

# EVERY DRAFTER'S DREAM: THE FLEXIBLE IRREVOCABLE TRUST

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## **I. Introduction.**

Our transfer tax system motivates wealthy individuals to give property to spouses, children, grandchildren, and others in an effort to reduce anticipated transfer taxes that hover over us. Donors motivated by tax considerations often desire to have their cake and eat it too — that is, they wish to give away property for tax purposes, but, yet, keep control over the property for all other purposes.

Importantly, our transfer tax system treats every individual as separate and distinct from every other individual regardless of relationship. This distinctiveness is not true elsewhere in the Internal Revenue Code. For example, under the income tax laws, husbands and wives may be treated as one person (*e.g.*, §§ 672(e), 1041, and 1272(a)(2)(E)(iii)), individuals may be attributed ownership of certain assets actually owned by other family members or other related entities (*e.g.*, § 318), and transactions between related taxpayers may not be respected (*e.g.*, § 267).

But for gift and estate tax purposes, the ownership and rights over property by an individual will not be attributed to another regardless of relationship. For example, Prop. Reg. § 20.2036-2(c) provides that the attribution rules of § 318 are not to be used to attribute voting rights to the decedent. The IRS has long tried to impose a family attribution rule, not for the purposes of attributing ownership or rights to another, but for the purpose of denying marketability and minority discounts when valuing closely-held businesses owned by a family, but to no avail. And the IRS capitulated on this point in Rev. Rul. 93-12, 1993-1 C.B. 202, *rev'g* Rev. Rul. 81-253, 1981-2 C.B. 187.

Since transfer taxes have been levied, taxpayers have tried to make gifts that are complete for gift tax purposes and will keep the property out of the donor's estate, and, yet, allow some continued control over the transferred property.

Business entities, such as corporations, partnerships, and limited liability companies, may accomplish such goals by allowing the donor to give interests in a controlled entity. But using a business entity may not be appropriate for all family assets or for all situations.

Sometimes irrevocable trusts are used to accomplish desires of our clients. But the idea of the trust and the donor's actions being irrevocable can make clients hesitant.

This paper discusses how a trust can be irrevocable for tax purposes and yet adapt to changing circumstances by giving others the right to change the terms of the trust. In essence, flexibility may be kept by giving carefully crafted limited powers of appointment to trusted persons.

## **II. Initial Assumptions.**

It often is easier to discuss how certain tax laws apply by showing how they apply to a hypothetical situation. For this purpose, let us assume that our clients are Donald and Daisy Mallard, and that they have a harmonious and happy marriage with three children being the tangible result of their union, Dewey, Louie, and Huey. Donald is a successful surgeon with significant annual earnings. Although Daisy is active with community organizations, she is not gainfully employed. The children are ages 10, seven, and four. Donald and Daisy wish to transfer property into trust for the irrevocable benefit of their children, but because of their tender years, want to be able to determine when and how much their children get and to modify the trust should changes ever be desired.

Donald, as the wage earner, will establish the trust for the children. Using the Mallards as our clients, we will discuss gift, estate, and income tax concerns and consequences in helping Donald and Daisy achieve their goals.

## **III. Gift Tax.**

**A. Completed Gifts.** Donald and Daisy understand that any giving of money and property must be considered a completed gift for gift tax purposes if they are to remove the property from their estates. In this vein, the Supreme Court in *Commissioner v. Estate of Church*, 335 U.S. 632, at 645 (1949), stated:

An estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, without possible reservations, parts with all of his title and all of his possessions and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or enjoy the property then or thereafter.

A gift is complete when the donor has so parted with dominion and control as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another. Regs. § 25.2511-2(a). If the grantor's creditors can reach the property, the gift will not be complete.<sup>1</sup> ORC § 5805.06(A)(2) provides that, with

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<sup>1</sup> *Outwin v. Comr.*, 76 T.C. 153 (1981), *acq.*, 1981-2 C.B. 2; *Estate of German v. U. S.*, 85-1 USTC ¶13,610 (1985).

respect to an irrevocable trust, a creditor or an assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.<sup>2</sup>

A gift is not considered incomplete merely because the donor can change the time or manner of enjoyment. This is because the gift tax is an excise on the act of giving and is measured by the value of the property passing from the donor and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.<sup>3</sup> This statement informs us that merely having a completed gift is not always enough because one may have made a completed gift but, yet, have the transferred property included in his gross estate.

Thus, we start with the premise that the donor must part and will part with all dominion and control over the property given to the trust. In other words, there must be a completed gift for federal gift tax purposes and no retention of control by the donor that will give rise to the transferred property being included in the donor's gross estate.

**B. Split Gifts.** Section 2513 provides that a gift made by one spouse to any person (other than his spouse) will be considered as if each spouse made one-half of the gift if both spouses consent to this result and the other conditions of § 2513 are met.

Section 2513(a) states that this fiction — each spouse being deemed to have made one-half of the gift — is for the purpose of the gift tax sections only. This is echoed in the regulations which state that “A gift made by one spouse to a person other than his (or her) spouse may, *for the purposes of the gift tax*, be considered as made one-half by him and one-half by his spouse ...” Regs. § 25.2513-1(a) (emphasis added).<sup>4</sup>

*Example:* Donald makes gifts of \$20,000 to each of his children. Donald and Daisy consent to split these gifts pursuant to § 2513. Daisy is considered to have made gifts of \$10,000 for gift tax purposes, but not for income or estate tax purposes. Daisy will be treated as making \$10,000 gifts to each of her three children for GST tax purposes because § 2652(a) specifically makes § 2513 applicable to the GST tax provisions.

Based on the above, the non-donor spouse can consent to split gifts in accordance with § 2513 and not be treated as the transferor for purposes of the estate or income tax provisions.<sup>5</sup> This is important if Donald and Daisy wish Daisy to exercise control over the trust and also wish to maximize the use of the gift tax annual exclusion.

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<sup>2</sup> This may be relevant where an irrevocable trust is characterized as a grantor trust for income tax purposes and the trustee has the discretion to reimburse the grantor for income taxes.

<sup>3</sup> Regs. § 25.2511-2(a).

<sup>4</sup> Also, see, *English v. United States*, 284 F. Supp. 256 (W.D. Fla. 1968).

<sup>5</sup> See PLR 200130030.

**C. Annual Exclusion Gifts Made in Trust.** Section 2503(b) provides that the first \$10,000<sup>6</sup> gifts (other than gifts of future interests in property) made from the donor to any person is excluded from the total gifts made by the donor to such person. Generally, gifts made to a trust for the benefit of the trust beneficiaries is a gift of a future interest and, thus, will not be excluded from total gifts no matter how small the amount of the gift is. However, allowing the beneficiary a right to withdraw gifts made to a trust, often referred to as *Crummey*<sup>7</sup> rights of withdrawal or *Crummey* powers, will cause such gifts to be characterized as present-interest gifts and qualify for the annual exclusion under § 2503(b). The fact that the nondonor spouse who consents to split a gift under § 2513 may also possess a *Crummey* right of withdrawal as the natural or legal guardian of a beneficiary does not prevent the creation of a present interest.<sup>8</sup> Although a discussion of *Crummey* powers is beyond the scope and purpose of this paper, below is an example of language that may be used in an irrevocable trust where flexibility is desired. Donald Mallard is considered the grantor and first person pronouns refer to him as grantor of the trust and Daisy is the trustee.

