Estate & Succession Planning Corner

By Lawrence I. Richman

How to Structure an Incomplete Gift in Trust So That the Trust is NOT a Grantor Trust

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While the tax advantages of grantor trusts remain the focus of interest on the part of estate planners, a recent private letter ruling details the circumstances and situations in which a Grantor may make a transfer in trust, have that transfer not be treated as a completed gift for gift tax purposes and have the transferee trust be treated as a separate taxpayer (*i.e.*, not as a grantor trust). It is an important current ruling because in order for a trust to be treated as a taxpayer separate and apart from the grantor, transfers in trust usually are completed gifts.[1] By providing a roadmap of the circumstances under which separate trust treatment will be allowed, the IRS is providing taxpayers with an outline of how to create separate taxable trusts without giving up total control.

In LTR 200502014,[2] the Grantor established an Irrevocable Trust for the benefit of himself, his spouse, his descendants, his sibling and his parent. Distributions of income and principal were authorized to be made to any one or more of the beneficiaries as the Distribution Committee unanimously agreed, or as the Grantor and one member of the Distribution Committee both agreed.

The Grantor retained a broad testamentary limited power of appointment under which the Grantor could appoint the trust estate remaining at his death to any one or more persons as long as the transfer was not to himself, his estate, his creditors or the creditors of his estate. If the aforesaid broad testamentary limited power of appointment were not exercised by the Grantor, then the remaining trust estate was to be divided equally between the Grantor's sibling and parent, but if neither of them were living, then *per*

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stirpes to the then-living descendants of the Grantor. Additional takers were provided in the event no descendant of the Grantor were then living.

The trustee of this irrevocable trust was a corporate trustee. However, the trustee was not responsible for making distribution decisions during the Grantor's lifetime, and instead, such decisions were to be made by the Distribution Committee, or by the Grantor and one member of the Distribution Committee by unanimous agreement. The Trust Agreement provided that the Distribution Committee was to initially consist of the Grantor's sibling and the Grantor's parent, who also were beneficiaries of the trust. The trust provided that at all times the members of the Distribution Committee were to consist of at least two persons who were beneficiaries of the trust. The Grantor and the Grantor's spouse were expressly prohibited from being members of the Distribution Committee. If there were less than two adult beneficiaries of the trust, then the parent or guardian of the beneficiary could be a member of the Distribution Committee. This provision was included because the trust provided that if either the Grantor's brother or his parent who were trust beneficiaries was to die before the Grantor, then the Grantor's eldest living descendant would be a successor member of the Distribution Committee. Significantly, the powers granted the Distribution Committee with respect to the making of distributions to the beneficiaries of the trust were expressly stated to be exercised only in a *nonfiduciary capacity* by an acknowledged instrument, in writing, delivered to the trustee.

As practitioners know, the grantor trust rules are a series of rules that appear in Code Secs. 671-677.[3] These rules detail a series of prohibitions regarding the enjoyment or control of trust income or *corpus* which, if violated, will result in the income of the trust being taxable to the grantor/transferor. LTR 200502014 notes the general rule of Code Sec. 671, which says that if a trust is a grantor trust, the income of the trust is includable in computing the taxable income of the grantor, cites the definition of adverse party in Code Sec. 672, and then proceeds to review, with little explanation or analysis, the applicable prohibited conduct detailed under Code Secs. 673, 674, 675, 676 and 677, before determining that under the above-recited facts, the trust would not be treated as a grantor trust.

It is critical to the IRS's ruling position that the Grantor's sibling and parent are considered adverse parties for purposes of the grantor trust rules, in that they are determined to have a substantial beneficial interest that would be adversely affected by the exercise or nonexercise of powers that the person possessing this beneficial interest has.[4] In other words, because (1) either the Grantor's sibling or his father must consent to any distribution being made, (2) their consent was not limited by any fiduciary constraints and (3) the amount of property held for either's benefit would be diminished if either of them were to make a distribution to anyone other than themselves, they were adverse parties to the Grantor, notwithstanding their family relationship.

