charitable remainder trust. See e.g., Ltr. Rul. 7730015; but see Ltr. Rul 9442017. However, difficulties arise if difficult-to-value assets are held in a charitable remainder unitrust ("CRUT"). A CRUT's assets must be valued annually. I.R.C. § 554(a)(2)(A). Regulations adopted in 1998 provide that "unmarketable assets" (defined as assets that are not cash, cash equivalents or assets that can be readily sold for cash or cash equivalents, Treas. Reg. § 1.664-1(a)(7)) must be valued either (1) by an "independent trustee", or (2) by a qualified appraiser. Treas. Reg. § 1.664-1(a)(7). For this purpose, an independent trustee is a person who is not the grantor, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of Section 672(c)).

Accordingly, if there are any difficult-to-value assets in a CRUT, an independent trustee (as defined above) must be used if the grantor does not want to have to incur the expense of obtaining a formal qualified appraisal of the trust assets each year.

f. Grantor Retained Annuity Trust (GRAT). The grantor typically serves as the trustee of the GRAT during the term of the annuity payments. (The assets will be included in the grantor's estate in any event if the grantor dies before the annuity payments end.) Generally, there is no requirement that the grantor live at least three years after ceasing to serve as trustee (because Section 2035(a)(1) provides that the three year rule applies if a Section 2036 or 2038 power is "relinquished;" the grantor does not "relinquish" anything at the end of the GRAT term, instead the instrument mandates that the annuity ends.)

If the grantor continues to serve as trustee following the end of the annuity term, the other requirements discussed in this outline in order to avoid estate inclusion under Sections 2036 and 2038 with respect to retained powers must be satisfied.

There is a special three-year problem if the GRAT owns stock in a "controlled corporation" and if the grantor has the right as a trustee (or co-trustee) to vote such stock. The grantor would have to cease serving as trustee or otherwise relinquish any voting rights at least three years before his death in order to avoid estate inclusion under Section 2036(b). See section II.B.4.k.(1) of this outline. If the grantor serves as trustee of a GRAT that may hold stock of a "controlled corporation," as defined in Section 2036(b), the trust instrument should specify that the grantor will not have the right to vote such stock, and there should be a co-trustee who has the right to vote such stock.

C. Federal Income Tax Issues.

1. Foreign Trust Status and Effects.

a. Tax Concerns With Being Foreign Trust. Various tax complexities arise for foreign trusts. A few of them are described.

(1) Reporting Requirements. U.S. beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the IRS on Form 3520. (Additional required information is described in Notice 97-34.) In addition, a U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made. In addition, the foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust may be liable for a 5% penalty of the value of the trust assets that are treated as owned by that person. I.R.C. § 6677(b). If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S. grantor must report the transfer. I.R.C. § 679(a)(5).

(2) Foreign Grantor Trust. If a U.S. grantor establishes a foreign trust for the benefit of U.S. beneficiaries, it is treated as a grantor trust. I.R.C. § 679. Upon termination of grantor trust status (i.e., at the death of the grantor or if there are no longer any U.S. beneficiaries), Section 684 imposes a tax on the unrealized appreciation. However, if that occurs because of the death of the grantor, the step-up in basis under Section 1014 should avoid having any gain to which Section 684 would apply.

(3) Foreign Nongrantor Trust. If a foreign trust is not treated as a grantor trust (which, for example, could occur despite Section 679 if it is created in a testamentary transfer at the death of the U.S. grantor, or it is created by a non-U.S. grantor, or if it is created during the lifetime of a U.S. grantor and does not have any U.S. beneficiaries) special income tax rules apply. It is subject to U.S. income tax only on certain types of income (primarily income effectively connected with a U.S. trade or business, I.R.C. § 871(b), U.S. source fixed or determinable annual or periodic income [such as interest, dividends, and rents], I.R.C. § 871(a)(1)(A), U.S. source gains, I.R.C. § 871(a)(1)(B & D), or income on the disposition of U.S. realty, I.R.C. §871(a)(1)(A)).

U.S. beneficiaries of foreign nongrantor trusts are subject to several special rules. DNI of a foreign nongrantor trust is determined under special rules, a primary distinction of which is that capital gains are included in DNI. I.R.C. § 643(a). The ticking time bomb for foreign nongrantor trusts is that if all of the DNI is not distributed each year, accumulation distributions (again determined under very special rules in Section 665(b)) are subject to the imposition of a tax under the throwback rule, I.R.C. § 665(d). Furthermore, the tax under the throwback rule is increased by an interest charge. I.R.C. §§ 667(a)(3) & 668. The interest rate is the floating interest rate under Section 6621 that applies to underpayments of tax generally.

(4) Cannot Be S Corporation Shareholder. A foreign trust is not an eligible S corporation shareholder. I.R.C. § 1361(c)(2) (last sentence).

(5) Bottom Line—Substantial Complexity and Possible Increased Tax Costs. The extremely brief preceding summary of some of the tax effects of foreign trusts demonstrates that the tax rules become substantially more complex, with huge penalties for failure to file required information to the I.R.S., and with potentially increased taxes (with interest charges).

b. Selection of Trustee Can Cause Foreign Trust Treatment. A trust is a foreign trust unless both of the following tests are satisfied: (1) courts in the U.S. must be able to exercise primary supervision over the trust; and (2) one of more U.S. persons have the authority to control all substantial decisions of the trust. I.R.C. §§ 7701(a)(30)(E) & (31)(B). A foreign person is someone who is not (among other things) a U.S. citizen or resident, or a U.S. domestic corporation. If a foreign person has control over only one "substantial decision," foreign trust status results. "Substantial decisions" are defined in the regulations to mean "all decisions other than ministerial decisions." Treas. Reg. § 301.7701-7(d)(1)(ii). Examples are included that are very expansive, including not only the power to determine the timing, amount and selection of beneficiaries, but other administrative actions such as making income/principal allocations, investment decisions, and compromising claims. The definition even includes the power to appoint a successor trustee (unless it is restricted so that it cannot change the trust's residency) and the power to remove, add, or replace a trustee. Id.

c. Summary of Selection of Trustee Issues Regarding Foreign Trusts. **Do not appoint a foreign person (anyone other than a U.S. citizen or resident or a U.S. domestic corporation) as a trustee with the power to control any substantial decision—unless the planner (who really knows what he or she is doing with foreign trusts) purposefully wants the trust to be a foreign trust. (This generally means that any non-U.S. person or persons must be less than half of the trustees, and no decisions are left specifically to their control even though non-U.S. persons are a minority vote.)**

2. Grantor Trust Rules—Effects of Grantor Trust Status.

a. Grantor Report Income For Income Tax Purposes. If the trust is a grantor trust, the grantor would report on his or her income tax return all income, deductions, and credits attributable to the trust property. The grantor should understand that the grantor trust rules could impose substantial liability on the grantor to pay income taxes on the trust's income.

b. Gift Tax Effects of Grantor's Payment of Income Taxes on Trust's Income. Payment by the grantor of income taxes with respect to the trust's income permits the trust to grow at a faster rate (because it does not have to pay income taxes). While the clear effect is to increase the trust value, there is no authority treating the grantor as making a gift for gift tax purposes when the grantor satisfies its own liability under the Internal Revenue Code to pay those incomes taxes. Presumably, the grantor would make a gift only if the grantor has a right to be reimbursed for the income tax pursuant to state law. See Practical Drafting 2575-2576, 2669-2671 (R. Covey ed., July 1991 and October 1991).

The Uniform Principal and Income Act and the Revised Uniform Principal and Income Act both provide that income taxes on trust capital gains that are taxable to the grantor should be paid from the trust principal. See Texas Trust Code §113.111(b)(5). If the grantor pays such income taxes (pursuant to federal tax law requirements), at least one state court case has held that the grantor has a right of reimbursement from the trust. Doughty Trust, 6 Fid. Rep. 2d 260 (Dist. Pa. 1986) (discussed in Practical Drafting 2575-2756 (R. Covey ed. 1991).). There is nothing in most state trust statutes suggesting that the grantor would have a right of reimbursement. Even assuming Doughty is correct, no gift should occur until the grantor pays income tax on capital gains and waives his reimbursement right. Subsequent to the Doughty case in 1986, no other cases have found that a right of reimbursement exists from a grantor trust to the grantor for income taxes paid by the grantor with respect to trust taxable income.

Even if there were a trend in the cases adopting the Doughty position, the result might be different under the Uniform Principal and Income Act (1997), which has now been adopted in an ever increasing number of states. UPIA (1997) provides that taxes "required to be paid by a trustee" are paid from income or principal of the trust, depending on the nature of the tax. Taxes with respect to a grantor trust are not "required to be paid by a trustee", so there should be no inference that a statutory principal-income allocation provision should create a right of reimbursement.

Even under the Revised Uniform Principal and Income Act (1962), and even in the unlikely event that the Doughty holding were to be adopted by other courts, it should not apply to taxes on ordinary income. Section 13(a)(6) of the 1962 Revised Uniform Principal and Income Act provides for the payment from trust income of "any tax levied upon receipts defined as income under this Act or the trust instrument and payable by the trustee." Under federal tax law, the tax on the trust ordinary income would be payable by the grantor and not by the trustee.

Letter Ruling 9444033 went so far as to include a dictum statement that "[i]f there were no reimbursement provision, an additional gift to a remainderperson would occur when the grantor paid tax of any income that would otherwise be payable from the corpus of the trust." Following numerous adverse comments from tax practitioners, the ruling was reissued about a year later without that sentence, and the IRS has yet to challenge taxpayers on this issue.

Several cases suggest that no gift should result from the grantor's payment of income taxes includible in his or her income under the grantor trust rules. See Commissioner v. Hogel, 165 F.2d 352 (10th Cir. 1947) (trust income attributable to grantor cannot be basis of gift tax liability, reasoning that gift results only when there is a transfer); Commissioner v. Beck, 129 F.2d 243 (2d Cir. 1941) (grantor cannot reduce value of transfer to trust for gift tax purposes by income taxes grantor is required to pay on trust income).

c. Income Tax Reimbursement Provision.

(1) GRATs. The IRS conditions the issuance of favorable rulings for GRATs on the inclusion of language in the trust instrument requiring that the trust distribute amounts to the grantor in addition to the retained annuity amount "to reimburse the grantor for any federal income tax paid by the grantor attributable to any trust income in excess of the [annuity]." Apparently, the IRS position is that this requirement is necessary to prevent a constructive addition to the trust by the grantor's payment of income taxes on the trust income. E.g, Ltr. Ruls. 200001013 & 200001015 ("if the total of the net ordinary income and capital gains received by the Trust during the [sic] any taxable year exceeds the amounts paid to Taxpayer in respect of such year as provided above, the trustee is to reimburse Taxpayer for any tax (whether federal, state, or otherwise) paid or payable on the excess").

Including such a reimbursement provision would seem to create some risk that the trust would be included in the grantor's estate under section 2036 (by providing for payment of legal obligations of the grantor.) However, various IRS private rulings have held that there will be no inclusion under Section 2036(a). See Ltr. Ruls. 199922062 (foreign trust providing that trustee must pay any federal or state income tax liability the grantor incurs to the extent it exceeds grantor's personal income tax liability computed as if he were not the owner or settlor of any portion of the trust), 9710006 (provision in trust instrument requiring distribution from trust to IRS to cover income tax liability of grantor owner that is attributable to the trust does not constitute retention of the right to income under section 2036(a) and will not cause corpus of trust to be included in grantor's gross estate); 9413045 (tax reimbursement provision does not cause estate tax inclusion under section 2036(a)(1)). A compromise approach for GRATs would be to include a provision that the grantor be reimbursed for income taxes of the trust only to the extent, if any, that such reimbursement is necessary to ensure that the annuity retained by the settlor will constitute a "qualified interest" under section 2702. See McCaffrey & Schneider, Drafting GRATs and QPRTs, ABA Section of Real Property, Probate and Trust Law Annual CLE Meeting (1995).

(2) Grantor Trusts Other Than GRATs. Income tax reimbursement provisions could also be considered for grantor trusts other than GRATs. The grantor may specifically want to provide that he or she will not be liable for taxes on the trust income (perhaps especially with respect to trust capital gains—which could be very large if the trust sells highly appreciated assets.) Such a reimbursement provision would remove some of the transfer efficiency of the arrangement from a transfer tax standpoint. However, if the client wants to include such a reimbursement provision, consider carefully whether the provision risks estate inclusion under section 2036(a) (as discussed above). The planner can draw comfort from the fact that the IRS has issued various rulings holding that estate inclusion would not result (as cited above). A recent private letter ruling (200120021) involved a grantor trust that was created for the benefit of the grantor's spouse and descendants. The trust permitted the trustee or a Trust Protector of the Trust, if not related or subordinate to the settlor, in their sole discretion, to distribute to the Internal Revenue Service or a similar state agency income or principal to satisfy the settlor's income tax liability attributable to the trust. The amount of the permitted distribution is equal to the excess of settlor's personal income tax liability over his personal income tax liability computed as if the trust were not a grantor trust. The ruling concluded that the trustee's/Trust Protector's discretionary power will not constitute retention by the settlor of the right to the income or enjoyment of the property under Section 2036(a).

d. S Corporation Shareholder. The trust will be a permissible shareholder of S corporation stock if the trust is a grantor trust as to income and corpus. I.R.C. §1361(c)(2)(A)(i). E.g., Ltr. Rul. 200001015.

e. Sales Between Trust and Grantor. No capital gain or loss should be recognized on

sales between the trust and the grantor. Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor). In that ruling, the I.R.S. indicated that it would not follow Rothstein U.S., 735 F.2d 704 (2d Cir. 1984) to the extent it would require a different result. See Rev. Rul. 92-84 (gain or loss on sale of asset by QSST, which is grantor trust, is treated as gain or loss of the grantor or other person treated as owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to corpus rather than to income); Ltr. Ruls. 200001015 & 200001013 (neither grantor nor trust will recognize gain or loss on transfer of assets to fund the trust, on trust's transfer of property to grantor in satisfaction of annuity payments, or on the substitution by grantor of assets of the grantor for assets of the trust), 9519029, 9504021, 9352017 (no gain or loss to grantor or trust on grantor's transfer of assets to GRAT or on trust's distribution of in-kind assets to grantor in satisfaction of annuity payments); 9230021 (funding grantor trust with partnership interest burdened with liabilities in excess of basis not treated as a transfer); 9146025 (transfer of assets from grantor trust to grantor not treated as a sale and assets have carryover basis; trust provided that grantor was entitled to receive fixed sum each year for a fixed term and an additional payment each year equal to the excess of the income of the trust over the fixed sum).

f. Exclusion of Gain From Sale of Personal Residence. The $250,000 ($500,000 for joint returns) capital gains exclusion under Section 121 for the sale of a principal residence by an individual is available if the residence is owned by a grantor trust. See Rev. Rul. 85-45, 1985-1 C.B. 783; Ltr. Rul. 9118017 (prior section 121 provision excluding gain on sale of residence by individual over age 55).

3. Grantor Trust—Trust Provisions that Cause Grantor Trust Status.

a. Power of Disposition by Related or Subordinate Parties Not Governed by Reasonably Definite External Standard.

(1) Overview. A power in trustees, more than half of whom are related or subordinate parties, to sprinkle or accumulate income or corpus of the trusts without a "reasonably definite standard" will not qualify for any of the exceptions from grantor trust treatment under Section 674(c)-(d). Furthermore, the trust can be planned to avoid the exceptions in Section 674(b)—generally by giving the trustee "spray" powers without having separate shares for the beneficiaries. Therefore, the trust would be a grantor trust under the general rule of Section 674(a).

(2) Section 674(a) General Rule. Section 674(a) triggers grantor trust treatment if the grantor or a non-adverse party holds a power of disposition over trust assets. Various exceptions in Sections 674(b), 674(c), and 674(d) can negate grantor trust treatment. Therefore, to rely on a trustee's general power of disposition to trigger grantor trust status requires very careful navigating of all of those exceptions.

(3) Section 674(b)(5) Exception for Corpus. Section 674(b)(5) is an exception from grantor trust treatment as to corpus if there is a reasonably definite standard (§674(b)(5)(A)) or if separate shares are created for the respective beneficiaries (§674(b)(5)(B)). Therefore, to avoid this exception, there should be no "reasonably definite standard" for the distributions, and the trustee should have a spray power and not have to charge any distributions of corpus against the beneficiary's proportionate share of corpus.

(4) Section 674(b)(6) Exception for Income. Section 674(b)(6) is an exception from grantor trust treatment as to income if any of the following apply:

(a) Income accumulated for a beneficiary must ultimately be payable to that beneficiary, to his estate, or to his appointees including anyone other than his estate, his creditors, or the creditors of his estate, §674(b)(6)(A),

(b) Income accumulated for a beneficiary must ultimately be payable on termination of the trust or in conjunction with a distribution of corpus that includes accumulated income to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, §674(b)(6)(B), or

(c) Income accumulated for a beneficiary is payable to the beneficiary's appointees or to one or more designated alternate takers (other than the grantor or grantor's estate) if the beneficiary dies before a distribution date that could reasonably be expected to occur within the beneficiary's lifetime, §674(b)(6)(second paragraph).

The regulations provide that these rules generally mean that the exception from grantor trust treatment will not apply "if the power is in substance one to shift ordinary income from one beneficiary to another." Treas. Reg. §1.674(b)-1(b)(6)(i)(c). An exception from this general summary of the income exception applies if the grantor or a nonadverse party has the power to shift income from one beneficiary to another by accumulating income with a provision that at a later distribution date the accumulated income will be distributed to current income beneficiaries in shares that are irrevocably specified. For example, an instrument might provide for payment of income in equal shares to two daughters but permit withholding the distribution from either daughter. When the youngest daughter reaches age 30, the remaining trust would be distributed equally between the two. If income is withheld from a daughter, this has the effect of ultimately shifting one-half of the accumulated income from one daughter to the other. However, this shift would not negate the exception from grantor trust treatment. Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 1).

Accordingly, provisions that would flunk this exception include the following. Permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries. See Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 2). Alternatively, if the grantor wishes to provide for "separate shares" for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and does not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment.

(5) Section 674(c), Independent Trustees. Section 674(c) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if no more than half of the trustees are related or subordinate parties and they have the power to distribute or accumulate income or corpus for a class of beneficiaries. To avoid this exception, more than half of the trustees would have to be "related or subordinate parties who are subservient to the wishes of the grantor." The term "related or subordinate party" is defined in Section 672(c).

(6) Section 674(c), "Subservient to the Wishes of the Grantor." The Section 674(c) exception from grantor trust treatment provides that no more than half of the trustees can be related or subordinate parties "who are subservient to the wishes of the grantor". Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor. This presumption is difficult to overcome, and would require a finding that the trustee is not acting in "accordance with the grantor's wishes." S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).

The requirement that the trustee be "subservient to the wishes of the grantor" to cause grantor trust treatment raises an interesting estate tax question. If the person who holds the power to make distributions without a standard is in fact subservient to the wishes of the grantor, does a potential estate inclusion issue arise under Sections 2036 and 2038? See Estate of Goodwyn v. Comm'r, 32 T.C.M. 740 (1973) (de facto control of trustee was insufficient to cause inclusion in grantor's estate under §2036).