### ***LIMITED RIGHTS OF WITHDRAWAL***

Each child of mine and the descendants of any deceased child of mine (for convenience, referred to in this Article as “Beneficiaries” and individually as a “Beneficiary”) will have the right to withdraw gifts made to this trust in accordance with the following provisions. This right is superior to and takes precedence over all powers of the Trustee, including any power to make discretionary distributions.

The Trustee is prohibited from accepting any gifts from Daisy, although this will not prevent the Trustee from accepting gifts made to the trust by me even though Daisy and I consent to have such gifts treated for federal gift tax purposes as if Daisy contributed one-half of such gifts. If it should be discovered that the Trustee accidentally accepted any gift from Daisy, upon such discovery, such gift will be returned to Daisy.

**2.1. Amount That May Be Withdrawn.** With respect to all gifts made to this trust, whether directly or indirectly, in any calendar year, each Beneficiary may withdraw an amount equal to the lesser of --

- twice the annual exclusion allowed under Section 2503(b) of the Code for the year in which such gift was made, less the amount, if any, that such Beneficiary could withdraw from any gifts made earlier in such year, or

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<sup>6</sup> This amount is indexed for changes in the cost of living pursuant to § 2503(b)(2) and for 2007 is \$12,000.

<sup>7</sup> The name comes from *Crummey v. Commissioner*, 397 F.2d 82 (9<sup>th</sup> Cir. 1968).

<sup>8</sup> See PLR 8712014.

- the value of such gift divided by the number of such Beneficiaries.

**2.2. Informing The Beneficiaries Of Their Right To Withdraw Gifts.** The Trustee will inform the Beneficiaries in any reasonable manner of each gift made to this trust and of their rights to withdraw such gift. Such notice need not be in writing.<sup>9</sup> I or others may notify the Beneficiaries of any gift or of their rights to withdraw any gift.

**2.3. How The Right To Withdraw Is To Be Exercised.** Any exercise of a right to withdraw must be made by a writing, signed by the person exercising this right, and delivered to the Trustee. Upon receipt of a proper exercise, the Trustee will select and distribute any assets of the trust to satisfy such exercise.

**2.4. When The Right To Withdraw Will Lapse.** Any amount that a Beneficiary may withdraw as of the last day of any calendar year will lapse to the extent of \$5,000 or an amount equal to five percent of the value of the trust estate determined as of the end of the calendar year, whichever is greater. I intend that any lapse fall within the provisions of Section 2514(e) of the Code.

**2.5. Authority Of Representative.** Whenever a Beneficiary is under a legal disability, the notice required to be given to such Beneficiary will be given to any one of his or her legal or natural guardian, a grandparent, other relative, or any other competent adult, even though such individual is a Trustee, provided, however, in no event will notice be given to me regardless of my relationship to such Beneficiary. The person to whom notice is given will have the right to exercise for and in behalf of such Beneficiary the right to withdraw given to such Beneficiary.

**2.6. Value Of Gifts.** The value of any gift made to this trust will be equal to its value for federal gift tax purposes.

**2.7. A Donor May Change These Provisions.** If a donor specifies that a gift to this trust (a) may not be withdrawn, (b) may be withdrawn by other or additional persons, (c) may be withdrawn in amounts or in a manner different than that provided for above, or (d) will be subject to different conditions, the conditions so imposed by the donor will supersede the above terms of this Article 2.

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<sup>9</sup> Written notice is not required especially when notice is deemed to exist automatically. See PLR 200123034 (“If any child of Grantor is serving as trustee of this trust, then he or she shall be deemed automatically to have received the notice required to be given by the trustee”); PLR 8445004.

### **III. Estate Tax Considerations for the Donor.**

**A. Giving Away Property, But Keeping Rights; the String Sections.** The gross estate includes not only property that the decedent owned at death (§ 2033), but also property that the decedent had given away but over which he kept particular rights or benefits so as to cause such property to be included in his gross estate under §§ 2036, 2037, and 2038. These sections sometimes are called “string” sections and it is the avoidance of these sections that often is the challenge where the client wishes to give away property on the one hand and keep control on the other hand.

A common thread of §§ 2036 - 2038 is that (1) the decedent has gratuitously transferred property, and (2) the transferor/decedent has kept some right or benefit prohibited by such sections. With respect to §§ 2036 and 2038, such retained right may be exercised by the decedent alone or in conjunction with other people. With respect to § 2037, such retained right is a reversionary interest with a value that exceeds 5% of the value of the property. Because we assume that Donald will not keep any reversionary interest, we will focus our attention on §§ 2036 and 2038.

Section 2036 causes property to be included in the decedent’s estate if the decedent has transferred property by gift and he has kept for his life (1) possession or enjoyment or the income of the transferred property, or (2) the right, *either alone or in conjunction with any person*, to designate the persons who will possess or enjoy the property or its income.

Section 2038 causes property to be included in the decedent’s gross estate if he has transferred property by gift and, at the date of his death, the enjoyment of the property was subject to change through the exercise of a power by *the decedent alone or in conjunction with others* to amend, revoke or terminate.

It is important to note that both sections require the decedent to possess the prohibited powers and does not cause inclusion if any family member of the decedent has such powers. This is discussed more in the next section.

Sections 2036 and 2038 can be avoided by the decedent not keeping (1) any right to enjoy or possess the property, (2) any income from the property, (3) any right to determine who will enjoy or possess the property, (4) any right to determine who will receive the income, and (5) any right to amend, revoke or terminate the trust.

*Note:* The regulations to § 2036 provide that transferred property to be applied toward the discharge of a legal obligation of the decedent is considered the retention of the use of the property. Thus, a trust that is to be applied for the support of the decedent’s children can give rise to inclusion in the transferor’s gross estate under

§2036 if (1) the decedent is obligated to support the children (*e.g.*, the children are minors), and (2) the trustee is required to use the trust for such support.<sup>10</sup>

This trap can be avoided either by providing that the trustee may, but is not required to, provide for the beneficiary's support, or by providing that no distribution will satisfy a legal obligation of the decedent. Many trusts specifically prohibit the trustee from satisfying any legal obligation of the grantor or the trustee of the trust.

*Note:* The regulations to § 2038 provides that § 2038 will not apply if the decedent's power to amend or revoke the trust can be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law.

ORC § 5804.11 provides, in part, "If upon petition the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court shall enter an order approving the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust. Similarly, New York law (EPTL §7-1.9) permits a grantor, upon the written consent of all persons beneficially interested in the trust property, to revoke or amend the trust. As a result, the law of Ohio and New York gives to every grantor the right to amend and revoke his trust, but only with the consent of the persons who are beneficially interested in the trust.<sup>11</sup> And, as a further result, such power to amend or revoke is not subject to § 2038. Further, such power ought not be subject to § 2036 because in making the transfer of the property to the trust, the grantor has not retained or reserved any right, a condition that must exist before § 2036 will be applied. Instead, the law has conferred the right on the grantor.

**B. Giving Rights to Others.** To accomplish Donald and Daisy's desires, Donald cannot retain any prohibited string, lest he get a rope burn. (*See, Old Colony Trust v. U.S.*, 423 F.2d 601 (1<sup>st</sup> Cir. 1970), where the court quipped that "the cost of holding onto the purse strings may prove to be a rope burn.")

But nothing forbids Donald from giving such rights to other persons and not having the string sections apply. This conclusion is supported by the statutes as noted above, as well as by a reading of the regulations. Regs. § 20.2036-1(b)(3) states that the phrase, "right ... to designate the person or persons who shall possess or enjoy the transferred property, or the income therefrom," does not apply to a power held solely by a person other than a decedent. Likewise, Regs. § 20.2038-1(c) provides that § 2038 does not apply to a power held solely by a person other than the decedent.

