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Federal Income- and Transfer-Tax Consequences of Domestic Asset-Protection Trusts

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INTRODUCTION

The domestic asset-protection trust (APT) raises intriguing federal income- and transfer-tax issues. In this article, the author attempts to gather relevant authorities to guide the practitioner in analyzing these issues.

INCOME TAX

If the settlor of a domestic APT retains the option to receive discretionary income and principal distributions, the APT will be a grantor trust with respect to its ordinary income and capital gains under §677 unless distributions to the settlor must be approved by an adverse party (e.g., a beneficiary who will receive assets that are not distributed to the settlor).[1] Consequently, a settlor who wants the trust to be a grantor trust does not have to include one of the powers that are typically provided to obtain grantor-trust treatment (e.g., a power to add charitable beneficiaries (§674(c)) or a ''swap power'' to reacquire trust property in a nonfiduciary capacity (§675(4)(C)).[2] If a domestic APT is designed to be a completed gift and excluded

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[1] §677(a). All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] §674(c), §675(4)(C). *See* Paul Hood, *Around the Edges of the Swap Power, Tera Firma or Terra Incognita,* LISI Est. Plan. Newsl. #2707 (Mar. 4, 2019), www.leimbergservices.com;

from the gross estate, grantor trust treatment might be desirable because the trust will not be diminished by federal income taxes. The tradeoff is that the settlor might be taxed on income that he or she does not actually receive. As is true in all situations of this type, the planner should make sure that the settlor is ready to assume this burden.[3]

Even though a settlor does not have to include a swap power in a domestic APT to obtain grantor-trust status, he or she might want to include one if the APT is designed to be a completed gift and if the settlor wants to be able to exchange low-basis assets in the APT for high-basis assets still in the gross estate in order to get a stepped-up basis for the low-basis assets at death. The Delaware Act allows a settlor to have a swap power.[4] To prevent a creditor from asserting that an APT does not conform to the applicable statute, such a power probably should not be included unless the applicable statute contains a Delaware-like clause.

Tax Reimbursement — Discretionary

Under Delaware law, the trustee of a grantor trust now may reimburse the settlor for income taxes caused by grantor-trust treatment unless the governing instrument provides to the contrary.[5] In addition, the Alaska, Delaware, and South Dakota statutes specifically permit the settlor to include a provision in an APT that authorizes the trustee to reimburse the settlor for income taxes attributable to the trust on a discretionary basis.[6] Inclusion of a discretionary tax-reimbursement clause in an APT governed by the law of a state that does not specifically authorize the settlor to keep such a power might be inadvisable for the reason noted above. In such a state, of course, the settlor might be reimbursed for income taxes pursuant to the trustee's power to make distributions for the settlor's benefit. Nevertheless, if the settlor is reimbursed for income taxes too often, the IRS and creditors might contend that the settlor and the trustee had agreed when the trust was created that these distributions would be made. Under the Alaska, Delaware, and South Dakota statutes,[7] though, the settlor retains no rights except those expressly provided by the trust instrument.

Tax Reimbursement — Mandatory

Many domestic APTs are designed to be grantor trusts and incomplete gifts. In such a case, it is not disadvantageous from an estate-planning standpoint for the APT to pay its own income taxes. With this in mind, the Alaska, Delaware, and South Dakota statutes authorize reimbursement of income taxes on a mandatory basis.[8]

State Income Tax — Reduction

As discussed below, a domestic APT might be used to escape the income taxes of many states if the APT is structured as a nongrantor trust for federal purposes.