(7) Section 674(d), Reasonably Definite External Standard. Section 674(d) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if the trustees (other than the grantor or grantor's

spouse) have the power to make or withhold distributions of income or corpus, if the power is limited by a reasonably definite external standard.

(8) Summary of Trust Provisions to Trigger Grantor Trust Status Under Section 674. **Navigating all of the exceptions based on a dispositive power of the trustee requires very careful planning. A non-adverse party must serve as trustee with a power of disposition over trust assets (Section 674(a)). The instrument must not have reasonably definite external standards for distributions (to avoid Section 674(d)), and more than half of the trustees must be related or subordinate parties (to avoid Section 674(c)). In addition, the trustee should have a spray power over corpus distributions and not have to charge any distributions of corpus against the beneficiary's proportionate share of corpus (to avoid Section 674(b)(5)). Also, the trust should permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries (to avoid Section 674(b)(6)). (Alternatively, to avoid Section 674(b)(6), if the grantor wishes to provide for "separate shares" for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and do not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment.)**

(9) Does Not Have the Appearance of Just Being a "Grantor Trust" Provision. An advantage of qualifying for grantor trust treatment under this approach is that it does not have the appearance of merely being a provision added to confer grantor trust status. The provision has real-life economic consequences that are of major importance to trustors--the decision of who has the power to control distributions.

(10) Giving Grantor's Spouse Power to Control Distributions Without a Reasonably Definite Standard. One possible method of using this approach to cause grantor trust status would be to give the grantor's spouse the power to distribute income or corpus to third parties without including a "reasonably definite external standard". As long as the spouse did not make any contributions to the trust, this power should not result in estate inclusion for the spouse (as long as the spouse cannot distribute to himself or herself or in satisfaction of his or her legal obligations). The trust instrument should carefully plan who the successor trustees would be in the event the spouse ceases to serve, to assure that more than half of the trustees would be related or subordinate parties.

b. Power of a Non Adverse Person to Distribute to or Accumulate Income for the Grantor or the Grantor's Spouse, §677(a)(1) or (2).

(1) Probably Results in Grantor Trust Treatment Only as to Income. The literal language of Section 677(a) would suggest that income and corpus of the trust would be treated as a grantor trust. I.R.C. Section 677(a) ("the owner of any portion of a trust…whose income…is, or…maybe" distributed or accumulated for distribution to the grantor or the grantor's spouse). However, an example in the Regulations very specifically indicates that the Section 677 power only results in the grantor being treated as the owner of the income portion of the trust and not the corpus. Treas. Reg. §1.677(a)-1(g), Ex. 1.

Despite the very clear example in the regulations, the IRS has issued several private letter rulings holding that both the income and corpus portion of a GRAT would be treated as owned by the grantor under the grantor trust rules because the annuity amount would be payable from principal to the extent that income was insufficient. Letter Rulings 9504021, 9451056, 9449012, 9444033, and 9415012. See also Ltr. Rul. 9501004 (CRUT treated as grantor trust as to income and corpus under §677(a) because of the possibility that income allocable to principal could be used to satisfy the unitrust payment). However, the IRS is currently taking the position that a retained annuity alone no longer confers grantor trust status as to both the income and corpus portion of a GRAT. Letter Ruling 9625021.

(2) Grantor or Grantor's Spouse as Discretionary Beneficiary Plus Power of Appointment May Cause Grantor Trust Status As to Income and Corpus. Various rulings have indicated that a combination of Sections 677 and 674(b)(3) can be used to confer grantor trust status as to income and corpus for a GRAT. The authority to make distributions of the annuity payments would result in grantor trust treatment as to the income under Section 677. If the grantor retains a testamentary power of appointment to appoint the trust assets (in the event the grantor dies before the stated termination of the GRAT), this power will result in grantor trust treatment as to the corpus under Sections 674(a) and 674(b)(3). See Treas. Reg. §1.674(b)-1(b)(3) ("if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion"). Letter Rulings 200001013 & 200001015 (grantor trust treatment as to income because trustee had discretion to pay all of GRAT's income—if any is remaining after payment of the annuity payments—to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 9707005 (GRAT is a grantor trust as to income and corpus under §674(a) and §677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder); 9625021.

(3) Grantor Trust Status May be Unintended. Additional economic flexibility can be created for the parents engaged in transfer planning if one of the parents transfers his or her separate property into a trust that would include the spouse as a discretionary beneficiary. The trust should specifically restrict the use of trust income to discharge the grantor's obligation of support. Treas. Reg. §20.2036-1(b)(2). (Each spouse cannot name the other as beneficiary or the reciprocal trust doctrine may apply.) By including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the unlikely event that the spouse ever needed distributions from the trust. However, the parties should be aware that including this provision will cause the trust to be a grantor trust as to the income under Section 677.

(4) Difficult to Relinquish Grantor Trust Status if Spouse is Discretionary Beneficiary. If the spouse is included as a potential beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift from the spouse may result (unless the relinquishment is a qualified disclaimer within nine months of the creation of the interest.) One possible planning strategy would be to give an independent party the power to remove the spouse as a discretionary beneficiary.

(5) Grantor Status Would Be Terminated at Spouse's Death. If Section 677 is being utilized to confer grantor trust status by including the grantor's spouse as a potential beneficiary, the death of the spouse would result in the trust no longer being a grantor trust (unless one of the other grantor trust provisions applies.)

c. Power of Non-Adverse Person to Use Income to Pay Life Insurance Premiums on Life of Grantor or Grantor's Spouse, §677(a)(3).

(1) Statutory Provision. The grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. I.R.C. §677(a)(3). This statutory provision appears to be very broad. Literally, giving a trustee the power to pay life insurance premiums on income of a trust would conceivably cause all of the income and corpus of the trust to be a grantor trust.

(2) Grantor Trust Treatment May Apply Only as to Actual Payment of Life Insurance Premiums. The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's

spouse. Treas. Reg. §1.677(a)-1(b)(2). However, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. Weil v. Comm'r, 3 T.C. 579 (1944), acq. 1944 C.B. 29: Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd., 116 F.2d 929 (8th Cir. 1940), cert. denied, 313 U.S. 594 (1941); Moore v. Comm'r, 39 B.T.A. 808, 812 (1939), acq., 1939-2 C.B. 25; Letter Ruling 6406221750A (June 22, 1964). But see Letter Ruling 8852003 (power to pay premiums causes entire trust to be grantor trust). See also Letter Ruling 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income). See generally Zaritzky, Drafting and Planning Life Insurance Trust for Policies Both Traditional and Unusual, UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶403.2.D.2.a. (1994).

(3) Not Useful to Assure Grantor Trust Status. Due to the case law limitations discussed above, the power is not useful as a tool to assure that a trust will be treated as a grantor trust.

d. Actual Borrowing of Trust Funds by Grantor or Grantor's Spouse Without Adequate Interest Or Security, §675(3).

(1) Actual Borrowing Required. Under §675(3), if the grantor has (directly or indirectly) actually borrowed corpus or income from the trust and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated a grantor trust. Grantor trust treatment will not result if the loan provides for adequate interest or security and if the loan is made by a trustee other than a related or subordinate party. Under the statute, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status.

(2) Grantor Trust Status if Loan Outstanding Any Time During the Year. The statutory language suggests that grantor trust status depends upon whether a loan is outstanding at the beginning of a taxable year. Under that interpretation, if borrowing occurs during year one, but is repaid before year two, grantor trust status would not exist in either year one or year two. However, the IRS interprets §675(3) as imposing grantor trust status if the loan to the grantor has been outstanding any time during the year. Rev. Rul. 86-82, 1986-1 C. B. 253, following Mau v. United States, 355 F. Supp. 109 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/98 and repaid on 1/2/99, the grantor would be treated as owning the trust for all of 1998 and 1999 under Revenue Ruling 86-82.

(3) Unclear as To Portion of Trust Treated as Grantor Trust. It is not clear whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus which could have been borrowed if some borrowing occurs. Compare Bennett v. Comm'r, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; held that grantor was taxable on portion of current year's income which the principal of the loan at the beginning of the year bears to the total trust income from the trust inception) with Benson v. Comm'r, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; held that grantor should be taxed on all trust income). Unless the grantor borrows the entire corpus, there can be no assurance that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

(4) Permits Toggling, But Close Supervision Required. Because grantor trust status is predicated on actual borrowing, it would be possible to toggle grantor trust status on and off. If the grantor wanted to achieve

grantor trust status in any particular year, the grantor could borrow all of the trust funds for some period of time during the year (if the trustee is not a related or subordinate party, the borrowing should not provide for adequate interest or security. However, if the trustee is a related or subordinate party, the borrowing could provide for adequate interest and security and still result in grantor trust status.) The grantor would need to repay the entire amount of the loan before the end of the taxable year, so that the grantor could make an independent decision in the following year whether the grantor trust status was desired in the following year.

e. Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets By Substituting Assets of Equivalent Value, §675(4)(C).

(1) Nonfiduciary Capacity Determination. The regulations provide that "the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." Treas. Reg. §1.675-1(b)(4). The IRS has taken the position in several rulings that whether the grantor holds the power in a nonfiduciary capacity for purposes of section 675 is a question of fact to be determined by the district director after returns have been filed. Ltr. Ruls. 199942017, 9645013, 9525032, 9407014, 9352007, 9352004, 9337011, 9335028, 9248016, 9253010. Other letter rulings have not applied the facts and circumstances requirement, but have held that the substitution power caused the trust to be a grantor trust. Ltr. Ruls. 9451056, 9352017, 9351005, 9345035, 9248016. Some rulings have applied a compromise approach, stating that the grantor trust determination depends on the facts and circumstances but that, assuming exercise of a Section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. E.g., Letter Ruling 9810019 (charitable lead trust).

(2) Trustee Should Not Hold Power. Because grantor trust status depends upon the power being held in a "non fiduciary" capacity, the power of substitution should not be held by the trustee. Similarly, a trustee's approval or consent should not be required.

(3) Retention of Power by Grantor. Can the grantor retain a nonfiduciary power to substitute assets of equivalent value without causing inclusion in the grantor's estate for estate tax purposes? A 1975 Tax Court case is often cited for the proposition that a substitution power will not cause estate tax inclusion. Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975). Interestingly, the facts in Jordahl involved a situation in which the grantor held the substitution power in a fiduciary capacity. Is this difference critical? The reasoning in the Jordahl case would suggest that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

"Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprived the remainder of benefits or to deprive an income beneficiary of property.] Substitutions resulting in shifted benefits would not be substitutions of property 'of equal value.'"

Commentators have generally concurred that the Jordahl result should apply even where the substitution power is held in a nonfiduciary capacity. See Practical Drafting 3753-3757 (R. Covey ed. 1994). In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for

income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl): 9227013, and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

(4) Substitution Power Held By Third Party. Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor's brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). In addition, allowing a third party to hold the substitution power could create additional flexibility to "turn off" or to "toggle" grantor trust status (as discussed below).

The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power "exercisable in a nonfiduciary capacity by any person"); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by "any non adverse party"). However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. (If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under §4941(d).) Letter Ruling 9037011 gave one of the trustees a power to "acquire any property that held in trust by substituting property…". The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to "reacquire" trust assets.

(5) Substitution Power Held by Grantor's Spouse. If someone other than the grantor can hold the substitution power (as discussed above), the grantor's spouse could be given the substitution power. This should avoid any risk of estate inclusion in the event that the Jordahl result is overturned. However, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under Section 672(e).

(6) Power of Substitution Held by Insured Not an Incident of Ownership. A power of substitution held by an insured should not constitute an incident of ownership over a policy owned by an irrevocable life insurance trust. Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), Letter Ruling 9413045 (citing and relying on Jordahl case).

f. Power of Non-Adverse Trustee to Make Loans to the Grantor and/or Grantor's Spouse Without Adequate Security, §675(2).

(1) Mere Existence of Power Sufficient. The mere existence of the power exercisable by the grantor or a non adverse party that enables the grantor to borrow corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security, will confer grantor trust status. I.R.C. §675(2). The mere existence of the power is sufficient to cause grantor trust status regardless whether the power is actually exercised. (Contrast this provision with Section 675(3), discussed below, which requires an actual borrowing of trust funds by the grantor to confer grantor trust status.)

(2) Grantor Treated as Owner of Entire Trust. As long as the power extends to borrowing corpus or income from the trust, grantor trust status will result as to the entire trust. (Some of the other grantor trust powers will result only in partial grantor trust treatment.)

(3) Power to Borrow Without Adequate Security is Sufficient. If the grantor has the power to borrow funds either without adequate security or without adequate interest, the trust will be treated as a grantor trust. Grantor trust status can be achieved if the trustee has the power to lend unsecured, even if the loan provides for adequate interest. Letter Rulings 199942017 (grantor has authority to borrow all or any of the corpus or income "without adequate security"), 9645013, and 9525032. To avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate tax inclusion, the lending power should be limited to the authority to make loans without security, and should not include the authority to make loans to the grantor without adequate interest. Furthermore, in order to assure that the "adequate" requirement is satisfied, the power is typically drafted in a manner that would explicitly permit making loans without any security to the grantor. See Ltr. Ruls. 9645013 (non-adverse party authorized to lend to the grantor without security) and 9525032 (grantor's power to borrow without security causes GRAT to be grantor trust). However, in Letter Ruling 199942017, the IRS issued a ruling that the trust would be a grantor trust where the grantor retained the power to borrow all or any portion of the corpus or income of the trust "without adequate security". (Presumably, the result would be the same if the trustee merely had the power to lend without adequate security as opposed to the grantor having the power to borrow without adequate security.) Interestingly, in that ruling, the S corporation and the grantor who were seeking the grantor trust ruling represented that their intention was "that this section allows Settlor to exercise this power unconditionally, without the approval of the trustees, or any other party".

(4) Non Adverse Party Other Than Grantor Should Hold the Power. A provision giving the grantor the power to make loans to himself or herself without adequate security would cause grantor trust treatment under Section 675(2), but could risk estate inclusion for estate purposes if the IRS were to determine that the power gave the grantor the authority to receive trust assets for less than full and adequate consideration. To minimize this estate inclusion risk, the power should be held by a non-adverse party other than the grantor. The safest course would be to use someone who is not a "related or subordinate party" to the grantor, by analogy to Revenue Ruling 95-58, 1995-2 C.B. 191, which permits a grantor to remove a trustee without risking estate inclusion under Sections 2036 or 2038 as long as the replacement trustee must be someone who is not a related or subordinate party within the meaning of Section 672(c).

g. Power of Non-Adverse Party to Add Beneficiaries, §674(b), §674(c), 674(d).

(1) Statutory Provisions. Section 674(a) states the general rule that a grantor is treated as the owner of the trust the beneficial enjoyment of which is subject to a power of disposition. Exceptions are provided in Sections 674(b), 674(c), and 674(d). The provisions for many of those exceptions provide that the exceptions will not apply if "any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children". If such a power to add beneficiaries exists, the exceptions provided in Section 674(b), (c), and (d) will not apply, so the general rule in Section 674(a) provided for grantor trust treatment would apply.

(2) Who Should Hold the Power? The exception to the exceptions in Sections 674(b), (c), and (d) applies if "any person" holds the power to add beneficiaries. Therefore, there is no limitation on who can hold the power as far as whether the power will result in grantor trust status. The general rule of Section 674(a), which triggers grantor trust treatment where there is a power of disposition over trust

property, applies only if the power of disposition is exercisable "by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." However, as long as a non-adverse party holds a power over dispositions, there is no requirement that the person who holds the power to add beneficiaries be a non-adverse party. However, a beneficiary should not hold the power to add non-charitable beneficiaries, or else gift consequences might result from its exercise.

(a) Grantor. The grantor should not hold the power to add beneficiaries because that retained power would cause the transfer to result in an incomplete gift. Treas. Reg. 25.2511-2(c)(f). In addition, the assets may be included in the grantor's estate under Sections 2036(a)(2) or 2038.

(b) Grantor's Spouse. The power could be held by the grantor's spouse without risking estate inclusion as long as no property is contributed to the trust by the spouse and as long as the spouse is not controlled by the grantor. (However, a successor holder of the power should be provided or else the death of the spouse could cause a termination of grantor trust status.)

(c) Beneficiary. The power to add beneficiaries should not be held by a beneficiary. An exercise of the power by a beneficiary might result in a deemed gift. Perhaps a gift would not result if the beneficiary merely has the power to add to the class of permissible beneficiaries but another trustee holds the power to make discretionary distributions to the added beneficiary.

(d) Trustee. The power to add beneficiaries is sometimes granted to the trustee of the trust. See Letter Rulings 199936031 (trustee who was a non-adverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date), 9709001 & 9010065 (independent trustee holds power to add charities as beneficiaries). Query whether fiduciary principles would place any constraint on the ability of the trustee to add a beneficiary. If the client would really like the prospect of adding charitable beneficiaries of the trust in certain circumstances, perhaps the instrument could give guidance to the trustee regarding the situations in which the trustee should particularly consider adding charitable beneficiaries. However, the instrument should not add objective standards that may likely never be satisfied before a charitable beneficiary could be added. A court might determine in that situation that no real ability to add charitable beneficiaries existed.

(3) Classes of Beneficiaries That May Be Added. The statute provides that the power to add beneficiaries "to provide for after-born or after-adopted children" would not cause grantor trust status. There appears to be no other limitations on the permissible class of added beneficiaries.

(a) Charities. Various cases and rulings have recognized grantor trust status where there is a power to add charities as beneficiaries. Eg. See Madorin v. Comm'r, 84 T.C. 667 (1985) (power of trustee to add charitable organizations causes grantor trust treatment); Ltr. Rulings 199936031 and 9709001. Another permissible way of limiting the types of charities that could be added would be to permit only the addition of charitable remainder trusts or charitable lead trusts with the grantor's issue as the noncharitable beneficiaries.

(b) Specified Classes of Individuals. The power could be granted so broadly as to permit adding any person as a permissible additional beneficiary. However, most grantors would be uncomfortable granting that broad of discretion to any individual. The permissible classes of additional beneficiaries could be limited in any manner desired by the grantor. For example, the power could be given to add members of a specific group, such as nieces and nephews, spouses of children, or more remote relatives. However, it is not clear that a power to "add" persons who are already contingent remote beneficiaries would be treated as a power to "add" beneficiaries that would trigger grantor trust treatment. "Adding" beneficiaries in that situation arguably just elevates their beneficiary

status, but really does not "add" them as beneficiaries.

(4) Special Power of Appointment. A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status. See Letter Ruling 9643013 (trustee for one trust and grantor's spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor's descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the §674(c) exception did not apply).