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The first of the list of grantor trust causing "strings" considered was whether the Grantor had retained a reversionary interest. Code Sec. 673(a) provides that a reversionary interest exists when as of the inception of the trust the grantor has retained a reversionary interest that exceeds five percent of the value of the trust. While most events constituting a reversion may be actuarially determined, in the instant situation, the Grantor's interest in income or principal is immediate and does not occur upon the death of another person or upon the occurrence of a particular event. Accordingly, there is no finding of a reversion under Code Sec. 673.

The next grantor trust provision considered was Code Sec. 674(a), which causes grantor trust treatment when income or principal of a trust is subject to a power of disposition exercisable by the grantor or a nonadverse party without the approval or consent of any adverse party. In the instant situation, no distribution of income or principal could occur without the consent of the Grantor's parent or of his sibling, each of whom, as indicated above, falls within the definition of adverse party.

The one power over the disposition of income and principal retained by the Grantor that was exercisable solely by him, and in all events, was his testamentary broad limited power of appointment. Code Sec.

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674(b)(3), however, provides that grantor trust status is not triggered by a power exercisable only by will, unless income of the trust can be accumulated for disposition pursuant to such a testamentary power without the approval or consent of an adverse party. In the instant situation, the power of appointment retained by the Grantor was a testamentary power exercisable by the Grantor's will. Furthermore, as only one adverse party need consent to the accumulation of income in order for the exception under Code Sec. 674(b)(3) to apply, the structure of the Distribution Committee ensures that result because, in order for there not to be a distribution, at least one member of the Distribution Committee must decide that a distribution is not to be made. (Under the facts presented, if both decided to make a distribution, the rules of the Distribution Committee would result in a distribution being made.)

It has been the position of the IRS for over 10 years that the determination of grantor trust status under Code Sec. 675 is fact-driven. Consistent with that view, in LTR 200502014 the IRS notes that the facts and circumstances of the operation of the trust must be reviewed before concluding whether administrative control is exercisable primarily for the benefit of the grantor, rather than the beneficiary of the trust.

Code Sec. 676 results in grantor trust status when a grantor retains a power to revoke a trust, and revest in himself, title to trust property. Under the facts of PLR 200502014, the broad testamentary limited power retained by the grantor would allow the grantor to revoke the trust, but does not allow the grantor (or any nonadverse party) to revest the grantor with title to the trust property.

Finally, the IRS considered the application of Code Sec. 677, which results in grantor trust status when income of a trust, without the approval or consent of any adverse party, may be distributed to the grantor or the grantor's spouse, or may be accumulated for future distribution to the grantor or the grantor's spouse. In the instant situation, no distribution could be made to the Grantor without the consent of at least one adverse party.

The balance of the ruling confirmed long-standing law under Code Sec. 2511 that a gift is not complete to the extent the donor/grantor retains a power to name new beneficiaries or change the interests of beneficiaries, unless the power is a fiduciary power limited by an ascertainable standard. In the instant situation, the Grantor's broad testamentary limited power of appointment meant that the Grantor could unilaterally alter the beneficial interests under the trust causing the gift to be complete only upon death.

At a time when not making taxable gifts is often desirable (due, in part, to the limited $1 million taxable gift exemption), the ability to create a separate trust that is a taxable entity without the need to have a completed lifetime gift presents numerous planning opportunities. These range from the possible benefits of creditor remoteness to flow-through entity planning circumstances, in which having a disregarded entity is not desirable. Being able to structure an incomplete gift in trust so that the trust is not a grantor trust should enhance the available planning options.

Endnotes

1 It has been several years since the IRS has considered arrangements which seek to take advantage of the adverse party rules in order to avoid grantor trust status. *See, e.g.,* LTR 200247013 (Aug. 14, 2002) and prior to that, LTR 200148028 (Aug. 27, 2001).

2 LTR 200502014 (Sept. 17, 2004).

3 Code Sec. 678 concerns circumstances under which someone other than the grantor/transferor is treated as the grantor and Code Sec. 679 deals with transfers to foreign situs trusts.

4 *See also* the decision in *F.G. Paxton*, 75-2 USTC ¶ 9607, 520 F2d 923 for an interesting perspective on the adverse position of a remainder beneficiary.

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