TRANSFER TAXES

Domestic APTs present federal gift-tax, estate-tax, and GST-tax implications. Many domestic APTs are structured to be incomplete gifts for federal gift-tax purposes and to be includible in the settlor's gross estate for federal estate-tax purposes. Nevertheless, at the end of 2012, some clients created domestic APTs that were intended to be completed gifts and excludible from the gross estate for fear of the pending decrease in the federal transfer-tax exemptions scheduled for January 1, 2013. In addition, clients are considering establishing domestic APTs with these attributes to lock in transfer-tax exemptions before they decrease in amount in 2026 or even earlier, depending on political developments. As discussed below, the settlor of a domestic APT may prevent the creation of the trust from being a completed gift by retaining certain powers. As also discussed below, it is possible that such a trust, from which the settlor may receive distributions only on the exercise of discretion, may be structured to be a completed gift for federal gift-tax purposes and to be excluded from the gross estate for federal estate-tax purposes.

Charles A. Redd, *Unexpected Consequences of Irrevocable Grantor Trusts,* 157 Tr. & Est. 10, 11-12 (Nov. 2018). *See also* Robert T. Danforth & Howard M. Zaritsky, 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E*; Christopher J.C. Jones & Caitlin N. Horne, *Grantor Trust Income Tax Reporting Requirements—A Primer,* 30 Prob. & Prop. 40 (Jan./Feb. 2016).

[3] *See Millstein v. Millstein*, 2018-Ohio-2295 (Ohio Ct. App. 2018) (court dismissed grantor's petition for reimbursement of income taxes). For a summary of *Millstein*, see Charles A. Redd, above Note 2 at 11-12.

[4] Del. Code Ann. tit. 12, §3570(11)(b)(8).

[5] Del. Code Ann. tit. 12, §3344. *See* Todd A. Flubacher & Zachary Haupt, *Delaware: New Tools for Tending an Evolving Landscape,* 158 Tr. & Est. 44, 46-49 (Aug. 2019).

[6] Alaska Stat. §34.40.110(m)(2); Del. Code Ann. tit. 12, §3570(11)(b)(9); S.D. Codified Laws §55-16-2(2)(k).

[7] *See* Alaska Stat. §34.40.110(i); Del. Code Ann. tit. 12, §3571; S.D. Codified Laws §55-16-8.

[8] Alaska Stat. §34.40.110(m)(2); Del. Code Ann. tit. 12, §3570(11)(b)(9); S.D. Codified Laws §55-16-2(2)(k).

ISSN 0886-3547

GIFT TAX

Rev. Rul. 2004-64 summarizes the operation of the federal gift tax as follows:[9]

> Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.
>
> Section 2512(b) provides that the gift tax applies only to the extent that property is transferred for less than an adequate and full consideration in money or money's worth.
>
> Section 25.2511-2(b) of the Gift Tax Regulations provides that a gift is complete and subject to gift tax to the extent the donor has so parted with dominion and control as to leave in the donor no power to change the disposition of the property, whether for the benefit of the donor, or any other person.

The ruling continues:[10]

> Section 25.2511-1(c)(1) provides that the gift tax applies with respect to any transaction in which an interest in property is gratuitously passed or conferred on another regardless of the means or device employed. Thus, the gift tax may apply if one party forgives or fails to collect on the indebtedness of another. Similarly, the gift tax applies if one person gratuitously pays the tax liability of another.

As will be seen, the settlor's retention of a nongeneral testamentary power of appointment over a domestic APT coupled with a power to veto distributions and/or a nongeneral lifetime power of appointment[11] will prevent him or her from making a completed gift[12] unless distributions actually are made.[13] If the settlor does not keep such powers, however, he or she will make a completed gift upon parting with dominion and control over the property that he or she puts in such a trust.[14]

Relegation-of-Creditors Doctrine General

The *Second Restatement of Trusts,* the *Third Restatement of Trusts,* and the Uniform Trust Code UTC recognize that a client may protect interests in an irrevocable trust created for others third-party trust from claims by the beneficiaries' creditors by subjecting such interests to a spendthrift clause[15] or by making them discretionary.[16] But, the *Restatements* and the UTC do not extend creditor protection to a settlor's retained beneficial interest in an irrevocable trust (''self-settled trust''), even if the trust contains a spendthrift clause.[17] For example, §58(2) of the *Third Restatement of Trusts* says that:[18]

> A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.