(5) Checks and Balances. Because of the very broad power granted to an individual to add beneficiaries, the grantor may feel more comfortable with a "checks and balances" system to assure that various individuals concur with the addition. (However, the consent of beneficiaries should not be required (because the actual grant of consent by beneficiaries may be a deemed gift)).

h. Summary of Selection of Trustee Issues With Respect to Grantor Trust Rules. **The trust will be a grantor trust if the trust may make distributions to the grantor or grantor's spouse (probably only as to trust income) or if premium payments may be made on life insurance on the life of the grantor or grantor's spouse (probably only as to the amount of premiums actually paid during the year.)**

If the planner wants to avoid grantor trust status, use one of the following exceptions. (1) Use an independent trustee (no more than half of whom are related or subordinate parties) and give them the authority to distribute assets among a designated class of beneficiaries. (2) Use a trustee other than the grantor or grantor's spouse, whose distribution powers are limited by a reasonably definite external standard. (3) With no limitation on who is the trustee—as to corpus use a reasonably definite distribution standard (or have separate shares for the beneficiaries), and as to income, either have (i) a vested trust for a single beneficiary, (ii) provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, or (iii) provide that on termination the assets may be appointed to appointees (other than the grantor or grantor's estate) if the trust is reasonably expected to terminate during the current beneficiary's lifetime. (4) Use an adverse party as trustee. Even if one of those exceptions is satisfied, also make sure the trust is not a foreign trust and that none of the proscribed administrative powers in Section 675 are present.

If the planner wants to trigger grantor trust status, use one (or more to be safe) of the following. (1) Select trustees and dispositive powers to flunk all of the exceptions in Section 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions. (2) Give a non-adverse party the power to add beneficiaries. (3) Give a non-adverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan. (4) Give the grantor a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case.)

4. Grantor Trust—Toggle Provisions.

a. Desirability of Flexibility. A grantor may be concerned with being liable for what could potentially be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to "turn off" the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to "toggle" grantor trust status could be achieved. For an excellent discussion of these issues, see Van Hoften, Planning With

Intentionally Defective Grantor Trusts, ALI-ABA Video Law Review 207 (March 26, 1997).

b. General Guidelines to Maximize Flexibility.

(1) Use Different Persons to Trigger Power Verses Right to Relinquish or Reacquire Power. If the grantor has the right to relinquish a power that causes grantor trust status but has the right to reacquire that power, the relinquishment would not be given effect. The regulations provide specifically that if the grantor has a power broad enough to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under Section 675, he will be treated as the owner of the portion from the trust's inception. Treas. Reg. §1.675-1(a). Therefore, at a minimum, if the grantor has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power (to toggle back "on" the grantor trust status.) Furthermore, the grantor's retention of the right to toggle grantor trust status might arguably constitute a Section 2036(a)(2) estate inclusion power or arguably result in an incomplete gift.

(2) Adverse or Non-Adverse Party Could Hold Power to Relinquish and Reinstate The Grantor Trust Power. Many of the grantor trust powers must be exercisable by a non adverse party in order to result in grantor trust status. However, the power to relinquish or reinstate a grantor trust power could be held by either an adverse party or a non-adverse party. (Non-adverse party status is only important for the person who holds the grantor trust power, and has no relevance to a person who has the authority to relinquish or reinstate that power.) An example of this is Letter Ruling 9010065, where the grantor's descendants (who were beneficiaries of the trust and, therefore, adverse parties) held the power to terminate the trustee's grantor trust power.

(3) Spouse Holding Power to Relinquish or Reacquire Grantor Trust Powers. The grantor's spouse could have the power to exercise the grantor trust power directly, or could be authorized to relinquish the grantor trust power. (This may be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor's spouse.) However, beware of Section 672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes. Accordingly, if the grantor's spouse is given the power to relinquish and to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

(4) Using Different Persons May Provide Helpful Checks and Balances. The powers used to result in grantor trust status may be very "powerful" powers. Giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers. Letter Ruling 9010065 illustrates an intricate checks and balances system. An unrelated trustee could add a qualified charity (which would cause grantor trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer's spouse (but if the spouse were not living, with the approval of the taxpayer's brother). Other parties (a majority of the taxpayer's adult descendants) were given the power to cut off grantor trust status by terminating the trustee's authority to designate additional beneficiaries.

(5) Relinquishment Should Address Whether it Binds Successors. The relinquishment of a grantor trust power should specifically indicate whether it is binding on successor trustees or successor persons holding the relinquishment power. Maximum flexibility could be retained by not having the relinquishment binding on all successors, so that a third party could reinstate the power. In that case, perhaps provide that the reinstatement power could only be exercised in a subsequent taxable year, to help clarify that the trust is not a grantor trust in the year in which the relevant power is relinquished.

c. Examples of Toggle Arrangements.

(1) Removal and Replacement Power of Trustees Where Power to Make Discretionary Distributions by Trustee Who is Not "Related or Subordinate" is Used to Cause Grantor Trust Status. The power of a trustee, more than half of whom are related or subordinate parties, to make discretionary distributions not covered by a reasonably external standard will result in grantor trust treatment as to the entire corpus and income of the trust. See section II.C.3.a. of this outline. A third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause more than half of the co-trustees to be related or subordinate parties (if grantor trust status was desired) or that would cause no more than one-half of the trustees as being related or subordinate parties (if grantor trust status was not desired.) The grantor should not hold the power to remove and replace successor trustees unless any such successor must be someone who is not a related or subordinate party in order to meet the "safe harbor" provided in Revenue Ruling 95-58, 1995-2 C.B. 191.

Using this mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee. If the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, it would be difficult to determine whether the next successor should be a related or subordinate party or not at the time that the trust agreement was prepared.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries.

(2) Third Party Having Authority to Cancel and Reinstate Substitution Power. Grantor trust status could be toggled by giving someone other than the grantor the right to cancel and reinstate a power of substitution under Section 675(4)(C).

(3) Power to Loan to Grantor Without Adequate Security. Either the trustee or the grantor could be given the authority to relinquish the trustee's power to make loans to the grantor without requiring adequate security. Someone other than the grantor could be given the power to reinstate the power to loan without adequate security. To provide additional checks and balances, different persons could be given the authority to terminate and reinstitute the power to lend without adequate security. However, if desired, a single person, who is not related or subordinate to the grantor (to put the grantor in the best position to argue that the power to lend without adequate security does not cause estate inclusion) could be given the power to both terminate and reinstate the lending power.

(4) Power to Add Beneficiaries. The person who is given the authority to add beneficiaries could also be given the authority to relinquish the right to add beneficiaries. If a potential toggle is desired, another party should be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries.)

III. BENEFICIARY TAX ISSUES

A. Gift Tax Issues.

1. Exercise of General Power of Appointment. Gift tax consequences for the beneficiary can arise if the beneficiary has a general power of appointment over the trust assets (meaning that the beneficiary has a power over the assets exercisable in favor of the beneficiary, his estate, his creditors, or the creditors of his estate.) I.R.C. § 2514 (c). In that case, if the beneficiary exercises the power, or releases the power, the beneficiary makes a taxable gift. I.R.C. § 2514(b). Accordingly, if a beneficiary ever has a general power of appointment over trust assets (perhaps through inadvertent inclusion of expansive discretionary distribution powers in a situation where the beneficiary at some point becomes the trustee), the beneficiary will have

not be able to divest himself of that power without being treated as making a transfer (if the power lapses during the beneficiary's lifetime, I.R.C. § 2514(b)) or as being included in the beneficiary's estate (if the beneficiary never releases the power, and dies holding the general power of appointment, I.R.C. § 2041(a)(2).)

While a release of the general power of appointment is treated as a transfer, whether it is a completed gift depends on whether the beneficiary still retains the power to shift benefits among a group of individuals. For example, assume the beneficiary is trustee and can make a discretionary distribution (with no standards) to a group of persons, including himself, and assume that he relinquishes the power to make a distribution to himself but can still make distributions among the remaining class of beneficiaries. No taxable gift has occurred, because "the possessor of the power has retained the right to designate the ultimate beneficiaries of the property over which he holds the power and since it is only the termination of such control which completes a gift." Treas. Reg. § 25.2514-3(c). See section II.A.3.a of this outline.

If the power holder retains a power that causes the gift to be incomplete, that retained power would cause estate inclusion under Section 2036 or 2038 if the power holder were the grantor. In that situation, Section 2041 includes the assets subject to that power at the decedent's death in the power holder's estate, the same as if the power holder still had the power to distribute the property to himself. I.R.C. § 2041(a)(2).

2. Exercise Limited Power of Appointment.

A limited power of appointment is the power to appoint property to a class of persons, which can be as broad as anyone other than the power holder, his estate, his creditors, or the creditors of his estate. If the person who holds the limited power of appointment over trust property is also a beneficiary of that trust, an exercise of the limited power of appointment to another individual reduces the pool of assets that might eventually be distributed to the beneficiary. In that circumstance, is the exercise of the limited power of appointment a gift? This is an important issue, because persons who hold limited powers of appointment over trust assets often are also beneficiaries.

a. Mandatory Income Interest. If the power holder also has a mandatory income interest in the trust, the Tax Court and the IRS maintain that a taxable gift occurs if the beneficiary/power holder exercises the limited power of appointment over a portion (or all) of the trust corpus. Estate of Regester v. Comm'r, 83 T.C. 1 (1984); Rev. Rul. 79-327, 1979-2 C.B. 342; Treas. Reg. § 25.2514-1(b)(2) The Court of Claims, in a 1956 case, concluded that no gift results in that situation. Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956). However, the IRS amended its regulations after the Self case to make its position clearer, and the regulations carry a presumption of correctness. See National Muffler Dealers Ass'n v. U.S., 440 U.S. 472, 477 (1979). See generally Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL.¶ 502.3 (1986).

b. Discretionary Beneficial Interest. If the power holder is merely a potential discretionary, and does not have a mandatory income interest, it is not clear at all that a gift should result from a lifetime exercise of the limited power of appointment to appoint some of the trust assets to others. Particularly if there are still some assets in the trust, the beneficiary/power holder may be able to receive as many distributions as a beneficiary that he would have received had the pool of assets not been depleted by the exercise of the power of appointment.

If the beneficiary/power holder is entitled to receive distributions under a HEMS standard, and if he exercises a limited power of appointment to appoint trust assets to his children, an example in the regulations says that there would be no taxable gift under Section 2514 (because the power to distribute to himself under the HEMS standard falls within the ascertainable standard exception, so a lapse of that right is not a gift under Section 2514.). Treas. Reg. § 25.2514-3(e) Ex. 2. However, the

regulation does not address whether the power holder has made a gift of the value of his right to distributions under the ascertainable standard under the general gift principles of Section 2511. See Henkel, Estate Planning and Wealth Preservation, ¶3.04[2] (2001).

The IRS has taken the position in private letter rulings that taxable gifts can result where the power holder who exercises a limited power of appointment is merely a discretionary beneficiary under the trust. Ltr. Ruls. 8535020 (IRS did not say how to value the gift); 9419007 (two daughters were beneficiaries of separate trusts and had power with a co-trustee to make distributions to herself with a HEMS standard; each daughter planned to appoint the trust assets to the other daughter; ruled that each daughter would make a gift of her right to receive HEMS distributions.)

Observe that this issue may not directly impact the selection of trustee issue—because the beneficiary/holder of the power of appointment may have the same potential gift tax consequences whether or not he or she is the trustee.

c. Summary. **If the instrument grants an inter vivos limited power of appointment to a trust beneficiary, the planner must recognize that the beneficiary will face this gift issue if he or she ever decides to appoint some or all of the trust assets during his lifetime. The gift tax issue could be avoided by giving the inter vivos power of appointment to someone other than the beneficiary. For example, the power of appointment might be granted to the beneficiary's spouse.**

3. Gift By Beneficiary If Fail to Exercise Rights.

If a beneficiary has ascertainable interests under the trust instrument, and if the beneficiary fails to enforce those rights, a taxable gift may result. See Dickman v. Comm'r, 465 U.S. 330 (1984) (failure to charge adequate interest on demand loan constituted continuing gift each year the loan remained outstanding); Snyder v. Comm'r, 93 T.C. 529, 546-47 (1989) (holder of preferred stock, which held a 7% noncumulative dividend had right to convert to another class of preferred that had a 7% cumulative dividend; held that annual failures to convert constituted continuing gifts to common shareholders of the preferred dividends that could have been paid by the corporation).

4. Gift if Beneficiary/Trustee Makes Distribution to Another Under Discretionary Standard.

A regulation indicates that a trustee with a beneficial interst in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a "reasonably fixed or ascertainable standard" (and the regulation goes on to give examples of standards that would qualify). Teas. Reg. § 25.2511-1(g)(2). The implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift would result.

For example, assume that Tom is trustee of a trust, and can makes distributions to himself for "health, support and maintenance." In addition, he can make distributions to his siblings for their "health, support, maintenance, or happiness." Under the regulations, distributions from Tom to his siblings appear to be a gift. The regulation applies to any trustee that has "a beneficial interest in trust property." (Indeed, that language would suggest that the same gift result might occur if the trustee is not a current potential beneficiary but only has a contingent remainder interest.) There have been no cases or rulings interpreting that regulation in this context. However, commentators have advised planners of the potential issue. E.g., Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 503.2 (1986). That commentator suggests including a "savings clause" provision in instruments providing "that no trustee shall have any discretionary power, other than a power described in Regulations Section 25.2511-1(g)(2), to pay to other than himself any trust property in which he personally has a beneficial interest." Id. at. ¶ 506, p. 5-70 (1986).

Planners often focus on limiting the trustee's ability to make distributions himself to only ascertainable standards, so that the trustee does not hold a general power of appointment. However, this regulation, if it is upheld, means that planners also need to limit the ability of trustees to make distributions for other beneficiaries to an ascertainable standard also if the trustee has any beneficial interest in the trust.

5. Gift if Beneficiary/Trustee Makes Distribution to Another Where Trustee's Determination "Is Conclusive".

Trust instruments sometimes attempt to protect a trustee against demands (and lawsuits) by beneficiaries to distributions by providing that "the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power" (or words to that effect.). The regulation addressed above specifically says that type of language means the distribution power is "not limited by a reasonably definite standard." Treas. Reg. § 25.2511-1(g)(2). Therefore, the possibility exists, under the regulation, that a distribution under that type of clause to a person other than the beneficiary-trustee would be treated as a gift.

6. Gift if Beneficiary/Trustee Fails To Makes a Distribution to Himself.

What if a beneficiary-trustee has the discretion to make distributions to himself within stated standards, and the trustee does not make any distributions to himself? Can the IRS argue that the trustee has a made a gift to the other beneficiaries? There are no cases where this issue has been raised. However, the possibility of the argument has been noted by commentators. See Pennell, Avoiding Tax Problems For Settlors and Trustees When An Individual Trustee is Chosen, EST. PL. 264, 271 (September 1982).

7. Summary of Application of Selection of Trustee to Gift Tax Issues.

Once a beneficiary becomes trustee or otherwise acquires a power that constitute a general power of appointment, there is a permanent taint that is difficult to shed. If the beneficiary realizes that there is a problem while he is still alive, getting rid of the problematic power generally will cause the beneficiary to make a completed gift for gift tax purposes (unless he still has the power to shift benefits among other beneficiaries.

In granting ascertainable distribution rights to beneficiaries, (including a trustee who is a beneficiary) realize that the IRS might conceivably argue for a gift if the beneficiary does not enforce his legal rights. If a trustee has any beneficial interest in the trust, the regulations say that the trustee makes a gift if he makes a distribution to other beneficiaries under a discretionary power to make distributions that is not limited by an ascertainable standard. To be safe, provide that any trustee who also has a beneficial interest in the trust is limited to a HEMS standard in making distributions to other beneficiaries as well as to himself and do not provide that the trustee's determination in that regard is "conclusive" (or other words to that same effect).

B. Estate Tax Issues—Dispositive Powers.

1. Section 2041—General Rules.

a. General Rule. If a decedent has at his death a "general power of appointment" over property , or if the decedent released or exercised the general power of appointment over property while retaining powers over the property that would cause the property to be included in his estate under Sections 2306-2038 if he were the grantor of such property, the decedent will have to include the trust property in his estate. I.R.C. § 2041(a)(2) (There are substantially different rules under Section 2041 for powers created on or before October 21, 1942 compared to powers created after that date. This outline only addresses powers created after October 21, 1942.)

Section 2041 applies to powers over property that do not cause estate inclusion under Sections 2036 to 2038. Treas. Reg. § 20.2041-1(b)(2). Therefore, powers of a grantor are analyzed under those Sections. Powers of individuals

other than the grantor are analyzed under Section 2041.

b. General Power of Appointment. An individual has a "general power of appointment" if he has the power to determine who (including himself) may become the owner of the property.

Under Section 2041, a decedent has a general power of appointment if he has a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; unless the power satisfies one of several important exceptions, discussed in the following subsections c-f below.

Sometimes he planner specifically wants to create a general power of appointment in a beneficiary (for example, to cause the trust assets to be included in the beneficiary's estate for estate tax purposes rather than being subject to the generation-skipping transfer tax.) Even though the general power of appointment is needed for some tax purpose, the settlor may wish to limit, as much as possible, the beneficiary's ability to divert the assets away from the settlor's family. The IRS has acknowledged that merely allowing exercise in favor of the creditors of the beneficiary's estate is sufficient to create a general power of appointment. E.g., Ltr. Rul. 8836023.

c. Ascertainable Standard Exception. If the power to consume, invade or appropriate property for the decedent is limited by an ascertainable standard relating to his health, education, support, or maintenance, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(A). This exception is addressed in detail in section III.B.4. of this outline below.

d. Joint Power—Exercisable With Grantor. If the power is exercisable only in conjunction with the creator of the power, it is not a general power of appointment. I.R.C. § 2041(b)(1)(B). (The policy behind this exception is that the creator of the power will likely have to include the property in his estate under Sections 2036 or 2038 if the grantor holds this power jointly with the power holder. See section II.B.3.d.(2-4) of this outline.)

e. Joint Power—Exercisable With Person With Adverse Interest. If the power is exercisable only in conjunction with a person who has a "substantial interest" in the property which is adverse to the exercise of the power in favor of the decedent, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(C)(ii).

As to the "substantial" requirement, the regulations merely say that an interest is substantial if its value in relation to the total value of the property subject to the power is "not insignificant." Treas. Reg. § 20.2041-3(c)(2). The IRS has ruled privately that the actuarial value of the interest of the other party must be at least five percent of the trust's value to be "substantial." Ltr. Rul. 8911028

The regulations provide several examples of "adverse" interests. A taker in default of exercise of the power is an adverse party. Treas. Reg. § 20.2041-3(c)(2). In addition, a coholder has an adverse interest if the coholder may possess the power to appoint the property to himself after the decedent's death. I.R.C. § 2041(b)(1)(C)(2); Treas. Reg. § 20.2041-3(c)(2).