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<sup>10</sup> See *Estate of Gokey v. Commissioner*, 72 T.C. 721 (1979).

<sup>11</sup> This is in accord with the Uniform Trust Code (§ 411(a)) and with the Restatement (Third) of Trusts (§ 65).

To like effect, Prop. Regs. § 20.2036-2(c) states that the fact that a relative of the decedent is trustee of a trust to which the decedent has transferred stock shall not in itself require a finding that the decedent indirectly retained the right to vote that stock.

The ability to safely give powers to others may be illustrated under Regs. § 20.2037-1(e), Example 6, which reads as follows:

The decedent transferred property in trust with the income to be accumulated for his life and, at his death, the principal and accumulated income to be paid to the decedent's then surviving children. The decedent's wife was given the unrestricted power to alter, amend, or revoke the trust. Assume that the wife survived the decedent but did not, in fact, exercise her power during the decedent's lifetime. Since possession or enjoyment of the property could have been obtained by the wife during the decedent's lifetime under the exercise of a general power of appointment, which was, in fact, exercisable immediately before the decedent's death, no part of the property is includible in the decedent's gross estate.

Although found under § 2037, the example makes no mention that the trust property would be included in decedent's gross estate under § 2036 or 2038. (In this vein, see Regs. § 20.2036-1(b)(3) and Regs. § 20.2038-1(b) which refers the reader to another section for possible inclusion.) Nor should such sections apply and this should be so even if the wife only had a limited power of appointment. Further, in the above example, for § 2037 to apply, if at all, the wife must have a general power of appointment. But, if the decedent has no reversionary interest, § 2037 will not apply, regardless of the interest held by the wife.

Further, when Congress wanted to attribute to the decedent the powers held by another, it has done so specifically. For example, former § 2036(c)(3)(C) stated that an individual and such individual's spouse are treated as one person. And § 672(e) treats a grantor as having all powers or interests held by his spouse.

This conclusion that powers must be held by the decedent and are not attributed to him from others also is supported by case law. In *Kneeland v. Commissioner*,<sup>12</sup> the decedent established an irrevocable trust for his family, but under which his wife could revoke the trust and have the principal returned to the decedent. The court held that the power of the decedent to influence his wife to revoke the trust, did not support inclusion of the trust in the decedent's estate. Also, this potential ability to influence did not rise to the level of agency; the ability to influence is not the same as the ability to control and direct.

The court also held that the decedent's interest, if any, was, at most, a mere possibility of a reverter and was not a transfer to take effect in possession or enjoyment

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<sup>12</sup> 34 B.T.A. 816 (1936).

at or after the decedent's death for purposes of the predecessor to § 2037 (citing *Helvering v. St. Louis Union Trust Co.*, 296 U.S. 39, as controlling).

To like effect, in *Ballard Est. v. Comr.*,<sup>13</sup> the decedent's wife had the power to amend and revoke the trust and the opinion states, "The evidence shows that the decedent's wife talked matters over with him and respected his judgment on financial matters. That does not mean, however, that the familial relation gave decedent the power to amend or revoke the trust."

This conclusion also is supported by *Tully v. U.S.*<sup>14</sup> The decedent, Tully, was employed by Tully and DiNapoli, Inc., a company owned 50% by Tully and 50% by Vincent DiNapoli. Tully, DiNapoli, and the company entered into a contract whereby the company agreed to pay death benefits to their respective widows.

The IRS alleged that the payment made to Mrs. Tully ought to be included in Tully's gross estate under § 2038. The Court of Claims found that Tully had made a transfer in the death benefits by executing the agreement for purposes of § 2038. But the Court of Claims found that Tully did not have the required power to alter, amend, revoke or terminate the transfer. In discussing the meaning of the phrase, "a power to alter, amend, revoke or terminate" found in § 2038, the Court of Claims stated that such a power "expressly exercisable in conjunction with others falls within § 2038(a)(1), but 'power' as used in § 2038 does not extend to powers of persuasion. If § 2038(a)(1) reached the possibility that Tully might convince [the company] and DiNapoli to change the death benefit plan, it would apply it to speculative powers. Section 2038(a)(1) cannot be so construed."

*Note:* In none of the above regulations or cases was there an agreement or understanding between the decedent and the person who has powers over the assets that the decedent would control the other. And there should be none. The decedent may have had expectations of what would be done, but the decedent could not legally control or direct what would be done.

The following six examples will highlight the flexibility available to the Mallards. My hope is that the reader will find the conclusions so obvious as to question the need for this paper. In all examples, we assume that Donald has not given life insurance or any other interest within three years of death that would result in such insurance or interest being included in Donald's gross estate because of § 2035.

**Example 1:** Donald makes a gift of property to Daisy. Donald retains no rights or benefits. At Donald's death, none of this property is included in his gross estate.

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<sup>13</sup> 47 B.T.A. 784 (1942), *aff'd*, 138 F.2d 512 (2<sup>nd</sup> Cir. 1943).

<sup>14</sup> 528 F.2d 1401 (1976).

This result may seem so obvious as to not need discussion. But the following important aspects of our tax laws can be emphasized.

Donald's estate does not include property owned by Daisy, and this is so notwithstanding that they are married, that Daisy received the property from Donald, and regardless of how close to Donald's death such transfers were made. Further, Daisy's rights over the property are not attributed to Donald and this is so even though Daisy may deal willingly with the property as Donald asks.

In *Estate of Andersen*,<sup>15</sup> husband had given closely-held stock to his wife. Several years later, husband became concerned about possible marital discord and instructed his lawyer to persuade the wife to execute a trust instrument to assure his continued management of the company. The trust provided a life estate for the wife but named the husband as the trustee so that he could maintain control over the company. The husband argued that he should be treated as the grantor of the trust. But the court held that husband's gift was complete and, as a result, the wife was the true grantor of the trust. The facts that, one week after the gift, wife authorized husband to use most of the shares as collateral for loans, that the wife had little real say as to the stock, and that the husband persuaded wife to establish the trust so that he could keep control over the gifted shares of stock did not change the fact that husband's gift to the wife was complete and that the wife was the grantor of the trust.

At Daisy's death, the property will be included in her gross estate under § 2033 because she owns the property.

**Example 2:** Donald establishes an irrevocable trust for the primary benefit of his children, Dewey, Louie, and Huey. Daisy is the trustee and, as long as she is acting as the trustee, she may distribute to any of the children as much income and principal as she considers best. Daisy cannot satisfy any legal obligation of hers or of Donald's.

Again, Donald's estate will not include any of the trust property. Donald's gift was complete when made and he did not retain any rights or benefits over the transferred property. Nor will Daisy's estate. Donald was the transferor, but retained no rights or benefits. Daisy was given rights, as trustee, but did not transfer any property for estate tax purposes.

**Example 3:** Donald makes a gift to an irrevocable trust administered for the primary benefit of Dewey, Louie, and Huey. Daisy has a limited power of appointment to direct distributions to their children.

Just as in the above examples, at Donald's death, none of the trust property is included in Donald's gross estate. Again, this is true notwithstanding the fact that had

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<sup>15</sup> T. C. Memo 1973-248.

Donald kept the right that he had given to Daisy, the trust property would be included in his gross estate.

At Daisy's death, none of the trust property is included in her gross estate because she does not own the property, she was not the transferor of the property so as to cause any of the string sections to apply (and this is true even if she had consented to split the gift under § 2513), and she does not have a general power of appointment.