A person is not adverse merely because he is a coholder of the power or because he is a potential appointee under the decedent's power. Id.; Miller v. U.S., 387 F.2d 866 (3rd Cir. 1968); Estate of Towle v. Commissioner, 54 T.C. 368 (1970). A person is not adverse just because he is a trustee of the trust. Miller v. U.S., 387 F.2d 866, 869-70 (3rd Cir. 1968); Rev. Rul. 82-156, 1982-2 C.B. 216. Furthermore, naming the spouse of a person who would have an adverse interest does not satisfy the adverse party requirement—because the spouse has no chance for direct personal benefit from the property. Stephens, Maxfield, Lind & Calfree, Federal Est. & Gift Tax'n ¶4.13[4][c] (2001).

f. Joint Power-Exercisable With Person Who is Potential Appointee. A coholder of a power of appointment who is a potential appointee under the decedent's power of appointment does not have an adverse interest, for purposes of the prior exception. However, a further exception applies in that situation. In that situation, each

of the coholders could, in conjunction with the other, appoint the property to himself. In that situation, each coholder of the power is deemed to have a general power of appointment as to a fractional part of the property. The fractional part is based on the number of persons (including the decedent) in whose favor the power is exercisable. I.R.C. §2041((b)(1)(C)(iii). This rule is based on a self-interest concept. Conceivably, each person would give consent to the other person's exercise of the power only if the power is exercised in favor of all such persons equally. Thus, if three persons must join in the exercise only one-third of the value of the property would be included in the first decedent's estate.

g. Other Joint Powers. Powers of appointment which must be exercised in conjunction with any other person (not described in the prior three subsections) do not fall within an exception, and the decedent will be treated as having a general power of appointment even though the decedent cannot control the exercise of the power.

Section 2041 uses very similar language as Sections 2036 and 2038 in referring to powers exercised "in conjunction with another person." Accordingly, the conclusions reached by cases addressing the effects of joint powers by those Sections should apply to Section 2041. For example, it is sufficient that the other person must merely consent to exercise of the power; it is not required that the other person be able to initiate an exercise of the power (assuming both coholders agree). However, in that situation, the person who must merely consent to the exercise of the power by someone else is not elevated to the position of a coholder of the general power of appointment, so the fractional inclusion rule does not apply. Rev. Rul. 79-63, 79-1 C.B. 302 (at any time during the decedent's lifetime the decedent, with the consent of A, one of the decedent's children, could direct the trustees to distribute all or any part of the trust property to anyone, including the decedent).

h. Contingent General Powers of Appointment. If the existence of the power is by its terms contingent upon an event that did not occur before the decedent's death, it is not a power "which the decedent has at the time of his death"—which is a requirement for estate inclusion under Section 2041. "For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred." Treas. Reg. § 20.2041-3(b). If, however, the occurrence of the contingency was within the decedent's control prior to his death, he is deemed to have possessed the power even though he did not actually trigger the condition. Estate of Kurz v. Comm'r, 68 F.3d 1027, 1030 (7th Cir. 1995) (decedent had power to withdraw 5% of family trust only if she first withdrew all of the marital trust; "the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment"). Kurz relied, in part, on the first sentence of regulation § 20.2041-3(b), which provides that the power is considered to exist on the date of death even though the exercise of the power is subject to the precedent giving of notice.

Under this same principle, the IRS has taken the position that the mere fact that a testamentary trust was not funded and the decedent had not accepted office as trustee, under which he would have the power to make distributions for his "reasonable comfort" or "best interests," did not preclude the decedent from being deemed to have a general power of appointment at his death. Tech. Adv. Memo. 9125002. The IRS reasoned that under local law, an interest in property established by a will takes effect at the time of death unless the will provides otherwise. See Treas. Reg. § 20.2041-1(e) ("power of appointment created by will is, in general, considered as created on the date of the testator's death"). In Estate of Bagley v. United States, 443 F.2d 1266 (5th Cir. 1971) (husband and wife were killed in automobile accident; husband's will said wife would be deemed to survive in a common accident and gave wife a

general power of appointment over property to qualify for marital deduction; wife's estate argued it did not have a general power of appointment because will had not been probated at time of her death; held, that power of appointment existed in the theoretical instant in which wife survived husband.)

The effect of these rules regarding contingencies is that once conditions have occurred such that a beneficiary is qualified to accept office as trustee (with overly broad distribution powers), the beneficiary has a general power of appointment. The beneficiary cannot avoid the general power of appointment taint by merely declining to accept office as trustee. However, a power holder may "disclaim" a power, and not be considered as having released the power, if the requirements of Section 2518 are met. Treas. Reg. § 20.2041-3(d)(6)(i), referencing Reg. § 25.2518-2(c)(3); see Ltr. Rul. 9521032. An attempt to disclaim a general power of appointment by limiting it to a limited power to appoint to others, or by limiting it to an ascertainable standard may not be recognized. Ltr. Rul. 8149009; Goudy v. United States, 86-2 USTC ¶ 13,690 (D. Ore. 1986), *revd. in unpub. opinion* (9th Cir. 1988); Treas. Reg. § 20.2041-3(d)(6). Under Section 2518, the power holder generally must disclaim the power within nine months after the transfer creating the power. Treas. Reg. § 25.2518-2(c)(3).

i. Effect of Incompetency of Power Holder. The incompetency of the power holder at the time of death does not nullify the power of appointment for purposes of Section 2041. E.g., Estate of Gilchrist v. Comm'r, 630 F.2d 1213 (5th Cir. 1980, *cert. denied* 446 U.S. 918; Williams v. U.S.. 634 F.2d 894 (5th Cir. 1981); Estate of Rosenblatt v. Comm'r, 633 F.2d 176 (10th Cir. 1980); Estate of Alperstein v. Comm'r, 613 F.2d 1213 (2d Cir. 1979), *cert. denied* 446 U.S. 918 (1980). The fact that the decedent was incompetent from the time that the power arose until his subsequent death has not mattered in various cases. E.g., Estate of Alperstein v. Comm'r, 613 F.2d 1213 (2d Cir. 1979), *cert. denied* 446 U.S. 918 (1980). Estate of Bagley v. United States, 443 F.2d 1266 (5th Cir. 1971); Pennsylvania Bank & Trust Co. v. United States, 451 F.Supp. 1296 (W.D. Pa. 1978).

j. Reciprocal Powers. The IRS applied an analogy of the reciprocal trust doctrine to general powers of appointment in private letter ruling 9235025. By analogy to that doctrine, where beneficiaries of two trusts can appoint property to each other, unrestricted by an ascertainable standard, the IRS stated that the trusts would be uncrossed, and each beneficiary would be considered to have a general power of appointment over the trust of which he is a beneficiary. In that ruling, the IRS cited Matter of Spear, Jr., 553 N.Y.S.2d 985 (Sur. Ct. 1990), in which the court adopted the reciprocal trust theory to find that trust beneficiaries had general power of appointments to qualify for the "Gallo exemption" that was available for GST purposes prior to 1990. The IRS again observed that the possible application of the reciprocal trust theory to powers of appointment in private letter ruling 9451059. In that ruling, the settlors' two daughters had a power to appoint the trust property to any descendant of the settlor other than herself, including the other daughter. While noting the potential application of the theory, the IRS concluded that the particular factual situation did not justify its application.

2. Independent Trustee With Complete Discretion.

a. General Rule—No General Power of Appointment. If a trustee is someone other than a beneficiary, Section 2041 generally will not apply to the beneficiary, even if the trustee has very broad discretion in making distributions to the beneficiary. For example, in the Estate of Estate of Cox, 59 T.C. 825 (1973), *acq*., 1973-2 C.B. 1, the court held that, under Texas law, the income beneficiary did not hold a power of invasion or appointment with respect to a testamentary trust that provided the trustee (the testator's son) was to have the 'sole and exclusive right of management' of the trust property, and that if the income was insufficient to comfortably and adequately supply the beneficiary with all comfort and necessities, then the beneficiary's comfort and necessities were to be provided for by the trustee selling trust assets.

In reaching its decision that the trustee and not the beneficiary had the power of appointment or invasion, the court determined that neither the words of the will nor the extrinsic evidence indicated an intent by the testator to grant such a power to the income beneficiary. It thus decided that to attribute to the beneficiary an implied power of invasion would be inconsistent with the testator's intent and with the will provision expressly granting the trustee 'sole and exclusive' management powers.

The IRS addressed this issue in detail in Revenue Ruling 76-368, 1976-2 C.B. 271, and concluded that an invasion power that is not limited by an ascertainable standard that is held by independent trustee, cannot be imputed to the decedent so as to render the power taxable in the decedent's gross estate under Section 2041. In the facts of that ruling, the trustee, an independent bank, was authorized to invade the trust corpus and pay portions thereof to or for the use and benefit of the decedent in such manner as the trustee, in its sole and unfettered discretion, deemed advisable should the decedent be in need of funds in excess of the trust income for 'health, comfort, maintenance, welfare, or for any other purpose or purposes.' The trustee was directed to liberally exercise its discretionary power of invasion. Prior to the decedent's death in 1976, numerous requests had been made to the trustee for additional funds and all such requests of the decedent had been honored by the trustee. The ruling pointed to various cases holding that an independent trustee's powers should not be imputed to a beneficiary.

b. Power to Bring Judicial Action to Compel Trustee to Make Distributions. The fact that a beneficiary might be able to go to court and force a trustee to make distributions within a broad standard does not mean that the beneficiary has a general power of appointment. The IRS made that very argument in Security-Peoples Trust Co. v. U.S., 238 F. Supp. 40, 46 (W.D. Pa. 1965). The IRS in that case argued that under Pennsylvania law, the beneficiary could compel the trustee to distribute principal under the "health, comfort, maintenance or welfare" standard, and thus could control the disposition of the trust property. The court rejected the IRS's argument, and pointed out that the trustee alone held the power to distribute and that this power could not be imputed to the beneficiary.

The IRS agreed that it would not pursue making this argument in the future in Revenue Ruling 76-368, 1976-2 C.B. 271. The IRS specifically pointed to the Security-Peoples decision in support of its conclusion that the power of an independent trustee could not be imputed to the beneficiary. In that ruling, the IRS acknowledged directly that a beneficiary could bring a lawsuit had the trustee, in the judgment of the decedent, failed to liberally exercise its discretionary power of invasion on the decedent's behalf. However, the IRS concluded that this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary of the trust. Rev. Rul.76-368,

That is to be distinguished, however, from a situation in which a beneficiary has a power under the terms of the trust instrument to direct the trustee to make distributions to the beneficiary. See Tech. Adv. Memo. 8606002.

c. Giving Trustee Extremely Broad Discretion. A settlor with spendthrift children may wish to utilize extremely broad standards, or even no standards at all, but instead leave the trustee with extremely broad discretion to determine when to make (and not make) distributions. See section I.F. of this outline. Giving the trustee extremely broad discretion does not endanger Section 2041 inclusion. The IRS specifically addressed that issue in Revenue Ruling 76-368, 1976-2 C.B. 271. Under the facts of that ruling, the bank-trustee was authorized to invade the trust corpus for the use and benefit of the decedent in such manner as the trustee, in its sole and unfettered discretion, deemed advisable should the decedent be in need of funds in excess of the trust income for 'health, comfort, maintenance, welfare, or for any other purpose or purposes.' The Ruling's reasoning saw no problem with giving such broad discretion to the trustee. In fact, that extremely broad discretion helps thwart any possible argument that the beneficiary has

control to force distributions to himself by bringing a court action to force distributions.

Even if the trust instrument purports to give the trustee "sole and uncontrolled discretion" and provides that the trustee's decisions will be "final and conclusive," there are cases indicating that the trustee's discretion is still not absolute. Lucas v. Lucas, 365 S.W.2d 372, 376 (Tex. Civ. App.—Beaumont 1962, no writ). Courts may intervene if the trustee acts "outside the bounds of a reasonable judgment." To determine that, the test is ether the trustee acts "in that state of mind in which the settlor contemplated that it should act." First National Bank of Beaumont v. Howard, 229 S.W.2d 781, 784-85 (Tex. 1950).

3. Beneficiary as Co-Trustee.

Naming the beneficiary as a co-trustee does not help at all in avoiding Section 2041 if the co-trustees have the authority to make distributions to the beneficiary that are not subject to an ascertainable standard. See section III.B.1.g. of this outline.

Naming a co-trustee to serve with the beneficiary, however, can be very helpful if the trust instrument restricts the beneficiary/co-trustee form participating in any decision to make distributions to himself beyond an ascertainable HEMS standard. As long as the beneficiary has no right to succeed to the powers held by that co-trustee, the broad distribution powers of the co-trustee will not be imputed to the beneficiary.

Indeed, it is wise to use a "savings clause" that automatically restricts the beneficiary from taking any actions that might possible be construed as a personal benefit, unless those actions are limited by a HEMS standard, and to provide that any such actions would be taken only by the co- trustee. If no co-trustee is acting, the beneficiary/trustee could take steps to have the next successor trustee appointed as a co-trustee for the sole purpose of making that decision. See Section IV of this outline.

4. Beneficiary as Trustee—Distributions to Self as Beneficiary.

The practical difficulty of applying Section 2041 in practice comes in the very common situation where the settlor wishes to name a beneficiary as trustee and give the beneficiary the authority to make distributions to himself.

a. Ascertainable Standard Exception. As discussed above, there is an exception in the statutory language of Section for "a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent." I.R.C. § 2041(b)(1)(A). (This is unlike Sections 2036 and 2038, which contain no ascertainable standard exception in the statute. But that has not deterred the courts in fashioning an ascertainable standard exception for those sections also.)

b. Regulations. The regulations give a variety of detailed examples of language that constitutes an ascertainable standard:

"A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words 'support' and 'maintenance' are synonymous and their meaning is not limited to the bare necessities of life. … Examples of powers which are limited by the requisite standard are powers which are limited by the requisite standard are powers exercisable for the holder's 'support,' 'support in reasonable comfort,' 'maintenance in health and reasonable comfort,' 'support in his accustomed manner of living,' 'education, including college and professional education' 'health,' and 'medical , dental, hospital and nursing expenses and expenses of invalidism.'" Treas. Reg. § 20.2041-1(c)(2).

The regulation also gives the following examples of standards that do not constitute an ascertainable standard:

"A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard." Id.

c. Slight Difference in Language Can Be Critical. A very slight difference in language may produce a different result. For example, in Estate of Vissering v. Comm'r, the trustee authorized distributions "required for the continued comfort" of the beneficiary, as well as other standards. 990 F.2d 578 (10th Cir. 1994), *rev'g*, 96 T.C. 749 (1991). The Tenth Circuit acknowledged that the use of the word "comfort," without further qualifying language, creates a general power of appointment. However, the trust language puts a limit on this word, saying it permits distributions only as "required", not as "determined" or "desired." Furthermore, the court observed that the invasion must be for the beneficiary's "continued" comfort, implying amounts reasonably necessary to maintain the accustomed standard of living. The Court concluded that such words did not constitute a general power of appointment.

When the stated standards differ from the safe harbor standards described in the regulation, it is often impossible to rationalize results that have been reached in varying cases. For example, in Whelan v. U.S., the court held that an invasion power "for the **reasonable support, care and comfort** of such beneficiary" constituted an ascertainable standard. 81-1 USTC ¶ 13,393 (S.D. Cal. 1981). Seven years earlier, the very same court held that a standard permitting invasion of corpus for "**reasonable care, comfort and support**" was not an ascertainable standard. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974).

Another example of the impossibility of rationally categorizing the cases based on the language in the instrument is Brantingham v. U.S., 631 F.2d 542 (7th Cir. 1980). The decedent's will contained a provision stating that "my wife shall have and is hereby given the **uncontrolled right**, power and authority to use and devote such of the corpus thereof from time to time as in their judgment is necessary for her maintenance, **comfort and happiness**." Those words are typically held not to constitute an ascertainable standard. However, the court analyzed Massachusetts law, and concluded that this language constituted an ascertainable standard. The IRS has indicated that it will not follow the Brantingham case. Rev. Rul. 82-63, 1982-1 C.B. 135.

The Vissering case and the combination of the Whelan and Tucker cases illustrate the extreme danger in modifying, even slightly, the standards given as safe harbor language in the regulations. The Brantingham case illustrates that using some of the magic "bad" words may nevertheless be sanctioned by a court, but one certainly cannot rely on such a result.

d. Two-Fold Analysis Approach; Combination of Clauses and Total Context of Standards Control, Not Presence of Single Words. One commentator has suggested applying a two level analysis. The courts have reviewed trust instruments in their entirety rather than just focusing on "magic" words that are or are not present. First, are the powers of invasion of trust assets limited to ascertainable standards related to the beneficiaries' health, education, support or maintenance, thus bringing the trust assets within the safe harbor language of Section 2041(b)(1)(A)? Second, are the standards expanded (or restricted) elsewhere in the trust documents? See Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990).

A detailed compilation of cases that have addressed the ascertainable standard exception under Section 2041 are contained in several differing articles. See Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 247-49 (1981) (chart compilation of cases and rulings); Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt. Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990) (chart summarizing cases under Sections 2036 and 2038 and separate chart summarizing cases under Section 2041).

e. Summary of Standards that Typically Are Not Ascertainable. While there is no uniform consistency in the cases, courts have typically found certain words not to be ascertainable:

"For example, the federal courts have repeated concluded that the presence of any of the condemned, operative words—'welfare and 'happiness'—prevents a standard from being ascertainable. Other synonymous words and phrases *not* limited to an ascertainable standard include: 'well-being,' 'benefit,' 'use and benefit of,' 'enjoyment,' 'pleasure,' 'as she may require,' 'as she may see fit,' 'business purpose,' and 'any purpose whatsoever.'" Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 244 (1981).

f. Example Cases and Rulings Finding Ascertainable Standard Exists. The following is a sampling of some of the cases and rulings that have found that an ascertainable standard exists. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974) "reasonable care, comfort, and support"); Estate of Vissering v. Comm'r, 990 F.2d 578 (10th Cir. 1994) ("required for the continued comfort"); Martin v. U.S., 780 F.2d 1147, 1150 (4th Cir. 1986) ("[i]n the event of the illness of Theo N. Martin or other emergency"; court said clear that IRS argument "was a loser", and if argument was not "frivolous" before, it became so after Sowell decision of Tenth Circuit was issued); Finlay v. U.S., 752 F.2d 246 (6th Cir. 1985) ("right to encroach if she desires"); De Oliveira, Jr. v. U.S., 767 F.2d 1344 (9th Cir. 1985) ("for the benefit of"); Sowell v. Comm'r, 708 F.2d 1564 (10th Cir. 1983) ("in case of emergency or illness"); Pittsfield Nat'l Bank v. U.S., 181 F. Supp. 851 (D.C. Mass 1960) ("as he may from time to time request, he to be the sole judge of his needs"); Estate of Anderson v. U.S., 96-1 USTC ¶ 60,223 (D. Neb. 1995) ("reasonably necessary for … comfort, support and maintenance") Hunter v. U.S., 597 F. Supp. 1293 (W.D. Pa. 1984) ("should any emergency arise"); Estate of Strauss v. Comm'r, 69 TCM 2825 (1995) ("care and comfort, considering his standard of living as of the date of … death"); Estate of Duvall v. Comm'r, 66 T.C.M. 164 (1993) ("to do as she pleases"); Whelan v. U.S., 81-1 USTC ¶ 13,393 (S.D. Cal. 1981)("reasonable support, care and comfort"); Rev. Rul. 78-398 ("'"maintenance and medical care"); Ltr. Rul. 9203047 ("maintenance, support and comfort, in order to defray expenses incurred by reason of sickness, accidents, and disability").

The IRS has been surprising lenient in a number of private letter rulings in interpreting standards to come within the ascertainable standard requirement. E.g., Ltr. Ruls. 200028008 (construing reference to "other emergency" following an ascertainable standard as limited to the type of emergency covered by that standard); 200013012 ("actual living expenses only"); 9728023 ("comfortable" modified "support and maintenance"); 9713008 (treats "care" equivalent to "support"); 9516051 (such distributions as the trustee deemed requisite or desirable under the circumstances if the trust income were insufficient to met the beneficiary's reasonable needs); 9203047 (reference to "comfort" is qualified by other language limiting payment to medical costs); 9012053 ("to relieve emergencies affecting" beneficiaries; power to invade for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of Martin v. U.S. decision).

g. Example Cases and Rulings Finding That Ascertainable Standard Does Not Exist. Miller v. U.S. 387 F.2d 866 (3rd Cir. 1968) ("proper maintenance, support, medical care, hospitalization, or other expenses incidental to her comfort and well-being"); Strite v. McGinnes, 330 F.2d 234 (3rd Cir. 1964) ("reasonable needs and proper expenses or the benefit or comfort" of beneficiaries); Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985) (one paragraph of the will authorized distributions "for her own proper maintenance;" that paragraph was nullified by more expansive powers in the next paragraph to use the assets "for whatever purpose she desires"); First Virginia Bank v. U.S., 490 F.2d 532 (4th Cir. 1974) ("right to dispose, sell, trade, or use (the stock) during her lifetime for her comfort and care as she may see fit"); Doyle v. U.S., 358 F. Supp. 300 (E.D. Pa.

1973) ("comfort, maintenance and support"); Estate of Jones v. Comm'r, 56 T.C. 35 (1971) ("”in cases of emergency, or in situations affecting her care, maintenance, health, welfare and well-being;" court says that words "comfort" and "well-being" and "comfort, welfare or happiness" are not ascertainable); Lehman v. U.S., 448 F.2d 1318 (5th Cir. 1971) (holder of life estate could "consume, invade, or appropriate" the corpus for her "support, maintenance, comfort and welfare,"); Hyde v. U.S., 950 F. Supp. 418 (D. NH 1996) ("as in her sole discretion shall be necessary and desirable"; court rejected taxpayer's argument that the power was limited to emergencies) Estate of Schlotterer v. U.S., 421 F. Supp. 85 (W.D. Pa. 1976) ("comfort and pleasure"; court focused on "pleasure" saying it is synonymous with gratification, enjoyment and pursuit of happiness); Forsee v. U.S., 2001-1 USTC ¶ 60,393 (D. Kan. 1999) ("happiness, health, support and maintenance"); Renfro v. U.S., 78-1 USTC ¶ 13,241 (E.D. Tx. 1978) (holder of life estate could "sell, mortgage or otherwise dispose of such property at such times and on such terms as to her may seem proper"); Franz v. U.S., 77-1 USTC ¶ 13,182 (E.D. Ky. 1977) ("care, maintenance and welfare", stating "one cannot escape the import of the word 'welfare' as being 'very broad' and indicating 'the extent of the discretion given to the trustee'"); Stafford v. U.S., 236 F. Supp. 132 (E.D. Wis. 1964) ("use and enjoy the principal … for his care, comfort, and enjoyment"); Estate of Little v. Comm'r, 87 T.C. 599 (1986) ("proper support, maintenance, welfare, health and general happiness in the manner to which he [was] accustomed at the time of the death of [his wife];" court reasoned that standard did not relate just to HEMS, giving example of travel as an unrelated item to HEMS that might have been permissible under the standard in the agreement); Estate of Penner, 67 T.C. 864 (1977) ("business purpose"); Estate of Lanigan v. Comm'r, 45 T.C. 247 (1965) ("use and benefit"); Estate of Beyer v. Comm'r, T.C. Memo 1974-24 ("sole discretion … for any purpose whatsoever"); Rev. Rul. 82-63, 1982-1 C.B. 135 ("maintenance, comfort, and happiness"); Rev. Rul. 77-194, 1077-1 C.B. 283 ("proper comfort and welfare"); Rev. Rul. 77-60, 1077-1 C.B. 282 ("as desired to continue an accustomed standard of living"); Rev. Rul. 76-547 ("health, care, maintenance, and enjoyment"); Ltr. Rul. 9344004 ("comfort," "happiness," and "welfare"); Ltr. Rul. 9318002 (("comfort," "happiness," and "welfare"; ruling subsequently revoked without explanation by Letter Ruling 9510001); Tech. Adv. Memo. 9344004 ("health, maintenance, support, comfort, and welfare at the standard of living to which he had become accustomed", applying Texas law); Ltr. Rul. 9125002 ("reasonable comfort, best interest, and welfare"); Ltr. Rul. 9113026 ("care, support, maintenance, and welfare"); Ltr. Rul. 9030032 ("”if that spouse's income from other sources is not sufficient for the surviving souse's 'support and comfort in the manner in which she was accustomed'", reasoning that "support in reasonable comfort" is an ascertainable standard while "comfort" standing alone is not); Tech. Adv. Memo. 8606002 (provision for distributions for ascertainable standard, coupled with power to distribute for "emergency needs"); Tech. Adv. Memo. 8304009 ("any great emergencies which may arise in the lives and affairs … such as extra needed medical services or hospitalization"); Ltr. Rul. 7841006 ("emergency"); Ltr. Rul 7812060 ("as may be necessary for the well-being of my son")

h. Rulings Related to Standard of Living. The Regulations provide that "support in his accustomed manner of living" is an ascertainable standard. Treas. Reg. § 20.2041-1(c)(2). The following cases and rulings have held that references to a standard of living constituted an ascertainable standard. Estate of Vissering v. Comm'r, 990 F.2d. 578 (10th Cir. 1994) ("continued comfort" implies amounts reasonable necessary to maintain the accustomed standard of living); Estate of Klafter v. Comm'r, 32 T.C.M. 1088 (1973) (discretion to distribute income "to maintain [beneficiary's] standard of living in the style to which she has been accustomed" is an ascertainable standard under Section 2036); Ltr. Ruls. 9036048 ("determines to be advisable, considering resources otherwise available to them . . . to provide for their health, education, support and maintenance in the manner of living to which they have become accustomed"); 7836008 ("reasonable health,

education, support and maintenance needs consistent with a high standard and quality of living"); 7914036 ("to maintain the standard of living to which he or she was accustomed during the lifetime of the first of us to die, at and immediately prior to the time of the death of the first of us to die"; ruling reasoned that "accustomed standard of living" alone is not sufficient, but here, the word "maintain" tied the standard to one of the four HEMS standards).

The following rulings have held that references to a standard of living did **not** constitute an ascertainable standard. Rev. Rul. 77-60, 1977-1 C.B. 282 ("continue an accustomed standard of living" without further restriction is not ascertainable); Ltr. Rul. 8339004 ("to provide comfortably for his wants according to the style of living which we have enjoyed").

i. Rulings Related to "Emergency" Standard. For gift tax purposes, Regulation § 25.2511-1(g)(2) refers to a "reasonably fixed or ascertainable standard." In an example, that Regulation states that "a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living' *or to meet an emergency*, would be such a standard." Based on this language in the gift tax regulations, one would assume that an "emergency" standard would be treated as an ascertainable standard for purposes of Section 2041. Nevertheless, the IRS maintains (and has been successful in persuading some courts) that a distribution standard based on "emergency" relates to the "timeliness" of a distribution, not to need in terms of health, education, support, maintenance, or other ascertainable standards, and thus does not qualify as an ascertainable standard for purposes of Sections 2041 and 2514. E.g., Tech. Adv. Memo. 8606002 (provision for distributions for ascertainable standard, coupled with power to distribute for "emergency needs"); Tech. Adv. Memo. 8304009 ("any great emergencies which may arise in the lives and affairs … such as extra needed medical services or hospitalization"); Ltr. Rul. 7841006 ("emergency").

j. Possibility of Reformation. If a "bad" word is included in the standard, there may be a possibility of reforming the instrument based on mistake. E.g., Ltr. Ruls. 200144018 (inclusion of reference to "welfare" was mistake; reformation to delete that word did not result in release of general power of appointment); 200024015; 199936029.

k. Effect of Providing that Trustee Must/May Consider Outside Resources. A provision that the trustee either should or should not or may consider the beneficiary's outside resources in determining whether to make distributions under a standard that comes within the ascertainable standard should not have any effect on that decision. See Ltr. Rul. 9036048 ("determines to be advisable, considering resources otherwise available to them . . . to provide for their health, education, support and maintenance in the manner of living to which they have become accustomed").

l. Small Trust Termination Provision. A provision giving the trustee the authority to terminate the trust and distribute to the current income beneficiaries (which could include the trustee individually) may create a general power of appointment. Often such clauses are sometimes restricted so that they can only be exercised if the trust reaches an objective small amount. If that is the case, the general power of appointment probably would not arise until the trust diminishes to that size limit, at which time the power could be exercised. See section III.B.1.h of this outline. The IRS has ruled that the power of a trustee-beneficiary to terminate under very limited circumstances would not create a general power of appointment. Tech. Adv. Memo. 8606002. If an objective formula is not used, the trustee-beneficiary is at risk as to whether, in the exercise of its fiduciary capacity, it would have actually have the power in existence at the time of his death. See generally Pennell, Avoiding Tax Problems For Settlors and Trustees When An Individual Trustee is Chosen, EST. PL. 264, 271-72 (September 1982) ("Accordingly, when a beneficiary is acting as trustee, the provision ought to be set to a clearly specified dollar amount. In the alternative, the determination of when

termination may occur should be given to some other party.").

m. State Laws Limiting Discretionary Distributions for Self to an Ascertainable Standard. Various states have enacted laws that automatically restrict standards for distributions from trustees to themselves individually.

The New York statue contains an absolute prohibition against a trustee exercising a discretionary distribution power in favor of itself. N.Y. CLS EPTL § 10-10.1.

Other states apply the prohibition only if the distribution power in the instrument is not limited by an ascertainable standard relating to the health, education, maintenance or support of the power holder. ALASKA STAT. § 13.36.153; CONN. GEN. STAT.. § 45a-487(b); FLA. STAT. § 737.402(4)(a); MINN. STAT. § 501B.14; UTAH CODE § 75-7-41-(1);W. VA. CODE § 44-5-13. The Florida statute gives the trustees and beneficiaries of existing trusts the right to opt out of the statute, for fear that the prohibition in the statute would cause a lapse of a general power of appointment by trustee-beneficiaries who formerly had unlimited discretion to make distributions to themselves. However, the IRS subsequently ruled that the Florida statute would not be treated as causing the lapse of a power of appointment. Rev. Proc. 94-44, 1994-2 C.B. 683.

Several states have statutory provisions permitting trustees to exercise discretionary distribution powers in favor of themselves, but the statutes cut back the power to one that may be exercised only to make distributions for the power holders' health, education, support or maintenance. D.C. CODE § 21-1722; MD. CODE § 14-109; N.J. STAT. § 3B:11-4.1, PA. CONS. STAT. § 7504.

Some of the statutes also address other issues than just restricting distributions to the trustee-beneficiary. An example is the Utah Code provision. It also (1) restricts discretionary allocations of receipts and disbursement between income and principal, unless the trustee acts in a fiduciary capacity where he has no power to enlarge or shift a beneficial interest except as an incidental consequence of the discharge or his fiduciary duties; (2) restricts making or obtaining discretionary distributions to satisfy his legal obligations; and (3) restricts any powers that indirectly permits control over those other issues, including the right to remove and replace the trustee. The Utah statute makes clear that it does not apply to (1) revocable trusts, (2) a settlor's spouse as beneficiary of a marital trust, (3) distributions within an HEMS standard, or (4) powers "clearly intended" to be general powers. Also, it provides that if any restricted power is held by two or more trustees, it may be exercised by the trustee who is not disqualified. If there is no acting co-trustee, the restricted power may be exercised by a trustee appointed under the appointment provisions of the trust instrument or by a court.

Cases have recognized the effectiveness of such state laws in preventing a beneficiary from acquiring a general power of appointment. E.g., Sheedy v. U.S., 691 F. Supp. 1187 (E.D. Wis. 1988).

There have been discussions of adopting such a law in Texas, but the response so far has been not to, for concern that the settlor may have really intended the beneficiary-trustee to be able to make distributions for himself beyond just providing for the beneficiary's HEMS (for example, to provide medical expenses of the beneficiary's child). As the estate tax exemption amount increases, fewer and fewer people will be subject to the estate tax, and there is a concern that the legislature should not be re-writing the trusts of individuals without extraordinarily compelling reasons to do so.

5. Beneficiary as Trustee—Effect of Authority to Satisfy Trustee's Support Obligations; The *Upjohn* Issue.

a. Regulations—Power to Discharge Decedent's Obligation is Power Exercisable in Favor of Decedent. The regulations provide that a power to satisfy the decedent's obligation is treated as a power exercisable in favor of the decedent:

"A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent … is considered a power of appointment exercisable in favor of the decedent or his creditors." Treas. Reg. § 20.2041-1(c)(1). See also Treas. Reg. § 25-2514-1(c)(1).

Therefore, if a trustee has the power to make a distribution that satisfies any of his obligations, the trustee is deemed by the regulations to have a power to distribute to himself. Thus, **although the trustee is not a beneficiary at all** under the trust, power of appointment problems for the trustee can still arise if any person that the trustee owes legal obligations to is a beneficiary.

b. The Illogical Disconnect. A trustee may have the power to distribute property to himself for his support and he does not have a general power of appointment. But the trustee may not possess the very same power to make distributions to his minor children for their support. The reason is that the power to satisfy the trustee's obligations is treated as a power to distribute to the trustee. Therefore, that power is a general power of appointment, unless it meets the ascertainable standard exception. The ascertainable standard exception, however, requires that the power be related to the power holder's "… support." Because the power is related to the child's support and not the support of the trustee, it is not limited by an ascertainable standard. The IRS concurs with this analysis. See Rev. Rul. 79-154, 1979-1 C.B. 301; Ltr. Ruls. 8924011, 8921022

c. Upjohn. This issue has become known by the name of a case that does not address this precise Section 2041 issue at all. Upjohn v. U.S., 72-2 USTC ¶12,888 (W.D. Mich. 1972). That case involved a Section 2503(c) trust which provided that the trustee should not make any distributions that would satisfy the settlor's legal obligation of support. This issue was whether that constituted a "substantial restriction" on the right to make distributions to the beneficiary, so that it did not qualify under Section 2503(c), in which event gifts to the trust would not qualify for the annual exclusion. The court rejected the IRS's argument, that this restriction constituted a substantial restriction, on the theory that is was no restriction at all to say that the trustee should not make a distribution to satisfy a need of the minor that someone else would provide anyway (i.e., the parent, because of the support obligation). In this regard, the provision really enlarged the rights of the minor child under the instrument, because it assured that the trust funds would be used to provide additional benefits that were not already provided for by the support obligation.

The Section 2041 problem exists if the surviving spouse serves as trustee of a Section 2503(c) trust. Unless the taxpayer can convince the court to rule like Upjohn that a limitation on making distributions in satisfaction of the trustee's legal obligations is not a substantial restriction, the spouse cannot serve as trustee of a Section 2503(c) trust. Either the trust would restrict the trustee from making distributions to satisfy his legal obligation of support (in which event it is not a valid Section 2503(c) trust if a court cannot be persuaded to follow Upjohn), or else the spouse would have a general power of appointment. Hence, clauses to solve this problem have come to be known as "Upjohn clauses."

Interestingly, no case has addressed what seems to be the real issue. If a trustee makes a distribution to a minor, and the parent uses that to provide what should be the parent's legal obligation, has the parent violated his duty to his children, in effect converting the child's assets for his own use? Does the parent still owe the amount of such support payment to the child? If so, a distribution from a trust to a minor does not satisfy the parent's legal obligation of support. See section II.B.2.c.(3) of this outline. Stated differently, a distribution that satisfies the power holder's legal obligation is in reality a distribution to the power holder. If the instrument says that no distribution may be made to the power holder other than for the power holder's health, education, support or maintenance, the distribution would not be authorized (because it is not for the power holder's " … support"—but for the payment of a claim against the power holder.) See Horn, Whom Do You Trust: Planning, Drafting and

Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 (1986).

d. The Fix. To cure any possible argument, planners insert what has become known as the Upjohn clause: A clause prohibiting the trustee from making any distribution that would have the effect of discharging that trustee's legal obligations. For an excellent discussion of the tax effects if a trust does not absolutely prohibit satisfying legal obligations of the donor or of a trustee, see Pennell & Fleming, Avoiding the Discharge of Obligation Theory, PROBATE & PROPERTY 49 (Sept./Oct. 1998). One ruling approved a clause requiring that if the trustee (a surviving spouse) had the obligation to support any other trust beneficiary, the trustee was required to appoint a special trustee of her choosing at that time to make distributions for that beneficiary. Ltr. Rul. 9036048. See Section III.D.5. of this outline.

6. Special Issues With Settlor's Spouse as Trustee.

A very common estate plan is to name the surviving spouse as the trustee of any trusts created in the decedent's will. A variety of tax and legal issues may arise that the planner should carefully consider. See generally Karisch, Protecting The Surviving Spouse, 38th SWLF WILLS & PROB. INST. (1999).

a. Restrict Power to Distribute to Self to Ascertainable Standard. The trust should restrict the spouse-trustee from making any distributions to himself that are not related to health, education, maintenance and support.

b. Restrict Incidents of Ownership. In case the trust owns any life insurance on the spouse's life, the trust should restrict the spouse, as trustee, from having the power to exercise any incidents of ownership over such policy.

c. Restrict Power to Distribute to Minor Children or Otherwise in Satisfaction of Spouse's Legal Obligations. In order to avoid the "Upjohn issue," the spouse should be restricted from exercising any power to make a distribution in satisfaction of any of his legal obligations. See section III.B.5. of this outline.

d. Spouse and Children as Discretionary Beneficiaries—Use Ascertainable Standard for Distributions to Children Also. Under Treas. Reg. § 25.2511-1(g)(2), the spouse is treated as making a gift if (1) the spouse has a "beneficial interest" in the trust, and (2) the spouse makes a distribution to someone else under a standard that is not an ascertainable standard. See section III.A.4. of this outline. Accordingly, if the spouse is the trustee, it is likely that the spouse has some kind of beneficial interest in the trust. If so, the trust instrument should restrict the authority of the spouse-trustee to making distributions to any other beneficiaries only under an ascertainable standard.

e. Use Tax Savings Clause. The author strongly urges using a tax savings clause designed to cure all of those prior problems in every trust—especially where the spouse is serving as trustee. See section IV of this outline.

f. Fiduciary Obligations. In some situations, spouses as trustees may face tremendous emotional pressures in responding to requests/demands from children for distributions. The spouse may face fiduciary issues in light of the conflict of having both the spouse and children as beneficiaries. The spouse may face fiduciary issues in connection with decisions that may be made innocently for independent tax reasons. (An example would be a spouse-trustee who makes distributions to himself under a HEMS standard to carry out all DNI to the spouse (and tax the income at lower rates) when the spouse had sufficient outside resources and could not justify a need for those distributions.)

g. Income Tax. As discussed in Section III.E. below, the spouse may potentially be treated as the owner of the trust under Section 678 if the spouse is the sole trustee and has the authority to make distributions to himself.

h. QTIP Trusts. The spouse may wish to make gifts of assets in a QTIP trust to take advantage of the lower effective gift tax as

compared to the estate tax. To keep from including the trust directly in the spouse's estate, the QTIP trust will probably not give the spouse unlimited discretion to make distributions from the QTIP (which would permit large distributions to the spouse so that he could make gifts.) For that situation, having a third party as trustee could be helpful. See generally Tiernan, Creating an Amicable Estate Plan for the Decedent's Children and the Second Spouse, 94 J.TAX'N (Feb. 2001).

i. Clayton Trusts. A QTIP trust may specify that the trust passes differently depending on whether or not the QTIP election is made. If the trust provides that the trust assets will pass outright to the surviving spouse if the QTIP is not made, the spouse should not serve as the executor with the authority to make that election. (If the spouse has the authority, through making a tax election, to receive the trust property not subject to an ascertainable standard, the spouse would have a general power of appointment. If the QTIP trust assets will pass to a standard bypass trust (which would be restricted so that the spouse would not have a general power of appointment), there should be no problems with having the spouse serve as executor with the authority to decide whether to make the QTIP election.

j. Section 2503(c) Trusts. As discussed in section II.B.6.a., neither the settlor nor the settlor's spouse should serve as trustee of a Section 2503(c) trust. (If the spouse serves as trustee, there is a clear Upjohn problem. Either the trust might not qualify for Section 2503(c) treatment because it does not satisfy the substantial restriction requirement, or else the spouse would have a general power of appointment. See Section III.B.5. of this outline.)