**Example 4:** Donald makes a gift to an irrevocable trust administered for the primary benefit of Dewey, Louie, and Huey. Daisy has a limited power of appointment to direct distributions to or for the benefit of any person, including Donald, but excluding Daisy, her creditors, her estate, and the creditors of her estate. Also, Daisy cannot create another power as defined in Code § 2041(a)(3). However, Daisy may exercise this power of appointment by making appointments from the trust estate in cash or in kind, including a direction to the Trustee to distribute specific property to, or in trust for the benefit of, any one or more of the objects of the power; by creating life estates for any one or more objects of the power and remainders to other objects; and by imposing lawful restrictions and conditions on any appointment, provided that no one other than permitted objects of the power of appointment is benefited by such exercise.

The tax result should not change regardless of how broad Daisy's limited power of appointment is. As with all examples, Donald's gift was complete when made and he did not retain any rights or benefits over the transferred property. Daisy's power is a limited power of appointment as defined under § 2041.

**Example 5:** The same as above, but, in addition, to Daisy's broad limited power of appointment (1) Daisy may amend the trust to add or delete beneficiaries, including Donald, and (2) Daisy may increase, decrease or modify the benefits given to any beneficiary. But in no event can Daisy appoint any trust property to herself, her creditors, her estate, and the creditors of her estate, nor may Daisy amend the trust so as to increase any benefits or rights originally given to her under the trust.

Once again, none of the trust property will be included in Donald's estate or Daisy's estate (assuming that Daisy does not give property to Donald or amend the trust so as to cause the trust to be included in his estate).

The "additional powers" given to Daisy are not additional powers at all because her limited power of appointment effectively allows her to accomplish the other matters set forth.

**Example 6:** Donald establishes an irrevocable trust for the primary benefit of his children. But the trust provisions give to Donald's estate planning adviser (attorney, accountant, investment adviser, etc.) the power to appoint the property to Donald.

The result ought to be no different than the preceding examples. But might a court consider the professional adviser, who has no personal relationship to the beneficiaries and no independent concerns regarding the beneficiaries, to be Donald's agent? If this is so, then might a court be willing to find an understanding existing between Donald and his adviser that his adviser will follow all of Donald's instructions?

What this last example shows is that there are some lines that one may not be comfortable in crossing, notwithstanding legal support for the position.

Perhaps this example illustrates best the reality that Daisy (or other family members) will have a greater likelihood of defying Donald than any of Donald's professional advisers. For example, if Donald subsequently wishes to disinherit Louie, Daisy may not exercise powers to effectuate this result, while a professional adviser, having no relationship to Louie, may not care and may not wish to antagonize Donald who is a client and friend.

But in *Estate of Hilton W. Goodwyn*,<sup>16</sup> the court, relying on *U.S. v. Byrum*,<sup>17</sup> stated that the right or power must be a legal right reserved in the trust instrument or at least by some form of agreement between the trustees and the grantor. And that de facto control over the trustee was not enough to trigger § 2036 or 2038. The court went on to state:

To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the *Byrum* case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.

It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that [the trustees] permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. ... Had they so elected, [the trustees] could have taken control of the trust res at any time.

*Also see, Estate of Hilton W. Goodwyn*,<sup>18</sup> which held that the grantor trust rules also did not apply to the trust.

Absent an agreement or understanding, the taxpayer ought to prevail against a presumed agency argument. As found in *Kneeland* and *Tully*, the ability to influence

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<sup>16</sup> T.C. Memo 1973-153.

<sup>17</sup> 408 U.S. 125.

<sup>18</sup> 35 T.C.M. 1026 (1976).

does not rise to the level of legal control. Also, as in *Ballard* and the example cited under the regulations to § 2037, familial relationship, in itself, is insufficient to support an agency argument.

Presuming an agency relationship between the transferor and the trustee had some success in the arena of life insurance being deemed transferred by the decedent (*see, Bel v. U.S.*,<sup>19</sup> *Detroit Bank & Trust Co. v. U.S.*,<sup>20</sup> and *Kurihara Est. v. Comr.*,<sup>21</sup>), but this was not universal (*see, Hope v. U.S.*<sup>22</sup>). But in the arena of powers being granted to another, the law, the cases, and the regulations require an actual determination of agency and legal control. For example, in Rev. Rul. 80-346,<sup>23</sup> the IRS found that the grantor could vote stock indirectly because there was an agreement between the grantor and the trustee that the trustee would vote the stock only with the grantor's consent.

The parties should realize that no agreement should or can exist between them regarding the exercise of powers and this can be set forth in the trust instrument. Language appropriate for this may read as set forth below. Donald is assumed to be the grantor and all first person pronouns refer to him, while Daisy has the ability to amend the trust similar to example 5 above.

***Independence.*** I understand that I cannot control or direct Daisy in the exercise of or in refraining from the exercise of the above rights and powers given to Daisy. Daisy may exercise or refrain from exercising the rights and powers given to her above in any manner as she wishes, even though such exercise or refusal to exercise may be contrary or in opposition to my wishes.

Is this provision self-serving? No, not in the sense that it is only a ruse to cover up an actual agreement. Rather, it sets forth clearly that Donald cannot control or direct Daisy's decisions.

**C. Further Comment on Domination.** Where Donald gives rights to another, such rights can be attributed to Donald where Donald actually controlled the other's actions or where an agreement exists to the effect that the grantor is to have the interest or power. In cases discussing the ability of the grantor to control the trustee, it has been held that there is no retention just because the trustee is related to the grantor, or because the trustee tends to follow the grantor's wishes in exercising discretion.<sup>24</sup>

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<sup>19</sup> 452 F.2d 683 (5<sup>th</sup> Cir. 1971), *cert. denied*, 406 U.S. 919 (1972).

<sup>20</sup> 467 F.2d 964 (6<sup>th</sup> Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

<sup>21</sup> 82 T.C. 51 (1984).

<sup>22</sup> 691F.2d 786 (5<sup>th</sup> Cir. 1982) (remanding to determine whether or not the trustee had no discretion and was in fact controlled by the decedent).

<sup>23</sup> 1980-2 C.B. 271.

<sup>24</sup> *Comr. v. Irving Trust Co.*, 147 F.2d 946 (2<sup>nd</sup> Cir. 1945); *Ballard Est. v. Comr.*, 47 B.T.A. 784 (1942), *aff'd*, 138 F.2d 512 (2<sup>nd</sup> Cir. 1943) (the wife's right to amend or revoke the trust not attributed to the husband); *Sherman Est. v. Comr.*, 9 T.C. 594 (1947) (reviewed), *nonacq.*, 1948-1 C.B. 4.

In *U.S. v. Byrum*,<sup>25</sup> the Court suggests that a grantor's influence over the fiduciary is legally irrelevant because, even if the fiduciary is prevailed on to breach his duties, the grantor has not retained any right to affect beneficial enjoyment.

The more recent decision of *Wall Est. v. Comr.*<sup>26</sup> supports the conclusion that an ability to influence (in this case by removing the trustee) does not rise to the level of a right to affect beneficial enjoyment. The court also declined to infer any kind of side agreement between the grantor and the corporate trustee in the absence of some compelling reason to do so.

The above reasoning ought to apply with respect to individuals who possess powers of appointment over property. In the absence of actual control or of an agreement to the effect that the grantor is to have the power, the grantor should not be treated as having retained any right that will result in estate tax inclusion under § 2036 or 2038.

**D. Keeping Certain Rights.** Are there any rights that Donald may keep? Donald may keep all powers that will not cause the trust to be included in his gross estate. One must be aware that avoiding one string section does not guaranty avoidance of all. *See, e.g.*, Regs. §§ 20.2036-1(b)(3) and 20.2038-1(b).

The better question, perhaps, is why have Donald keep any power. There may be no better answer than that sometimes clients insist on keeping some rights. The author's view is that Donald should not keep any powers because it does not add materially to the goals being sought. This being said, this section will discuss some administrative powers that Donald may keep without adverse estate tax consequences.

**1. Power to Change the Trustee.** A grantor who keeps the power to appoint himself a successor or substitute trustee, causes himself to be treated as holding all administrative and dispositive powers of the trustees. And this is true even though the grantor never exercised any powers or in fact becomes a trustee.

A grantor who keeps the power to remove trustees and to appoint substitute or successor trustees other than himself ought not have any estate tax consequence.<sup>27</sup>

The IRS had ruled in Rev. Rul. 79-353<sup>28</sup> that, where a trustee had discretionary power, not subject to an ascertainable standard, to distribute income and principal to or among a class of beneficiaries, the value of the undistributed principal and income was included in the gross estate if the decedent kept the power to remove the corporate trustee and replace it with another corporate trustee.

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<sup>25</sup> 408 U. S. 125 (1972).

<sup>26</sup> 101 T.C. 300 (1993).

<sup>27</sup> *See, Byrum v. U.S.*, 440 F.2d 949 (6<sup>th</sup> Cir. 1971), *aff'd*, 408 U.S. 125 (1972) (the grantor's power to replace the trustee by a corporate trustee did not make trust includible in grantor's estate).

<sup>28</sup> 1979-2 C.B. 325.

Rev. Rul. 79-353 was subject to much adverse comment following its publication and, ultimately, was rejected by the Tax Court in *Wall Est. v. Commissioner*.<sup>29</sup> In *Wall Est.*, the grantor created a trust for the benefit of her child and grandchild and named a corporate trustee. The trustee had discretion to distribute income and principal to the beneficiaries without being limited to ascertainable standards. Because the grantor retained a power to discharge the trustee and replace it with a new corporate trustee, the IRS included the trust property in the grantor's estate at her death under the reasoning of Rev. Rul. 79-353. The Tax Court held that the property was not included in the grantor's estate because the retained power did not affect the possession or enjoyment of the trust assets. The court reasoned that even though the grantor could discharge and replace the trustee, the trustee's independent fiduciary duties to the beneficiaries would prevent it from being manipulated by the grantor.

As a result of the decision in *Wall Est.*, the IRS revoked Rev. Rul. 79-353 in Rev. Rul. 95-58.<sup>30</sup> (PLR 9607008 extended this ruling to § 2041.) Rev. Rul. 95-58 ruled that a decedent would not be considered as having retained the powers of the trustee just because the grantor-decedent reserved the right to remove a trustee and appoint an individual or corporate successor trustee "that was not related or subordinate to the decedent (within the meaning of § 672(c))." This reference to "related or subordinate parties" in the ruling is unfortunate because there is no such reference or support for this position in §§ 2036 or 2038 or their regulations, or in *Wall Est.* or *Estate of Vak*.<sup>31</sup> It is difficult to fathom the IRS's irrational fixation with this issue.

*Query:* Does this reference to "related or subordinate party" mean that the IRS will impute to the decedent the powers of the trustee whenever the trustee is or could be a related or subordinate party? There is no basis for reaching such a conclusion.

If the power to appoint a trustee was exercisable only once, and if the decedent had exercised it before his death, the trust property is not included in the grantor's gross estate because the power did not exist at the time of death.<sup>32</sup> A similar result occurred where the retained power to appoint a successor trustee existed only if the named trustee resigned or was removed by judicial process.<sup>33</sup>

State law may save an inarticulate grantor by interpreting favorably the application of the power, and also whether a power actually existed. In *Durst v. U.S.*,<sup>34</sup> the decedent-grantor created an irrevocable trust but reserved to himself the power to appoint individual trustees to complement the corporate trustee. The government contended that such power would allow the grantor to appoint himself trustee and that

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<sup>29</sup> 100 T.C. 300 (1993).

<sup>30</sup> 1995-36 I.R.B. 16.

<sup>31</sup> 973 F.2d 1409 (8<sup>th</sup> Cir. 1992).

<sup>32</sup> Rev. Rul. 73-142, 1973-1 C.B. 405.

<sup>33</sup> Rev. Rul. 77-182, 1977-1 C.B. 273 (modified in Rev. Rul. 95-58 to provide that the successor trustee could be a corporate trustee or an unrelated or nonsubordinate individual trustee).

<sup>34</sup> 409 F. Supp. 1046 (W.D. Pa. 1976) *aff'd*, 559 F. 2d 910 (3<sup>rd</sup> Cir. 1977).

the trust property was includible in decedent's gross estate under §§ 2036 and 2038. In rejecting the government's argument, the court found that under Ohio law, the grantor did not intend that he be allowed to be appointed trustee. A review of the instrument as a whole as well as a review of extrinsic evidence showed that grantor's intention was to maximize tax savings of the transfer.

**2. Power Over Investments.** In *State Street Trust Company v. U.S.*,<sup>35</sup> the decedent at the time of his death, was a co-trustee of trusts established by him. Under the trusts, the trustees were given broad powers with respect to investing trust property, including the powers to invest in "non-legals," exchange trust assets for other assets without reference to the value of the property involved, and to allocate receipts and disbursements notwithstanding any determination of the courts.

The First Circuit found that these powers were so broad that, notwithstanding control by state courts of equity, the trustees had the power to substantially shift the economic benefits of the trusts between the life beneficiaries and the remaindermen. Based on this line of reasoning, the decedent/trustee was said to have retained the right to designate who would possess the property and income, thereby causing the property to be included in his gross estate under the precursor to § 2036.

*State Street* was overruled effectively by *Old Colony Trust Company v. U.S.*,<sup>36</sup> principally because of a different characterization of state law. In finding that under applicable state law, no amount of administrative discretion prevents judicial supervision of a trustee, it was noted that courts have never varied from a broad rule of accountability. Thus, the First Circuit held that no aggregation of purely administrative powers could constitute sufficient dominion or control so as to be equated with ownership and cause taxation under §§ 2036 or 2038.

Other courts have reached the same conclusion. The Tax Court has considered cases where the decedent kept the power to direct the trustee to sell, exchange, invest or reinvest the trust property, and the trustee was exonerated from liability for any resulting losses. In each instance, it was determined that the decedent did not have the power to alter, amend or revoke the trust because the trustee was nevertheless required by local or other law to act in good faith and to exercise fiduciary responsibilities to safeguard the trust property.<sup>37</sup>

Keeping the right to vote stock transferred to the trust will result in the trust being included in the grantor's gross estate if the corporation is treated as a controlled corporation under § 2036(b) and the other requirements of § 2036(b) are met. A decedent will be treated as having retained the right to vote transferred stock indirectly

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<sup>35</sup> 263 F. 2d 635 (1<sup>st</sup> Cir. 1959).

<sup>36</sup> 423 F. 2d 601 (1<sup>st</sup> Cir. 1970).