7. Summary of Selection of Trustee Issues Regarding Dispositive Powers Held by a Beneficiary.

The beneficiary should not have the power as trustee to make distributions to himself that are not limited by an ascertainable standard relating to his HEMS. If the beneficiary is a co-trustee (or holds a veto power), the beneficiary will be deemed to hold distributive powers of the trustee unless he is a co-trustee with the grantor (but then there would adverse tax consequences to the grantor) or an adverse party. If the beneficiary has a contingent power to become trustee in the future upon the occurrence of events outside his control, the beneficiary will not be deemed to hold the powers of the trustee until the triggering event actually occurs. Once the events have occurred entitling the beneficiary to become trustee, he will be deemed to hold any problematic powers (even before he accepts as trustee) unless he formally disclaimed the right to be trustee (generally within nine months of when the original transfer in trust was made.)

Reciprocal powers (in reciprocal trusts) may be uncrossed.

If there is a third party trustee: A third party trustee can have complete discretion over distributions. But if there are mandated distributions, the beneficiary will be deemed to have a general power of appointment over any undistributed but "accrued" amounts (but this does not apply if the trustee just has the discretion, even within a standard, to make distributions.) A third party trustee may be used as a co-trustee with a beneficiary, and the instrument could direct that any problematic powers (to make distributions beyond a HEMS standard to the beneficiary or to any other beneficiary or to make distributions that satisfy the beneficiary's obligation of support) would be held solely by the third party trustee. Even if there is a third party trustee, to be safe, the instrument should prohibit any distributions in satisfaction of legal obligations of the trustee.

If the beneficiary is trustee: Use an ascertainable standard. Do not get fancy and stray from the pure HEMS standard. Even slight word deviations could potentially have disastrous effects—or at least give rise to a lawsuit. Adding "in the accustomed standard of living" is satisfactory as long as those words modify the stated standard. (In

addition, as discussed in Section II.A.4., the instrument should not allow the beneficiary-trustee to make distributions to another beneficiary unless the distribution is within an ascertainable standard as to that other beneficiary.)

C. Estate Tax—Management/Administrative Powers.

1. The Issue.
Overly broad administrative powers might potentially create (1) estate tax inclusion problems under Section 2041 if the powers enable the power holder to favor himself, and (2) gift tax concerns under Section 2514 if the power holder could exercise the power to favor himself, but instead exercises the power in a manner that favors others.

2. Regulations.
The regulations to Sections 2041 and 2514 indicate that "mere … management {and} investment" powers will not cause the holder of the power to have a general power of appointment:

"The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties in not a power of appointment." Treas. Reg. § 20.2041-1(b)(1); 25.2514-1(b)(1).

3. Lack of Cases; Analogy to Section 2036-2038 Cases.
There have been very few cases addressing the effects of administrative and management powers under Section 2041. Estate of Rolin v. Comm'r, 68 T.C. 919 (1977), *aff'd,* 588 F.2d 368 (2nd Cir. 1978) (investment power not general power of appointment because required to be exercised in fiduciary capacity). However, the cases regarding the effects of administrative and management powers under Sections 2036 and 2038 should provide guidance by analogy. The underlying principles would seem to be the same. In particular, the Supreme Court's discussion in Byrum of the effects of management powers (in particular, in that case, the power to vote stock) in relation to the power to designate the persons who may possess or enjoy property or the income therefrom. As discussed above, the planner should be careful to make clear that any administrative owners of a beneficiary-trustee must be exercised in a fiduciary capacity. See generally section II.B.4. of this outline.

The lack of very many cases under Section 2041 regarding administrative powers, however, does raise potential concerns. Some planners may want to draft around potential arguments by the IRS in sensitive situations.

4. Potentially Troublesome Powers.
One commentator has given an excellent summary of potentially troublesome powers that might possibly be interpreted to give the trustee the power indirectly to favor himself:

"The mere existence of [an administrative] power arguably can be a power (even a general power of appointment or a power exercisable solely by the power holder to vest income or corpus in himself). The exercise or lapse of the power in favor of other than the power holder arguably can be a taxable gift. Potentially troublesome are powers:

(1) to retain, dispose and invest property when particular types of income are allocated to particular beneficiaries;

(2) to retain or invest in unproductive or underproductive property (especially if the governing instrument waives the application of state law that otherwise would require an adjustment in favor if income);

(3) to allocate receipts and expenses between income and principal;

(4) to lend without adequate security or interest;

(5) to exchange property with the trustee;

(6) to release a trustee or accept the trustee's account;

(7) to distribute in non-pro rata shares without regard to unrealized gain for tax purposes; and

(8) to pay (or cause payment of) death costs (i.e., debts, costs of administration and taxes) from one fund rather than another." Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 503.36 (1986).

Mr. Horn's article has a very thoughtful discussion of drafting steps that the planner might take to avoid potential problems in sensitive situations.

5. Income and Principal Allocations.

If the amount that is or may be distributed to the trustee depends on income/principal allocations (such as would occur if the surviving spouse or another beneficiary is the trustee of a QTIP trust), the regulation suggests that giving the trustee the power make such allocations would not raise problems, as long as the power is "exercisable in a fiduciary capacity." However, this is a particularly sensitive power. The potential problems of many other powers can be avoided by using a tax savings clause to limit any discretionary distributions to the trustee within an ascertainable standard. For many other issues, it may not matter how an administrative power is exercised, as long as ultimately any discretionary distributions to the spouse must meet an ascertainable standard. However, the exercise of the income/principal power will directly cause (or prevent) the distribution of assets if there is a mandatory income interest in the trust.

Regulations under Section 2056 regarding the mandatory income interest requirement in marital trusts may also give guidance by analogy:

"If it is evident from the nature of the trust assets and the rules provided for management of the trust that the allocation to income of such receipts as rents, ordinary cash dividends, and interest will give to the spouse the substantial enjoyment during life required by the statute, provisions that such receipts as stock dividends and proceeds from the conversion of trust assets shall be treated as corpus will not disqualify the interest passing in trust. Similarly, provision for a depletion charge against income in the case of trust assets which are subject to depletion will not disqualify the interest passing in trust, unless the effect is to deprive the spouse of the requisite beneficial enjoyment. The same principle is applicable in the case of depreciation, trustees' commissions, and other charges." Treas. Reg. § 20.2056(b)-5(f)(3).

"Among the powers which if subject to *reasonable limitations* will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets passing to the trust. … Nor will such a power [i.e., to retain unproductive property] disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets." Treas. Reg. § 20.2056(b)-5(f)(4) (emphasis added).

A very standard clause for QTIP trusts is to provide that the income/principal allocation power may not be exercised in a manner that would endanger the availability of the marital deduction. Similarly, in any trust where there is a mandatory income interest (or where distributions may only be made from income or principal, but not both) the planner should consider whether to be conservative and provide that whenever a beneficiary is serving as trustee, the income/principal allocations shall be made in accordance with applicable rules of law (or similar language). See Heisler & Butler, Trust Administration § 5.33 Illinois Inst. For Continuing Legal Ed. (1999). That might impose

a rather sever administrative burden, however, by forcing the trustee to get legal opinions on a variety of issues as to how the income/principal allocation should be made under the technicalities (and uncertainties) of the appropriate state trust laws. An alternative would be to give a non-beneficiary co-trustee broad discretion in making income/principal allocations. Typically, in that situation, there is just a requirement that any such fiduciary power be exercised in a reasonable manner.

6. Valuations; Non Pro Rata Distributions.

Some commentators have suggested that the drafter "should also avoid authorizing the trustee-beneficiary to divide or distribute trust property 'at such valuations as the trustee considers fair' or make 'non pro rate distributions' of trust property items." Id. The concern is that these powers might be argued to permit the trustee to shift benefits to himself. However, most planners do not impose these restrictions on trustee-beneficiaries. The Jordahl case, which held that a settlor-fiduciary who had the power to substitute assets of equivalent value with a trust did not have Section 2038 or 2042 powers over the trust, because the settlor would be required to exercise the power fairly in a manner that would not deplete the corpus of the trust. (That case even suggested that holding such a power in a nonfiduciary capacity would be permissible for purposes of Section 2038 and 2042.) Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975). See section II.B.4.g of this outline.

7. Tax Elections.

Certain tax elections can directly benefit the trustee in an individual capacity. For example, a decision to take administration expenses as income tax deductions rather than estate tax deductions will benefit income beneficiaries over remaindermen. However, most commentators believe that the exercise (or non-exercise) of such tax elections, which have an incidental effect of benefiting certain beneficiaries, should not raise Section 2041 concerns. See Adams, Questions & Answers, TR. & ESTS, 53 (Sept. 1985). However, the spouse should not have the power to make a QTIP election, where the assets will pass outright to the surviving spouse if the QTIP election is not made. See Section III.B.6.i of this outline.

8. Power to Adjust Under Section 104.

Section 104 of the new Uniform Principal and Income Act, was approved by the National Conference of Commissioners on Uniform State Laws in July 1997. It has been passed or is being considered in many states (including Texas, for the 2003 legislature). If a trust provides for the mandatory distribution of all income, and if a trustee makes the decision under section 104 to allocate some or all capital gains to income for a particular year, the decision directly impacts the amount to be distributed to the income beneficiary. Accordingly, section 104 of the Uniform Act and most of the states adopting the provision stipulate that the discretion may only be exercised by an independent trustee. See Section I.E of this outline. Query, what would be the tax effect if the trustee-beneficiary were authorized to make an adjustment under Section 104 only with court approval?

9. Incidents of Ownership Over Life Insurance.

If the trust holds any life insurance on the trustee's life, the trustee should be restricted from having any discretion regarding exercising any incidents of ownership over the policy. See section II.B.4.k.(2) of this outline.

10. Beneficiary Consent to Trustee's Administrative Actions.

The regulations make clear that "the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein." Treas. Reg. § 20.2041-1(c)(1). Thus, unless the IRS could establish that a beneficiary is relinquishing clear legal rights (so as to constitute a gift—see Section III.A.3 of this outline), the ability of beneficiaries to consent to administrative actions should not case gift problems.

11. Beneficiary Power to Veto Stock Sales.

The IRS has ruled privately that a power in the beneficiary to veto proposed sales of stock by the trustee does not constitute a general power of appointment. Ltr. Rul. 9042048.

12. Power to Borrow, Pledge Trust Property, Dispose or Property and Contract With Trust.

The IRS has ruled privately that a testamentary beneficiary-trustee's power to borrow money, to pledge trust property as security, to renew indebtedness, to dispose of trust property, and to enter into any transaction with the executor of the decedent's estate without the consent or approval of any interested person or court is not a general power of appointment. In that situation, the wife had a mandatory income interest in the trust, was a discretionary beneficiary of corpus within a HEMS standard, and served as co-trustee with her daughter. Ltr. Rul. 8942094

13. Summary of Selection of Trustee Issues Regarding Administrative Powers.

Make explicitly clear that all of the trustee powers are held in a fiduciary capacity. If any beneficiary has a mandatory income interest, require that income/principal allocations be made in a reasonable manner, and to be conservative, say that such allocations should be made by a co-trustee who is not a beneficiary or remainderman. If the trustee will be able to make a Section 104 discretionary power to allocate corpus to income, there must be a non-beneficiary trustee (or co-trustee) exercising that power. The beneficiary should not hold any incidents of ownership over life insurance on the beneficiary's life. For the paranoid (in particularly sensitive situations), see Section III.C.4. for a listing of potentially troublesome administrative powers.

D. Trustee Removal and Appointment Powers.

1. Overview; Analogy to Grantor Powers.

If the power of the trustee to make distributions to a beneficiary is limited to a HEMS standard, and if the trustee is precluded from making distributions in satisfaction of his or own obligation to support a beneficiary, there is no estate inclusion problem for the beneficiary regardless who serves as trustee (ignoring restrictions that may be present under Section 2042 if the trust owns an insurance policy on the trustee's life.) In those circumstances, it does not matter how much control the beneficiary keeps over other trustees. However, if the distribution authority of the trustee is not so prescribed, the ability of a beneficiary to remove and replace trustees could give the beneficiary a general power of appointment. Many of the appointment/removal issues that affect grantors also affect beneficiaries. There is a detailed discussion of this issue regarding removal and appointment powers retained by grantors in section II.B.5. of this outline, and much (but not all) of that discussion is relevant for trustee appointment powers held by beneficiaries.

2. If Beneficiary-Trustee Declines to Accept Office as Trustee.

If a beneficiary is named as trustee, and if the beneficiary would have a general power of appointment because of dispositive powers of the trustee, the beneficiary will have a general power of appointment if he is the trustee, and as discussed in section III.A.1.a. of this outline, once the general power of appointment taint is cast, it is very difficult to ever get rid of that taint without gift or estate tax consequences. What if the beneficiary declines to serve as trustee before accepting office as trustee? That procedure apparently will not prevent the creation of a general power of appointment. However, the power holder may formally disclaim the power and not be treated as having released the general power of appointment, if the requirements of Section 2518 are satisfied. See section III.B.1.h. of this outline. The IRS ruled privately in technical advice memorandum 9125002 that the mere fact that the named beneficiary-trustee died before the trust was funded and before accepting office as trustee did not prevent the beneficiary from having a general power of appointment.

3. Power to Appoint Self as Trustee.

If a beneficiary has the power at any time to appoint himself or herself as trustee or co-trustee (unless the other co-trustee has a substantial interest in the trust that is adverse), the beneficiary will be treated as holding the powers of the trustee. The regulations provide directly that a donee's power to remove a trustee and appoint himself may be a power of appointment. Treas. Reg. § 20.2041-1(b)(1).

4. Power to Appoint Self as Trustee Under Limited Conditions That Have Not Yet Occurred.

"[T]he decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal." Treas. Reg. § 20.2041-1(b)(1).

5. Power to Appoint Co-Trustee to Exercise Tax Sensitive Powers.

Trusts often include a savings clause, to provide that the beneficiary-trustee cannot exercise various dispositive powers that would cause tax problems, but to provide that the beneficiary-trustee can appoint a co-trustee to exercise that discretion. The IRS has approved a similar arrangement in private letter ruling 9036048. In that ruling, the decedent's will named the surviving spouse as trustee of a bypass trust for the benefit of the spouse and descendants. The trust requires the surviving spouse to choose a special trustee in the event that the surviving spouse has a legal obligation to support any beneficiary under the bypass trust. The special trustee will have the exclusive power to make all decisions involving any discretionary distribution or allocation to such a beneficiary. The surviving spouse will not have the power to remove a special trustee. The ruling acknowledged the problem that would arise if the trustee could make distributions that would satisfy her legal obligations. (See section III.B.5. of this outline.) However, the IRS ruled that the procedure requiring the spouse to appoint a Special Trustee (of her choosing at that time) served to eliminate the problem.

6. Power to Appoint Successor Trustee Other Than Self.

A non-grantor beneficiary may name a successor trustee other than himself. The beneficiary, in that case, "never moves into a position of possessing the powers of the trustee and never has a voice in the determination of whether the power in the trustee will be exercised." 3A Casner, ESTATE PLANNING § 12.0, p. 84 (5th ed. 1986).

7. Power to Veto Appointment of Independent Trustee.

The IRS has ruled privately that the power to veto the appointment of an independent trustee and the subsequent legal right to petition the court to select an independent replacement who is not a related or subordinate to any of the beneficiaries is not a general power of appointment. Ltr. Rul. 9741009. (The facts of that ruling are rather vague, and the beneficiary served as a co-trustee, so it is not clear why any power over the appointment of a successor to another co-trustee raises any Section 2041 issues. If there are any Section 2041 issues, they presumably still exist because the beneficiary serves directly as a co-trustee.)

8. Power to Remove and Appoint Successor Other than Self.

If a trustee holds powers that would be treated as a general power of appointment if held by a beneficiary, will a beneficiary's power to remove and replace the trustee with someone other than himself cause the beneficiary to have a general power of appointment?

a. Power to Remove For Cause. If a beneficiary has the power to remove a trustee for cause and replace the trustee, the beneficiary does not have a general power of appointment. A power to remove a trustee only for cause is a power that is subject to a contingency that is beyond the control of the power holder. Therefore, such a power can be given to a beneficiary without concern that it will result in the trustee's powers being imputed to the beneficiary. See Treas. Reg. § 20.2041-3(b), discussed in section III.B.1.h. of this outline. Cf. Ltr. Rul 9832039 (right to remove and replace trustee for cause did not trigger Section 2042).

(However, if a grantor holds the power to remove and replace a trustee for cause, there may be at least theoretical concerns, because even contingent powers can still be taxable powers under Section 2036. Treas. Reg. § 20.2036-1(b)(3); see generally Moore & Powell, Millennium Schmimium: Is Your Tax Drafting Y2K Compliant? 34 ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. Fundamentals Program Materials (2000).

b. Power to Remove Without Cause. If the beneficiary holds the power to remove and replace the trustee without cause, there may be situations when the beneficiary would be power holder would be deemed to hold the powers of the trustee. If so, this would give the beneficiary a general power of appointment if the trustee can make distributions to the beneficiary that are not limited to HEMS or if the trustee can make distributions to a beneficiary who the trustee is obligated to support. Following the issuance of Rev. Rul 79-353, 1979-2 C.B. 325, the IRS extended that analysis to removal powers held by beneficiaries. Ltr. Rul. 8916032. In Rev. Rul. 95-58, 1995-2 C.B. 191, the IRS ruled that Sections 2036 and 2038 are not triggered if a grantor holds a removal and appointment power as long as the grantor must appoint someone other than the grantor who is not related or subordinate to the grantor under Section 672(c). The IRS, in private rulings, has extended the same principle to Section 2041 with respect to powers of removal held by beneficiaries. E.g., Ltr. Ruls. 9735023 & 9746007. The IRS granted a ruling in 2000 that is more liberal than Rev. 95-58, in that a beneficiary could remove and appoint a successor (including individuals who are beneficiaries). The ruling relied on a restriction in the trust agreement that prohibited any trustee from participating in any decision to pay or apply trust assets to himself or his issue, and provided that any such decision would be made by the other then acting trustees. In effect, the beneficiary could appoint anyone else, who could make distributions back to the beneficiary. One wonders if the IRS realized the impact of its ruling. Reliance on the ruling at the planning stage would seem unwarranted.

c. Power to Remove and Replace Trustee—Section 2042. The principles of Rev. Rul. 95-58 would appear to extend to the power of an insured to remove and replace a trustee who holds incidents of ownership over a policy on the insured's life. See a detailed discussion of this issue in section II.B.5.h. of this outline.

9. Summary of Selection of Trustee Issues Regarding Removal and Appointment Powers.

The beneficiary will have the powers of the trustee if the conditions have occurred giving the beneficiary the power to accept office as trustee or to appoint himself as co-trustee (unless the beneficiary formally disclaimed the right to become trustee within the required time.) If the conditions allowing appointment of the beneficiary as trustee have not yet occurred, he does not yet hold a general power of appointment.

A beneficiary-trustee can have the power to appoint a co-trustee who would exercise tax sensitive powers. (To be very cautious, the instrument could stipulate that any such co-trustee would have to be an "independent trustee"—with some definition of that term. However, that should not be required—unless there is an extreme case of a beneficiary having an explicit prearrangement with whomever he appoints directing how the co-trustee's powers will be exercised, and even there, the taxpayer could make strong arguments that the fiduciary responsibility of the appointed co-trustee should override any such informal "agreements.")

If a beneficiary has the right to remove the trustee and appoint himself, that beneficiary will be deemed to hold the powers of the trustee. If a beneficiary has the power to remove and appoint someone else—the IRS appears to recognize a safe harbor if the beneficiary must appoint someone who is not a related or subordinate party. If the power is retained to appoint a replacement who is a related or subordinate party, the taxpayer would argue, based on the Vak and Wall cases (see Section II.B.5.g. of this outline) that the fiduciary responsibility of any such successor would preclude the beneficiary

from being deemed to hold any powers such appointee would have as trustee.

E. Income Tax Issues.

1. Section 678—Income Taxed to Beneficiary As Owner Under Grantor Trust Rule.

a. Issue. If a beneficiary of a trust serves as the sole trustee and has the authority to make distributions to himself, there is the possibility (perhaps remote if the distribution power is limited by an ascertainable standard) that the income of the trust will be taxed to the beneficiary under a grantor trust rule, regardless of whether distributions are actually made to that beneficiary. Whether there is an ascertainable standard exception is not clear. If the beneficiary serves as co-trustee and does not make discretionary distribution decisions by himself, Section 678 clearly does not apply.

b. Statute. Section 678(a)(1) provides that an individual shall be treated as the owner of any portion of a trust with respect to which the individual has a power, exercisable solely by himself, to vest the corpus or income from the trust in himself. See Ltr. Rul. 8211057 (trustee-beneficiary with mandatory income/discretionary principal interest with $100,000 annual distribution cap taxable on income to that extent).

c. Ascertainable Standard Exception Is Uncertain. There is no ascertainable standard in the statutory language of Section 678. Many planners, however, take the position that the trustee will not be taxed on trust income under Section 678 if the trustee's discretion is subject to an ascertainable standard. The theory is that the statutory language requires that the trustee be able to vest the corpus or income in himself "solely by himself," and the trustee is not making a determination "solely by himself" if he is making a distribution decision based on whether ascertainable standards are satisfied. The legislative history states that Section 678 would treat a person as an owner of the trust "if he has an *unrestricted power* to take the trust principal or income." S. Rep. No.1622, 83d Cong., 2d Sess. 87 (1954) (emphasis added).

The reference to an unrestricted power is consistent with case law under a predecessor provision to Section 678. See Funk v. Comm'r, 185 F.2d 127 (3d Cir. 1950) (trustee's power to distribute income to herself for her "needs" did not cause trust income to be taxed to trustee as owner); Smith v. U.S., 108 F. Supp 772 (S.D. Tex 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953) (power to distribute income for support, maintenance, comfort and enjoyment; trustee not taxed on trust income as owner).

In addition, there is one reported case that has addressed this issue after the adoption of Section 678, and it adopts an ascertainable exception approach. U.S. v. DeBonchamps, 278 F.2d 127, 130 (9th Cir. 1960) (held that grantor trust rules applied to determine tax effects of holder of life estate; life tenant did not have unrestricted power under state law to distribute corpus to self, but only for "needs, maintenance and comfort"; held that undistributed capital gains not taxed to life tenant).

Private rulings from the IRS have been inconsistent. Compare Ltr. Rul. 8211057 (trustee-beneficiary with discretionary principal interest for "support, welfare and maintenance" taxable on income under Section 678) with Ltr. Rul. 9227037 (trustee-beneficiary with discretionary principal interest for "health, support and maintenance" held not taxable under Section 678). See also Ltr. Rul. 8939012 (trustee-beneficiary not taxable as owner of trust under Section 678; however exact distribution standard not clearly set forth in ruling).

d. Effect if Beneficiary-Sole Trustee Appoints Co-Trustee. If a beneficiary initially serves as sole trustee and appoints a co-trustee, the beneficiary who was initially the sole trustee will still likely be taxed on the trust income under Section(a)(2).

e. Distributions to Satisfy Trustee's Support Obligation. The authority of a sole trustee to make distributions that would satisfy such person's legal obligation of support will be taxed as income to the person only to the extent that such distributions are actually made. I.R.C.

§ 678(c). See Ltr. Rul. 8939012 (sole trustee not taxable under Section 678 where beneficiaries were trustee's adult children and descendants to whom he owed no legal obligation of support). (If any such support distributions are actually made, the power holder is taxed under Sections 661-662—based on an allocation of DNI—rather than being treated as the owner of a portion of the trust. I.R.C. § 678(c).)

f. Effect of Disclaimer. Section 678 does not apply if the power holder renounces or disclaims the power within a reasonable time after the holder first became aware of its existence. I.R.C. § 678(d). See section III.B.1.h. of this outline for a discussion of the Section 2041 effects of a disclaimer.

2. State Income Tax Issues.

State income tax considerations are important in the selection of trustee analysis, because a determination of what state has jurisdiction to impose its state income tax on the trust will, in some states, depend on the residency of the trustee or where the administration of the trust occurs. The one thing that is consistent across the board regarding the state income taxation of trusts is inconsistency. There is complex labyrinth of separate rules throughout the 50 states and the District of Columbia. (Texas planners generally have been spoiled by practicing in a state that does not tax trusts, and Texas planners typically have little experience in the complex world of state income taxation of trusts.) See generally ACTEC Study 6, State Taxation on Income of Trusts With Multi-State Contacts (2001); Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, 57-58 (March/April 2002); Gutierrez, The State Income Taxation of Multi-Jurisdictional Trusts – The New Playing Field, 36TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL , ch 12 (2002); Coleman, State Fiduciary Income Tax Issues & Jurisdictional Bases for State Taxation of Trust as a "Resident Trust", ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES vol 4, at 2061-2090 (April 2002).

a. Brief Overview of State Taxation Approach.. Grantor trusts are typically taxed to the grantor in his state of domicile. For non-grantor trusts, most states allow a deduction for distributions, and the distributed amounts are taxed to beneficiaries in their states of domicile. The undistributed income of trusts is taxed under the complex scheme of varying rules.

Almost all states will impose their taxes on undistributed income of trusts that is from real estate or businesses located in the state. (That can be a difficult determination for businesses which produce income in a variety of states.) Therefore, no matter whether a trust is a "resident trust" or a "nonresident trust," undistributed trust income from real estate and businesses in the state will be taxed by that state.

The remaining income is generally taxed based on where the trust is deemed to be a resident—and a wide pattern of residency rules have developed over the years in determining whether a trust is a resident trust or nonresident trust as to a particular state.

After going through the steps described above, if two different states impose income tax on the same trust, most states allow some form of credit to the extent that other states impose an income tax on the same trust income (but the form of the credit varies dramatically).

b. Resident vs. Nonresident Trusts. Most of the states typically follow one of several patterns to determine whether a trust is a resident trust for that state. Ten states do not specifically define a resident trust. Some states look at various factors in determining whether a trust is a resident trust.

(1) Residency of Grantor. Almost half of the states treat testamentary trusts of resident-decedents of that state as resident trusts. (Therefore, if a decedent dies in one of those states, any testamentary trusts created by that decedent are forever after taxed by that state.) The same states also tax inter vivos trusts created by a resident grantor. (These laws, regarding inter vivos trusts, have come under severe constitutional attack.)

For residents of these states who are creating trusts, state income taxation is still an important issue in the selection of trustee process. If the instrument appoints a trustee from a state that taxes based on administration or trustee residency, issues of dual taxation and multi-state credits arise.

(2) Administration in the State. Approximately seven states impose tax on the basis of administration in the state. Accordingly, appointing a trustee who would be conducting a significant part of the administration in one of those states would subject the trust to income taxation in that state.

(3) Residency of Trustee. Approximately eight states impose tax on the basis of the domicile of the trustee. (If there are co-trustees located in multiple states, the income may be pro-rated. For example, this is the approach in California.) Obviously, this is a very important fact to consider before appointing a trustee who is a resident of one of these states.

(4) Residency of Beneficiary. Only a handful of states impose tax on this basis.

IV. SAVINGS CLAUSES TO AVOID ADVERSE TAX EFFECTS FOR GRANTORS, BENEFICIARIES AND TRUSTEES

A. Significance of Savings Clauses Regarding Tax Effects For Grantors, Beneficiaries and Trustees.

To avoid inadvertent adverse tax effects, consider using a "savings clause" to limit automatically any retained powers of the grantor, or of the beneficiary. While a primary dispositive provision may come within accepted ascertainable standard language, other provisions of the will may inadvertently change the result. For example in Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985), one paragraph of the will authorized distributions "for her own proper maintenance," which would have been an ascertainable standard. However, it was nullified by more expansive powers in the next paragraph to use the assets "for whatever purpose she desires" 761 F.2d at 442, 443, and 444. An excellent discussion of the various provisions that could be included in savings clauses to avoid adverse tax consequences with respect to powers that trustees may have is in Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 506 at p. 5-70 (1986).

B. IRS Recognizes Savings Clauses For Section 2041 Purposes.

The IRS has recognized the effectiveness of savings clauses to avoid adverse tax results for grantors and beneficiaries. For example, one letter ruling concluded that the beneficiary-trustee did not have a general power of appointment because of this clause in the instrument:

"Restriction on exercise of power for fiduciary's benefit. (a) Except as provided in subsection (b), a power conferred upon a person in his capacity as a fiduciary to make discretionary distributions of principal or income to himself or to make discretionary allocations in his own favor or receipts or expenses as between income and principal cannot be exercised by him. If the power is conferred on two or more fiduciaries, it may be exercised by the fiduciaries who are not so disqualified. If there is no fiduciary qualified to exercise the power, it may be exercised by a special fiduciary appointed by the court." Ltr. Rul. 7935015.

C. Miscellaneous Examples of Savings Clauses and Other Clauses Important to Achieve Tax Effects of Irrevocable Trusts.

1. Irrevocability.
Any Trust created hereunder shall be irrevocable and shall not be altered, amended or revoked by the Settlor or by any other person. Any Trust created hereunder shall only be terminated in accordance with the provisions of this Agreement.

2. Fiduciary Powers Only.
All powers given to the Trustee by this Agreement are exercisable by the Trustee only in

a fiduciary capacity and no power given to the Trustee hereunder shall be construed to enable the Settlor or the Trustee or any person to purchase, exchange, or otherwise deal with or dispose of the principal or income therefrom for less than an adequate and full consideration in money or money's worth.

3. Settlor Prohibited From Serving as Trustee.

At no time shall the Settlor be appointed Trustee (Co-Trustee or otherwise) of any Trust created under this agreement.

Observe: Using this clause is not necessary if the trust has been carefully planned to avoid adverse tax consequences, as discussed in Section II of this outline.

4. Prohibit Distributions Satisfying Support Obligations of Settlor Or Beneficiary.

Notwithstanding any other provision of this Agreement, no person serving as Trustee shall have the power or authority to distribute income or principal of a Trust in a manner that would (i) discharge such person's legal obligation to support a beneficiary of the Trust, or (ii) discharge the Settlor's (or the Settlor's spouse's) contractual, support or other legal obligation.

5. Limitations on Beneficiary-Trustee as to Distributions, Termination, Estimated Taxes, and Life Insurance.

Beneficiary Serving As Trustee and Independent Trustee. If an individual serving as Trustee of any trust created under this Agreement is a beneficiary of such trust, such individual shall be authorized to make distributions to himself or herself pursuant to the terms of such trust, but such individual shall not possess or exercise any powers with respect to, nor authorize or participate in any decision as to: (i) any discretionary distribution or any loan to or for the benefit of himself or herself or any other beneficiary, except to the extent that such distributions are limited to amounts necessary for the person's health, maintenance, support and education; (ii) any discretionary distribution to any other beneficiary, if such distribution would discharge any of his or her legal obligations; (iii) the termination of such trust because of its small size, if such termination would result in a distribution to himself or herself or if the distribution would discharge any of his or her legal obligations; (iv) the treatment of any estimated income tax payment as a payment by such individual except to the extent that the payment is limited to an amount necessary for his or her health, maintenance, support and education; or (v) any action to be taken regarding an insurance policy held in such trust insuring the life of such individual unless such action is expressly authorized by other provisions of this Agreement. These decisions shall be made solely by the other then serving Trustee or Trustees of such trust ("Independent Trustee"). If such individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving for such trust, the currently acting Trustee may appoint the individual or entity next designated to act as Trustee as an Independent Co-Trustee of such trust; otherwise, upon written request of the currently acting Trustee, an Independent Co-Trustee of the trust shall be appointed by the Trustee Appointer. However, if an Independent Co-Trustee is appointed under these circumstances, the sole power and responsibility of the Independent Co-Trustee shall be to make decisions reserved to the Independent Co-Trustee.

Insurance On Life Of Beneficiary Serving As Trustee. This Section shall apply whenever any trust created under this Agreement owns any interest in an insurance policy on the life of an individual serving as sole Trustee of such trust. Such Trustee must: (i) designate the Trustee of such trust as the beneficiary of the policy to the extent of such trust's interest in the policy; (ii) continue to pay the premiums on such policy without using policy loans; and (iii) allow any policy dividends to reduce premiums. Upon termination of such trust, such Trustee must distribute the policy to the beneficiaries of such trust. Such Trustee shall not possess or exercise any other powers with respect to, or authorize or participate in any other decision as to, such

policy. All other actions with respect to the policy shall be made solely by the other then serving Trustee or Trustees of the trust ("Insurance Trustee"). If such an individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving, then the currently acting Trustee may appoint the individual or entity next designated to act as Insurance Co-Trustee; but if no successor Trustee is designated, upon written request of the currently acting Trustee, an Insurance Trustee shall be appointed by the Trustee Appointer. If an Insurance Trustee is appointed, the only authority of the Insurance Trustee shall be to exercise the exclusive authority to make discretionary decisions as to the policy, including decisions to surrender or cancel the policy, borrow against the policy, and distribute the policy during the term of such trust. The intent of Settlor is that no Trustee will have any "incidents of ownership" over an insurance policy on the Trustee's life within the meaning of Section 2042 of the Code.

Observations regarding the *Beneficiary Serving As Trustee and Independent Trustee* clause:

Clause (i) restricts distributions to the trustee except for HEMS to avoid inadvertent violations of Section 2041 generally and restricts any distributions to any other beneficiary of the trust except for HEMS to avoid Regulation § 25.2511-1(g)(2), as discussed in section III.A.4 of this outline.

Clause (ii) restricts making any distributions that satisfies the trustee's legal obligations to avoid the Upjohn issue, as discussed in Section III.B.5 of this outline.

Clauses (iii) (small trust terminations) and (iv) (estimated tax payments) are included to avoid Section 2041—in case those powers might be held to constitute Section 2041 powers.

Clause (v) is included to avoid having incidents of ownership in a policy on the trustee's life, as discussed in section II.B.4.k.(2) of this outline.

Observations regarding the *Insurance On Life Of Beneficiary Serving As Trustee* clause: This clause is also intended to avoid having incidents of ownership in a policy on the trustee's life. It mandates certain actions with respect to the policy (such as naming the trust as the beneficiary and paying premiums), so that the trustee could take extremely routine actions with respect to the policy without having to appoint another co-trustee to take those actions. With respect to discretionary decisions, a co-trustee must be appointed to take those actions.

6. Jerry Horn's "Short-Form" Savings Clause.

(1) No particular Trustee shall possess, or participate in the exercise of, any power given the Trustee by this instrument or by law to make any determination with respect to

(a) any payment or application which would discharge any legal obligation of such particular Trustee personally, or

(b) any payment to, or expenditure for the benefit of, such particular Trustee personally (neither the preceding portion of this paragraph (1) nor any otherwise-applicable rule of law shall limit such particular Trustee's possession or participation in the exercise of any power (or severable portion thereof) granted in this instrument to such Trustee to consume, invade or appropriate property for the benefit of such Trustee personally which is limited by an ascertainable standard relating to the health, education, support or maintenance of such Trustee personally.)

Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 at p. 5-14 (1986).

7. Broad Comprehensive Catch-All Savings Clauses for Settlor and Beneficiary to Avoid Estate Inclusion and Grantor Trust Treatment.

For a broad extremely comprehensive set of savings clauses to avoid estate inclusion and grantor trust treatment for grantors and to avoid estate inclusion for beneficiaries, see Appendix A for form clauses developed by Don Malouf and Alex Nakos, of Malouf Lynch Jackson Swinson, in Dallas, Texas.

V. CREDITOR ISSUES

A. Self-Settled Trusts.

Self-settled trusts for the benefit of the settlor generally may be reached by the settlor's creditors in Texas. However, under the Texas spendthrift statute for self-settled trusts, the settlor's creditors may reach "his interest in the trust estate." TEX. PROP. CODE 112.035(d); Matter of Shurley, 115 F.3d 337 (5th Cir. 1997). A few jurisdictions have changed their statutes to allow creditor protection for the settlor if certain requirements are met. Under those statues, the settlor must merely be a discretionary beneficiary of the trust, and the trustee must be someone other than the settlor. In addition, to come within the protection of those statues, there must be a **resident trustee from that state**.