<sup>37</sup> See, *Estate of Graham v. Commissioner*, 46 T.C. 415 (1966); *Estate of King v. Commissioner*, 37 T.C. 973 (1962), cited with approval in *U.S. v. Byrum*, 408 U.S. at 133 (1972).

if there is an agreement or understanding that the trustee would vote stock as directed by the decedent.<sup>38</sup>

**3. Power to Substitute Assets.** Where a grantor establishes a trust and keeps the right to reacquire the trust principal by substituting other property of an equivalent value, neither § 2036 nor 2038 ought to apply and the trust ought not be included in the grantor's gross estate for estate tax purposes.

In *Jordahl v. Commissioner*,<sup>39</sup> the Tax Court stated that a power to substitute property of equivalent value is not a power to alter, amend or revoke the trust as contended by the IRS, and compared it to a power to direct investments. Additionally, the Tax Court rejected the IRS's argument that the grantor could shift benefits between income beneficiaries and remaindermen. "We do not believe that decedent could have used this power to shift benefits in such a manner. Substitutions resulting in shifted benefits would not be substitutions of property 'of equal value'." Interestingly, the Tax Court found that the grantor was bound by fiduciary standards in the exercise of such right even though the governing instrument was silent.

Whether or not the right to substitute property is subject to fiduciary standards ought to be irrelevant to the issue of whether or not § 2036 or 2038 applies. Although the grantor may require an exchange of property between himself and the trust, presumably the trustee is under a duty to ensure that the property received are equivalent in value to the property delivered and to take the substitute property and invest, exchange or otherwise deal with them in a manner equitable to all beneficiaries in accordance with the terms of the trust.

The right to substitute property sometimes is used to cause an irrevocable trust to be characterized as a grantor trust by reason of § 675(4)(C). Note that such power must be exercisable in a nonfiduciary capacity if it is to trigger the application of the grantor trust rules.

*Query:* If a trust owns closely-held voting stock, can this right to exchange property be treated as a right to vote closely-held stock owned by the trust for purposes of applying § 2036(b)?

#### **IV. Estate Tax Considerations for the Donee - Powers of Appointment.**

It should now be apparent that Donald "keeps" control by giving control to Daisy (or other trusted individuals). If Daisy (or others) is to have control, one must examine and understand the rules concerning general powers of appointment under § 2041 of the Internal Revenue Code to make sure that the property will not be included in Daisy's estate.

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<sup>38</sup> Rev. Rul. 80-346, 1980-2 C.B. 271; PLR 9515003.

<sup>39</sup> 65 T.C. 92 (1975), *acq.* 1977-2 C.B. 1.

A general power of appointment means a power that is exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate.<sup>40</sup> The term includes all powers that are in substance and effect powers of appointment, regardless of the nomenclature used in creating the power and regardless of local property law connotations.<sup>41</sup>

Notwithstanding the above, if the power of appointment may be exercised by the decedent only in conjunction with (a) the creator of the power, or (b) a person who has a substantial interest in the property that is subject to the power and such interest is adverse to an exercise of the power in favor of the decedent, the power is not considered a general power of appointment.<sup>42</sup>

These exceptions may not be helpful for the Mallards. It does Donald no good if he has to consent to an exercise of the power of appointment because this will give rise to inclusion in Donald's estate under §§ 2036 and 2038. To require that the children (or other family members who are beneficiaries) consent to Daisy's exercise of the power may frustrate the desires of Donald and Daisy to determine what is best for their children.

Section 2041(b)(1)(A) does contain an exception that can be used to give Daisy even more latitude in dealing with trust property. Any power to appoint for the decedent's benefit that is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent is not considered a general power of appointment.

*Example:* Donald establishes an irrevocable trust for the primary benefit of Daisy, Dewey, Louie, and Huey. Daisy is the trustee and, as such, she may distribute as much income and principal (1) to any of the children as she considers best, provided that, she cannot satisfy any legal obligation of hers or of Donald's, and (2) to herself to provide for her support and health.

Additionally, Daisy, individually, (1) may appoint the property to any person, including Donald, (2) may amend the trust to add or delete beneficiaries, including Donald, and (3) may increase, decrease or modify the benefits given to any beneficiary, but in no event can Daisy appoint any trust property to herself, her creditors, her estate, and the creditors of her estate, nor may Daisy amend the trust so as to increase any benefits or rights to herself.

At Daisy's death, none of the property then comprising the trust ought to be included in her gross estate for federal estate tax purposes.

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<sup>40</sup> IRC § 2041(b)(1).

<sup>41</sup> Regs. § 20.2041-1(b)(1).

<sup>42</sup> IRC § 2041(b)(1)(A) and (C).

To determine whether or not a power of appointment is limited by an ascertainable standard, one must examine the nature of the power. For example, the following powers have been held not to be limited by an ascertainable standard relating to health, education, support or maintenance:

- ⇒ The power to appoint for a nonbusiness purpose;
- ⇒ The power to invade to “continue the donee’s customary standard of living”<sup>43</sup>;
- ⇒ The power to use property for comfort, welfare or happiness of the holder;<sup>44</sup>
- ⇒ The power to invade in cases of emergency; and
- ⇒ The power to appoint property for the purpose of discharging a legal obligation of a decedent. But, where the children of the holder are adults at the time of the death of the holder, the power to appoint for their support, health, education or maintenance is a special power of appointment and the trust principal is not taxable.<sup>45</sup>

The moral may be to parrot the language of the statute and provide that any power that Daisy may have to appoint property to herself is limited to provide for her health, education, support and maintenance.

The fact that the decedent is incapable or unable to exercise a general power of appointment is not pertinent to the inquiry into whether or not the property subject to the power is includible in the decedent’s gross estate. Taxation may occur even where the decedent is precluded under local law from exercising the power because of minority or mentally incapacity.

## **V. Income Tax Considerations to the Donor.**

A trust will be ignored for income tax purposes if the grantor has kept or is deemed to have kept one or more powers set forth in §§ 673-677 so as to cause him to be treated as the owner under § 671. In many instances where clients have the same goals as Donald and Daisy, the grantor will be considered the “owner” of the trust property and will include in computing his taxable income the items of income, deductions, and credits against tax of the trust.

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<sup>43</sup> Rev. Rul. 77-60, 1977-1 C.B. 282; *but, see*, for example, Regs. § 20.2041-1(c)(2) which states that “support in his accustomed manner of living” is an example of a power limited by an ascertainable standard.

<sup>44</sup> *But, see, e.g.*, Ohio Revised Code § 1340.22(B)(2) which provides that, *inter alia*, comfort is an ascertainable standard related to the health, education, support and maintenance of the beneficiary.

<sup>45</sup> Rev. Rul. 79-154, 1979-1 C.B. 301.

An individual that wishes to remove property from his estate for transfer tax purposes, but yet have the range of flexibility described above, must be willing to have the trust characterized as a grantor trust and the income attributed to him. This ought not be a concern because powers can be given to trusted family members who can direct distributions of trust property to the grantor to pay for the resultant income tax liability.<sup>46</sup>

**A. Benefit of Grantor Trust Status.** The question is not whether income earned by a trust will be taxed; the question is to whom. The possible candidates are the trust, the beneficiaries, and the grantor. If the trust or the beneficiaries pay the tax, the amount given to them by the grantor will be depleted by the amount of tax paid. If the grantor is responsible for the tax on the income, the grantor's estate will be depleted by the tax liability to the indirect benefit of the trust and the beneficiaries.

Under certain circumstances it will be desirable to have the trust characterized as a grantor trust so that the grantor will be responsible for the payment of the income tax on the trust income.

**Example:** Donald makes outright gifts of \$100,000 to each of Dewey, Louie, and Huey, who in turn invest such gifts. In the first year, Dewey, Louie, and Huey each earn \$8,000 of taxable income and each of them pays income taxes on such income.

Instead of making outright gifts to his children, Donald establishes a trust with the \$300,000 for the benefit of his three children, but which trust is a grantor trust under § 671. In the first year, the trust earns \$24,000 of taxable income that is distributed equally to Donald's children. But Donald reports and pays the income tax on the \$24,000, thus increasing effectively the property transferred to his children and further decreasing his estate ultimately subject to estate taxes.

The payment of the tax liability on the trust income attributed to the grantor under § 671 is not a gift to the trust because the grantor is paying his own tax liability.<sup>47</sup>

**B. Definitions Relevant to the Grantor Trust Rules.** Section 672 sets forth definitions and rules for grantor trusts, one of which is that the grantor will be treated as holding any power or interest held by the grantor's spouse.

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<sup>46</sup> Any such powers should be held in a nonfiduciary capacity so as to avoid creditor's having claims against the trust pursuant to ORC § 5805.06(A)(2) (a creditor or an assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit).

<sup>47</sup> See, Montesano, Carmela T., and Ann St. Laurent, *Defective Grantor Trusts: Gift Tax Consequences of Payment of Income Tax Liability by Grantor*, Tax Management Estates, Gifts and Trusts Journal (1995); Huffaker, Kassel, and Sidoni, *Is Income Tax Payment by Grantor Owner of a Subpart E Trust a Taxable Gift?*, J. of Tax'n 202 (April 1995). *But, cf.* PLRs 9444033 and 9504021.

In the examples above where Donald gives Daisy powers over the trust property, for purposes of the grantor trust sections, Donald is treated as holding those powers. § 672(e).

The grantor trust sections recognize that the grantor may control or be able to persuade persons who are related to him or are subordinate to him to do his bidding. For purposes of §§ 674 and 675, a related or subordinate party is presumed to be subservient to the grantor unless proved otherwise by a preponderance of the evidence.

A “related or subordinate party” means any nonadverse party who is (a) the grantor’s spouse if living with the grantor, (b) the grantor’s parents, siblings, and issue, (c) the grantor’s employee, (d) a subordinate employee of a corporation in which the grantor is an executive, and (e) a corporation or an employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control.

The above definition excludes many people who may be related to the grantor, but who are not considered related for purposes of the above definition. For example, the following persons are not considered related or subordinate to the grantor:

- ⇒ Aunts, uncles and cousins;
- ⇒ The spouses of the grantor’s siblings;
- ⇒ The parents, siblings and other relatives of the grantor’s wife;
- ⇒ The grantor’s partners and partnerships in which the grantor is a partner; and
- ⇒ The grantor’s co-members and limited liability companies in which the grantor is a member.

*Example:* Donald establishes a trust for the primary benefit of his children. He designates his long time partner and brother-in-law, Mickey, as the trustee. Mickey is not considered related or subordinate to Donald. As a result, Mickey, as the trustee, can have broad discretionary powers to accumulate or distribute income and principal among Donald’s children without causing the trust to be a grantor trust.<sup>48</sup>

Section 672 also provides that a person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of a power respecting the trust is an adverse party. All other persons are nonadverse parties. A trustee is not an adverse party merely because of his interest as a trustee. Thus, in the above example, Mickey is a nonadverse party. An individual may be adverse as to the income interest, the remainder interest or some other part of a trust, and need not be adverse to the entire trust.

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<sup>48</sup> Section 674(c).

*Example:* Donald establishes a trust for the primary benefit of his son, Louie, under which Louie is to receive all of the income. Mickey is the trustee and, under the trust, Louie, during his life and by his will, may appoint the trust principal to Donald. Louie's interest is adverse to the return of the principal to Donald during Louie's life, but is not adverse to a return of the principal to Donald after his death. In other words, Louie's interest is adverse as to ordinary income but is not adverse as to income allocable to principal. Therefore, assuming no other relevant facts exist, Donald would not be taxable on the ordinary income of the trust under sections 674, 676 or 677, but would be taxable under section 677 on income allocable to principal (such as capital gains), because it may in the discretion of a nonadverse party be accumulated for future distribution to Donald.<sup>49</sup>

Sections 674 to 677 will apply where the grantor or a nonadverse party, or both, have the particular powers set forth in these sections. Thus, determining the extent of a beneficiary's interest and whether or not it is adverse to the exercise or nonexercise of a power can be important.

**C. Some Powers that Result in Grantor Trust Status.** Many powers held by the grantor, the grantor's spouse or nonadverse parties can result in grantor trust status. Below are listed some powers that will cause a trust to be treated as a grantor trust.

- ⇒ The power to add beneficiaries, other than after-born or after-adopted children.<sup>50</sup>
- ⇒ The power to allocate income and principal among beneficiaries.<sup>51</sup>
- ⇒ The power to borrow trust funds without adequate security or interest, unless the trustee may make loans without interest or security under a general lending power.<sup>52</sup>
- ⇒ The power to vote stock or direct investments in a corporation in which the holdings of the grantor and trust are significant from the viewpoint of voting control.<sup>53</sup>
- ⇒ The power to reacquire the trust corpus by substituting other property of equivalent value.<sup>54</sup>

## **VI. Non-Tax Considerations.**

**A. Trouble in Paradise.** Donald must understand that Daisy can exercise or not exercise the rights given to her as she chooses even though contrary to his wishes. Donald and Daisy currently share the same goals and desires, but Donald realizes that

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<sup>49</sup> Regs. § 1.672(a)-1(c).

<sup>50</sup> IRC § 674(b)(5).

<sup>51</sup> IRC § 674.

<sup>52</sup> IRC § 675(2).

<sup>53</sup> IRC § 675(4)(A) and (B).

<sup>54</sup> IRC § 675(4)(C).

marriages can fail and is concerned about how Daisy may or may not exercise her powers in the event their relationship and marriage sours.

To address such concerns, Donald may wish to limit when Daisy can exercise her rights to amend the trust or to appoint trust property by providing that such powers can be exercised only if at the time of exercise (1) Donald is living, (2) Donald and Daisy are married and living together, and (3) Daisy has given Donald at least 10 days written notice of the exercise. Is such a provision intended to maximize Donald's ability to influence Daisy? Absolutely; but influence does not result in taxation. Spouses and family members are allowed to influence each other.

No provision is foolproof. If Daisy is determined to exercise her powers contrary to Donald's wishes, Donald must understand that Daisy will be able to do so.

*Note:* Daisy's exercise ought not be dependent on Donald's consent because Donald may then be construed as having the power in conjunction with Daisy.<sup>55</sup>

**B. Successors.** The ability to change the trust for Dewey, Louie, and Huey exists as long as Daisy exists. Donald and Daisy may consider designating someone who will have the powers to amend and appoint should Daisy cease to have such powers. Donald need not give a successor the same powers that he is willing to give to Daisy, but can tailor such powers to meet his concerns.

**C. Protection from Creditors.** Creditor protection has become a popular topic. Most often, such articles deal with foreign trusts and, more recently, domestic asset protection trusts. But can we use the above concepts to help Donald and Daisy with creditor concerns?

**1. Modify Assumptions.** Let us assume that Donald and Daisy do not have any creditor problems currently, but are concerned that a reversal of fortune, a successful malpractice case against Donald, or other financial misfortune could destroy the wealth they have built. They tell you that they like the general idea of transferring wealth to their children, but they would like "the ability to get it back if they should ever really need it." Also, they do not want to pay any gift tax and do not want to make any completed gifts, knowing that such property will be included in their gross estate for estate tax purposes.