B. Spendthrift Protection for Trust Beneficiaries.

Texas and many other states recognize that an individual may establish a trust for a beneficiary that prevents the beneficiary from voluntarily or involuntarily assigning his interest. TEX. PROP. CODE § 112.035(a); First Bank & Trust v. Gross, 533 S.W.2d 93 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ). While there is a strong policy recognizing spendthrift trusts, there are limitations. The assets can still be reached by claims for federal taxes (U.S. v. Dallas Nat'l Bank, 152 F.2d 582 (5th Cir. 1945)), and by claims for reimbursement for expenses incurred for the legal support and maintenance of a beneficiary's dependents, (TEX. FAM. CODE § 154.005, Lucas v. Lucas, 365 S.W.2d 372 (Tex. Civ. App.—Beaumont 1962, no writ), Kolpack v. Torres, 829 S.W.2d 913 (Tex. App.—Corpus Christi 1992, writ denied)). The effectiveness of spendthrift trusts against claims of a beneficiary's creditors may depend on various structure provisions for the trust.

A trust that is recognized as a valid spendthrift trust under state law will also be recognized in bankruptcy. 11 U.S.C. § 541(c)(2).

1. Discretionary Trust.

The strongest protection can be obtained by giving the trustee total discretion in making distributions to the beneficiary. Courts have held that spendthrift trusts which require distributions to be made for the support of the beneficiary may be reached by creditors for support-related debts, but creditors generally cannot seize assets of a spendthrift trust that allows the trustee to distribute property based solely on the trustee's discretion. See Hildenbrand, Asset Protection For Estate Planners, STATE BAR OF TEX. ADV. EST. PL & PROB COURSE (1995). A hybrid between a mandatory and discretionary trust is one that gives the trustee discretion, but provides that the trustee "shall consider that the primary purpose of the trust is to provide for the health, support, care, and maintenance of the beneficiary." Id.

Using a trustee with broad discretion to the trustee should provide strong arguments against creditor's claims.

"Under a discretionary trust, the beneficiary is entitled only to the income or principal that the trustee, in her discretion, shall distribute to him. G. Bogert, The Law of Trusts and Trustees § 228 (2d ed. 1979). The beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for his use any part of the trust property, nor can a creditor of the beneficiary reach any part of the trust property until it is distributed to the beneficiary. *Id*. Kolpack v. Torres, 829 S.W.2d 913, 915 (Tex. App.—Corpus Christi 1992, writ denied) (statute authorized court to award trust assets to pay beneficiary's obligation to pay child support from spendthrift trust, but court could not direct such payment until legal obligation of beneficiary had been established).

A broad discretionary trust cannot be used, however if the beneficiary is the trustee. The beneficiary-trustee would hold a general power of appointment under Section 2041 (if there is a broad discretionary standard not including detailed standards such as health, education, support and maintenance.) Furthermore, the creditor may be in a position to argue that the

beneficiary has control over the trust and that the creditor should be able to reach it.

2. Sprinkling Trust May Afford More Protection.

"Ideally, the trust should give the trustee the power to 'sprinkle' trust property among more than one beneficiary (perhaps, the beneficiary and the beneficiary's descendants), rather than limiting the trustee's discretion to a single beneficiary." Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.3 (2001).

3. Allow Trustee to Change Beneficiary or "Hold-Back" Distributions to Maximize Protection.

To be as conservative as possible where the settlor knows that a beneficiary has potential creditor's claim that may be pursued against the trust, the trust may authorize an independent trustee or Trust Protector to change the beneficiaries of the trust at the trustee's discretion. Alternatively, if the settlor wants to provide for mandatory distributions but also afford creditor protection to the beneficiary, the trust might use a "hold-back" provision, authorizing an independent trustee to withhold otherwise mandatory distributions if the trustee, in the exercise of its sole and absolute discretion should deem the distribution to be adverse to the beneficiary's interest. Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.16 (2001). In either of those situations, a third party trustee would be required.

4. Beneficiary as Trustee.

a. Same Person as Sole Trustee and Sole Beneficiary. A restraint on alienation generally is ineffective where the same person is given both the entire legal and beneficial interest (i.e., sole trustee and sole beneficiary) under the doctrine of merger of the legal and equitable title. See 2A Scott & Fratcher, The Law of Trusts § 99. Therefore, if the sole trustee is also the sole beneficiary, the beneficiary's creditors may be able to reach the property. However, the Texas merger statue specifically addresses that this rule will not invalidate a spendthrift trust. Under the Texas statute, if the sole trustee-sole beneficiary is not the settlor and if the trust is a spendthrift trust, the trust shall continue to be valid and the court shall appoint a new trustee or co-trustee. TEX. PROP. CODE § 112.034(c).

Typically, the merger doctrine does not apply, because there are remainder beneficiaries in most trusts that are different from the current beneficiary. In the unusual situation where a trust is created for one beneficiary that will pass to that beneficiary or his estate, the trust must not appoint the beneficiary as the sole trustee.

b. A Beneficiary is Also Trustee. "Black-letter" trust law would suggest that the beneficiary-trustee's creditors cannot reach the trust assets where the trustee is not the sole beneficiary. "If A holds upon a spendthrift trust for A and B, A's interest, being an interest under the trust and not a legal interest merely, cannot be assigned by him or reached by his creditors." 2A Scott & Fratcher, The Law of Trusts § 99.3.

Despite the "black-letter law," there is little in the way of strong authority saying that a trust beneficiary may also serve as trustee, and still be assured absolutely of relying on strong spendthrift protection. In Florida, for example, the courts have established that a creditor can reach the debtor's interest in a spendthrift trust (even where the trust is created by a third party) if the debtor-beneficiary can exercise dominion over the trust property. See In re May, 83 B.R. 812, 814 (Bankr. M.D. Fla. 1988) ("A trust fails, under Florida law, where the beneficiary exercises absolute dominion over trust property. … Similarly, where the beneficiary has the right to require the trustee to convey trust property to him or her, the beneficiary has dominion and control over the trust res and the trust will fail as a spendthrift trust.").

A recent bankruptcy case in Illinois allowed creditors to reach a spendthrift trust because the beneficiary had control to obtain the trust assets. In re George McCoy, 274 B.R. 751 (N.D. Ill. 2002). In that case, the surviving husband was

the trustee and primary beneficiary of a testamentary trust created under his wife's will. The trust authorized the trustee, in its discretion, to pay so much of the assets as the trustee determines "to be required or desirable for his health, maintenance and support. The trustee need not consider the interests of any other beneficiary in making distributions to my spouse." The court cited the Restatement (Second) of Trusts, for the proposition that "if the beneficiary can call for the principal or can take it as needed, the restraint on alientation is invalid." The court reasoned that the use of the term "desirable" and the fact that the trustee did not have to consider the interests of other beneficiaries meant that the husband-trustee did not have "a sufficient restraint to prevent the beneficiary to receive the corpus." The court interpreted the settlor's intent as giving the surviving spouse complete dominion and control. (Interestingly, the court said it would have recognized spendthrift protection if the trust had omitted the word "desirable" in the standard for distribution.)

Another recent arose under Arizona law. In re Pugh, 274 B.R. 883 (2002). In that case, a mother created two separate trusts, one for the benefit of each of her son and daughter. Each child was named as sole trustee of his or her trust, but before any distributions could be made, the child had to appoint a co-trustee, and could not participate in any distribution decisions. The son appointed the daughter as the co-trustee of his trust, but the evidence showed that the trust bank account was exclusively controlled by the son (who became the debtor in the bankruptcy case.) The court determined that the daughter did not, in fact, act as trustee. The Arizona spendthrift statute provides that a spendthrift trust is invalid if the sole beneficiary is also the trustee, and the court allowed the son's creditors to reach the trust assets. In reviewing this case, Mr. Gideon Rothschild, of New York, draws the conclusion: "Always appoint a co-trustee who participates in discretionary decisions!" Steve Leimberg's Asset Protection Planning Newsletter (May 1, 2002).

Commentators have raised questions about the result when a beneficiary-debtor is also the trustee. See Crowell, Asset Protection vs. Asset Collection, STATE BAR OF TEXAS ADV. EST. PL & PROB COURSE ¶ I.C.2 (1993) ("Query: what happens to a creditor's claim when the debtor is both the beneficiary and the trustee?"). Some commentators maintain that the beneficiary definitely should not serve as trustee if asset protection is important.

"Practitioners should generally avoid making the individual subject of asset protection planning a trustee of a trust, regardless of whether the individual created the trust or whether the trust was created for such individual by another party. Notwithstanding the fact that the trustee must govern himself or herself in accordance with fiduciary obligations, this situation raises the appearance of impropriety and may hinder the ability of a court to impartially consider the facts." Nelson, Asset Protection & Estate Planning Why Not Have Both? PWR OF ASSET PROTECTION ANNUAL WEALTH PROTECTION. CONF. (2002).

"It is still advisable to provide for the appointment of an independent trustee in an effort to foreclose any suggestion by the trustee/beneficiary's creditors that the law should be otherwise or that the trust is, in fact, somehow a 'sham'". Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.4 (2001).

Mr. Rothschild suggests that a bank or trust company should be used as trustee in particularly sensitive situations: "Even where the trust is not self-settled, where maximum asset protection is needed, a bank or trust company can be named as trustee in lieu of an individual." Id.

C. Summary of Selection of Trustee Issues With Respect to Creditors Rights.

If the settlor wishes to created a self-settled spendthrift trust, he will need to create the trust under the laws of one of the few states that have statutes recognizing spendthrift protection for self–settled trusts. Those statutes require using a trustee who resides in

that state. (Even then, is not clear that courts in the settlor's state of residence will recognize the spendthrift protection of the other state with respect to claims brought in the courts of the state of residence.)

To create spendthrift protection for beneficiaries other than the settlor, the law is unclear as to whether the beneficiary can be assured of spendthrift protection if he serves as the trustee with the ability to control distributions to himself. A creditor would be able to force the trustee to make distributions that the beneficiary, in his individual capacity, could compel. Whether creditors could compel distributions where the trustee is authorized to make distributions under an ascertainable standard is not clear. If creditor protection is important, to be conservative, a trustee other than the beneficiary should control distribution decisions to the beneficiary. However, it is certainly possible that a court would recognize spendthrift protection where the beneficiary is the trustee with an ascertainable distribution standard. In situations where creditor protection is not an immediate concern, the planner may, in weighing the issues, decide to name a beneficiary as trustee or co-trustee, but impress upon the beneficiary that he or she should resign as trustee as soon as possible when the beneficiary realizes that there may potentially be creditor issues in the future. (The beneficiary cannot wait too long in resigning, or else the creditor may raise arguments that the act of resigning is effectively a transfer in fraud of creditors rights under the Fraudulent Transfer Act, and that the creditor should still be able to reach the trust assets.)

APPENDIX A

Broad Comprehensive Catch-All Savings Clauses for Settlor and Beneficiary to Avoid Estate Inclusion and Grantor Trust Treatment

The author expresses appreciation to Don Malouf and Alex Nakos, of Malouf Lynch Jackson Swinson, in Dallas, Texas for permission to include these comprehensive savings clauses:

Restrictions on Trustees. *Notwithstanding any other provision of this Agreement (including, but without limitation, any power specifically conferred upon a Trustee hereunder), no Trustee shall ever participate as a Trustee of any Trust hereunder in (i) the exercise, or decision not to exercise, any discretion over payments, distributions, applications, uses or accumulations of income or principal to or for the benefit of a beneficiary or for such Trustee personally (including, but not limited to a payment, distribution, application or use of Trust property in discharge of such Trustee's legal obligations), unless the exercise or nonexercise of such discretion is limited by an ascertainable standard relating to the beneficiary or Trustee's health, education, support, or maintenance, (ii) the exercise or decision not to exercise any power conferred on the Trustees under Section ____ (dealing with merger of trusts), and Section ___ (dealing with change of situs) or (iii) the exercise of any general power of appointment described in Section 2041 of the Code. If any Trustee (in his individual capacity) is under a duty to support a beneficiary or is acting as a guardian, conservator or committee of any individual who is a beneficiary, such Trustee shall not participate in the exercise, or the decision not to exercise, any discretion over payments, distributions, applications or uses of Trust property to or for the benefit of a beneficiary in discharge of any obligation of support of such Trustee (in his individual capacity). The preceding sentence shall not restrict the Trustee from being able to make distributions to himself as a beneficiary for his health, education, support or maintenance. No Trustee shall participate in the exercise of any discretion (including, but without limitation, any discretion which would constitute an "incident of ownership" within the meaning of Section 2042(2) of the Code) with respect to any insurance policy on his or her life held hereunder. In each case, the determination of the remaining Trustees or Trustee shall be final and binding upon the beneficiaries of such trust. No individual shall serve as Trustee of any Trust which holds property with respect to which such individual has made a qualified disclaimer within the meaning of Section 2518 of the Code. In addition, notwithstanding any other provision of this Agreement (including, but without limitation, any power specifically conferred upon a Trustee hereunder), no Trustee shall possess any power that would cause the Grantor to be treated as owner of any portion of the Trust under Sections 671-677 of the Code or that would cause any portion of the Trust assets to be includible in the gross estate, for federal estate or state death tax purposes, of the Grantor or the Primary Beneficiary, or of any Trustee. No powers of any Trustee enumerated in this Agreement, or now or hereafter conferred upon Trustees generally, shall be construed to enable the Grantor or any other Person to purchase, exchange, or otherwise deal with or dispose of all or any part of the principal or income of any Trust for less than an adequate consideration in money or money's worth, or to enable the Grantor to borrow all of any part of the principal or income of any Trust, directly or indirectly, without adequate interest or without adequate security, or to allow any Person to exercise a power of administration (as described in Section 675(4) of the Code) over this Trust in a nonfiduciary capacity without the approval or consent of any Person in a fiduciary capacity.*

Powers of Independent Trustee. *Except to the extent specifically provided otherwise in this Agreement, the Independent Trustee shall have (i) the powers enumerated in this Section ___and (ii) any power not expressly granted to one or more Trustees and/or an Investment Manager in this Agreement to the extent such power is substantially similar to the types of powers expressly enumerated in this Section ___.*

(1) <u>Apportionment of Income and Expenses</u>. Where not otherwise clearly provided by law or otherwise set forth herein, the Independent Trustee shall have the power to determine with finality, as to each sum of money or other thing of value held or received by any Trustee, whether and to what extent the same shall be deemed to be principal or to be income, and as to each charge or expense paid by any Trustee, whether and to what extent the same shall be charged against principal or against income, including, without hereby limiting the generality of the foregoing language, power to apportion any receipt or disbursement between principal and income and to determine what part, if any, of income is available for distribution according to the terms hereof, and what part, if any, of the actual income received upon a wasting investment, or upon any security purchased or acquired at a premium, shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to set up such reserves out of principal or income as the Independent Trustee shall think fit.

(2) <u>Management of or Division into Shares or Separate Trusts</u>. To hold, manage, invest, and account for the several shares or separate Trusts which may be held in trust, either as separate funds or as a single fund, as the Independent Trustee shall think fit; if as a single fund, to make division thereof only upon the books of account, to allocate to each share or Trust its proportionate part of the principal and income of the single fund, and to charge against each share or Trust its proportionate part of the common expenses. In addition, the Independent Trustee shall have the power to divide any Trust established by this Agreement into separate identical shares or Trusts if the Independent Trustee determines that doing so may be advantageous for tax or other reasons.

(3) <u>Method of Distribution or Division</u>. In dividing the Trust estate into separate shares or trusts, or in distributing the same, to divide or distribute in cash, in kind, or partly in cash and partly in kind, using different properties according to their fair market values or undivided interests in the same property, as the Independent Trustee shall think fit for any purpose. The reasonable and good faith determination of the fair market value of the Trust estate or any part thereof shall be conclusive and binding on all parties.

(4) <u>Use or Occupancy of Trust Property</u>. To allow any of the following Persons to use or occupy any Trust property without payment of rent or other remuneration:

(a) Any beneficiary;

(b) With regard to any residential property occupied by a beneficiary, the spouse or significant other of the beneficiary and any descendants of the beneficiary;

(c) With regard to any residential property occupied by a beneficiary, any individual appointed by a court of competent jurisdiction and qualified to serve as the guardian of the person of such beneficiary; and

(d) With regard to any residential property occupied by a beneficiary, the spouse or significant other of the individual appointed by a court of competent jurisdiction and qualified to serve as guardian of the person of such beneficiary.

(5) <u>Termination of Small Trust</u>. Notwithstanding any provision of this Agreement, to terminate any separate Trust established by this Agreement whenever in the Independent Trustee's opinion such Trust is so small in value that the administration thereof is no longer economically advisable. In making this determination, the Independent Trustee is requested to take into consideration the financial and special advantages to the beneficiary or beneficiaries of continuing the Trust estate. In the event of a termination, the Independent Trustee shall distribute the remaining Trust assets to the then income beneficiary or beneficiaries, per stirpes. The Independent Trustee's judgment shall be final and binding

upon all interested parties, and distribution of Trust assets in any manner provided in this Agreement shall relieve the Trustee of any further responsibility with respect to such assets.

(6) Generation-Skipping Transfer Taxes and Payment. If the Independent Trustee considers any distribution or termination of any interest hereunder as a distribution or termination subject to a generation-skipping transfer tax, the Independent Trustee is authorized:

(a) To augment any taxable distribution by an amount which the Independent Trustee estimates to be sufficient to pay that tax and to charge the same to the particular Trust or share to which the tax relates without adjustment of the relative interests of the beneficiaries;

(b) In the case of a taxable termination, to pay the tax from the particular Trust or share to which the tax relates, without adjustment of the relative interests of the beneficiaries. If the tax is imposed in part by reason of the Trust property hereunder and in part by reason of other property, the Independent Trustee shall pay only the portion of the tax which the Independent Trustee determines in good faith to be attributable to the taxable termination hereunder, taking into consideration deductions, exemptions, credits and other factors which the Trustee deems advisable; and

(c) Subject to the limitations of the rule against perpetuities to postpone final termination of any particular Trust and to withhold all or any portion of the Trust property until the Independent Trustee is satisfied the Trustee and the Trust no longer have any liability to pay any generation-skipping transfer tax with reference to the Trust or its termination.

(7) Assistance to Certain Estates. The Independent Trustee may, in its sole discretion, utilize the principal of any Trust as set forth in this paragraph, and any payment made in the bona fide belief that it is pursuant to this paragraph shall be binding upon all beneficiaries:

(a) Investments. To purchase and to retain as investments any property, real or personal, belonging to the estate of the Primary Beneficiary.

(b) Loans. To make loans to the Executor of the Primary Beneficiary's estate on such terms as the Trustee deems advisable.

Renouncement of Interest by Grantor. Notwithstanding any other provision in this Agreement, no part of the principal or income of any Trust established herein shall ever revert to or be used for the satisfaction of legal obligations of the Grantor, and no income of any Trust established herein shall be applied to the payment of premiums of insurance on the life of the Grantor (or the Grantor's spouse, if any) without the prior written approval of all of the then income beneficiaries of such Trust. The Grantor renounces for himself and his estate any interest, either vested or contingent, including any reversionary right or possibility of reverter, in the principal and income of the Trusts, and any power to determine or control, by alteration, amendment, revocation, termination, or otherwise, the beneficial enjoyment of the principal or income of the Trusts.

Independent Trustee. Any original or successor Independent Trustee appointed pursuant to this Section __ shall be either (i) any Person other than (x) the Grantor, (y) any beneficiary, or (z) any Person who is "related or subordinate" (within the meaning of Section 672(c) of the Code) to either the Grantor or any beneficiary or (ii) any corporate fiduciary.