**2. Creditor Rights.** Absent fraud, generally, a creditor will only have such rights over property that the debtor has. For example, if Donald gives Daisy their home, we would not expect Donald's creditors to be able to seize the house to satisfy their claims against Donald.

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<sup>55</sup> See Rev. Rul. 70-513, 1970-1 C.B. 18.

*Example:* Donald establishes an irrevocable trust with \$2 million for the primary benefit of Daisy and his children, Dewey, Louie, and Huey. The transfer does not make Donald insolvent. Under the trust, while Donald is living (a) the trustee may distribute property among the children as the trustee considers best, but no distribution will satisfy Donald's or Daisy's legal obligations, and (b) Daisy has a power to appoint the trust property to Donald, his descendants, their spouses, and charity. If Daisy dies during Donald's lifetime, a majority of his children may appoint trust property to Donald.

Upon Donald's death, the trust will be distributed among Donald's descendants, their spouses, and charity, as Donald may appoint by will. In default of appointment, the trust will continue for Daisy, if she survives Donald, in such a manner so that the trust will qualify for the marital deduction. Upon the death of the survivor of Donald and Daisy, the trust continues for the children.

If Donald's gifts are not fraudulent transfers, this irrevocable trust ought to provide a layer of protection from Donald's creditors. Donald's creditors ought to have the same rights over the trust property that Donald has. In the above example, Donald may only direct that the trust property be given to his descendants, their spouses, and charity upon his death.

From a tax standpoint, Donald has not yet made a completed gift, notwithstanding the trustee's discretion, because of his ability to appoint property by his will.<sup>56</sup> If, during his lifetime, distributions are made to his children, then the gift would be complete as to the distributions and gift tax returns may be required.

At Donald's death, the trust is included in his estate under § 2036 because he kept a power to control beneficial enjoyment. But the trust can be structured to qualify for the marital deduction if Daisy survives him and, presumably, complement the rest of his estate plan.

Where Daisy can appoint trust property to Donald, and where the creditors are the joint creditors of Donald and Daisy, a court of equity ought to require Donald and Daisy to work together so as to avoid an inequity. But if creditor concerns exist for Donald and Daisy, consider the following thoughts:

- ⇒ Give the right to appoint trust property to Donald to a family member other than Daisy;
- ⇒ If Daisy is to have the power to appoint property to Donald, require the consent of other family members; and

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<sup>56</sup> See Reg. § 25.2511-2(c) (A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard).

⇒ Require that the exercise of the power must be voluntary and any court-ordered exercise is without effect.

I cannot say that the trust established by Donald and Daisy would deter an ardent and determined creditor, but it would seem to present obstacles at a more reasonable cost than might be incurred establishing foreign trusts.

## **VII. Having Your Cake and Eating It Too.**

Donald wishes to establish a trust for the benefit of his three children, Dewey, Louie, and Huey. Daisy will be the trustee. The trust principal is intended to be distributed eventually to Donald's children as they attain certain ages after Daisy's death. Donald does not want to have the trust property included in his estate or Daisy's estate. He does not mind having the income of the trust taxed to him as long as someone in the family can appoint trust property to him so that he can pay the tax. Lastly, Donald wishes to have control to the extent that the law will allow.

Based on the above discussion, Donald can establish a trust that can give Donald and Daisy the following powers.

Donald may —

1. have the power to substitute assets of an equivalent value without the consent of the trustee;
2. have the power to allocate receipts and disbursements as between principal and income, even though expressed in broad language;
3. have the power to change the trustees, but he cannot name himself as a trustee; and
4. have the right to direct investments and vote stock held by the trust other than stock of a controlled corporation.

Daisy may —

1. be the trustee with broad discretionary powers over the distribution of the trust income and principal to her children, but she cannot make any distribution that would satisfy a legal obligation of hers or of Donald;
2. be the trustee with discretionary powers to distribute trust income and principal for her health, education, support, and maintenance; and
3. have a broadly stated limited power of appointment that would allow her to appoint the property to Donald (and others), but not to herself, her creditors, her estate or the creditors of her estate.

If Donald does not want the trust to be treated as a grantor trust and does not want the income attributed to him under § 671, there remains powers and rights that the family can hold.

Donald may —

1. have the power to allocate receipts and disbursements as between principal and income, even though expressed in broad language;
2. have the power to change trustees, except that Donald cannot name himself as a trustee; and
3. have the right to direct investments and vote stock held by the trust other than stock of a controlled corporation.

Daisy may —

1. have the power to deal with income and principal for the children as permitted under § 674(b)(1), (5),(6), and (7); and
2. have a broadly stated limited power of appointment subject to the approval or consent of the children.

The children may —

1. have the power to appoint trust principal to Donald.

## **VIII. Conclusion.**

With a harmonious family, an individual can transfer wealth from his estate to those of his children (and others) while having trusted family members keep control over such property.

To those readers who remain uneasy based on the well-honed feelings that what is being proposed is too good to be true, a few final comments. It is important to note that the transfers made by Donald and suggested in this paper are completed gifts<sup>57</sup> and, thus, are subject to the federal transfer taxes. The integrity of our transfer tax system is upheld. This paper does not propose or suggest that property can be transferred gratuitously from Donald to his family outside of the transfer tax system.

Secondly, Donald only has expectations and never has the right to dictate or control what is to be done with the property he has given away. This can be said to be true of many gifts, in trust or otherwise. It is important for the reader to understand, and certainly for Donald to understand, that Donald has no ability to control the exercise or non-exercise of the powers he has given to Daisy or others. There must be no agreement existing between them that gives Donald the power that he apparently gave to Daisy.

Thirdly, the estate tax laws have long permitted husbands and wives to act in concert. Sections 2036 and 2038 clearly allow a spouse or other family members to hold powers over property that the decedent could not hold.

*Example:* Donald establishes an irrevocable trust for the primary benefit of his children, Dewey, Louie, and Huey. Donald files a gift tax return reflecting this gift. Daisy is the trustee and, as long as she is acting as the trustee, she may distribute to any of the children as much income and principal as she considers best. Daisy cannot satisfy any legal obligation of hers or of Donald's. In addition, (1) Daisy may appoint the property to any person, including Donald, (2) Daisy may amend the trust to add or delete beneficiaries, including Donald, and (3) Daisy may increase, decrease or modify the benefits given to any beneficiary. But in no event can Daisy appoint any trust property to herself, her creditors, her estate, and the creditors of her estate, nor may Daisy amend the trust so as to increase any benefits or rights to herself.

While Donald was living, Daisy followed his wishes. But Donald's wishes also matched Daisy's wishes. Upon Donald's death, ought this trust be included in Donald's estate because of Daisy's willingness to follow Donald's instructions? The answer ought to be no.

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<sup>57</sup> Except for the discussion of creditor protection, which section specifically states that the transfers are not completed gifts.

Husbands and wives (and families) often act in concert and in ways that promote family harmony and the tax laws do not promote the contrary. In the examples, Donald relinquished all control over the property that he gave to the trust and he entrusted Daisy with significant powers. Donald did all that the tax laws require him to do. He placed his faith in his wife and, in our examples, his faith was not misplaced. As a result, Daisy's willingness to follow Donald's directions or wishes does not prove that an agreement or understanding existed between Donald and Daisy that required Daisy to do Donald's bidding. It may be evidence of an increasingly rare event – a good marriage.