Nor do those authorities give any protection to a settlor-beneficiary's interest in a self-settled discretionary trust.[19] Thus, comment f to §60 of the *Third Restatement of Trusts* provides:[20]

> Where the trustee of an irrevocable trust has discretionary authority to pay to the settlor or apply for the settlor's benefit as much of the income or principal as the trustee may determine appropriate, creditors of the settlor can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor.

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[9] Rev. Rul. 2004-64.

[10] Rev. Rul. 2004-64 (citations omitted).

[11] *See* Christopher P. Cline, 825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations.*

[12] *See, e.g.,* PLR 202007010, PLR 202006002-006, PLR 201925005-010, PLR 201908008, PLR 201908003-007, PLR 201852009, PLR 201852014, PLR 201850001-006, PLR 201848002, PLR 201848009, PLR 201838002-007, PLR 201836006, PLR 201832005-009.

[13] Reg. §25.2511-2(f).

[14] Reg. §25.2511-2(b). *See* Henry J. Lischer, Jr., 845 T.M., *Gifts.*

[15] *Restatement (Second) of Trusts* §152, §153(1), §157 (1959); §157 cmts. a-e; *Restatement (Third) of Trusts* §58(1), §59 (2003); §58 cmt. a; §59 cmts. a(1), a(2), b-d; UTC §502-§503 (amended 2018). To view the text of the UTC and a list of the states that have enacted it, go to www.uniformlaws.org.

[16] *Restatement (Second) of Trusts* §155(1) (1959); §187; §155 cmt. b; §187 cmts. d-i; *Restatement (Third) of Trusts* §50, §60 (2003); §50 cmts. b, d; §60 cmt. e; UTC §504, §814(a) (amended 2018).

[17] *Restatement (Second) of Trusts* §156(1) (1959); *Restatement (Third) of Trusts* §58(2) (2003); §58(2) cmt. e; UTC §505(a)(2) (amended 2018).

[18] *Restatement (Third) of Trusts* §58(2) (2003).

[19] *Restatement (Second) of Trusts* §156(2) (1959); cmt. e; *Restatement (Third) of Trusts* §60 cmt. f (2003); UTC §505(a)(2) (amended 2018).

[20] *Restatement (Third) of Trusts* §60 cmt. f (2003).

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The 5th edition of the Scott treatise, which was published in 2007, discusses the traditional rule as follows:[21]

> The controlling policy is clear. The settlor can properly create a trust under which someone else takes a beneficial interest, and the settlor's creditors cannot reach this interest unless the creation of the trust amounted to a fraudulent conveyance. To the extent that the settlor retains a beneficial interest, however, that interest is subject to the claims of the settlor's creditors, even in the absence of fraud. It is plainly against public policy to permit the owner of property to create for his or her own benefit an interest in the property that is beyond the reach of creditors.

Caselaw throughout the country recognized the inability of settlor-beneficiaries to protect assets via self-settled spendthrift and discretionary trusts. Examples were *Greenwich Trust Company v. Tyson* (1942) in Connecticut[22] and *Ware v. Gulda* (1954) in Massachusetts.[23] For a time, it appeared that New York was an outlier because the Second Circuit observed in *Herzog v. Commissioner* (1941) that:[24]

> While here the trust was created by the grantor, there is no New York decision holding that the rights of creditors would differ from those available to them in a case where the trust is set up by a third party if the exercise of a power for his benefit is wholly dependent upon the discretion of the trustee.

Nevertheless, New York now is in the mainstream because a statute provides that a self-settled spendthrift trust is not immune from claims by the settlor's creditors,[25] and caselaw gives the same result for a self-settled discretionary trust.[26]

As of this writing, 19 states have departed from the rule that prevents a settlor-beneficiary from obtaining protection from creditor claims through a self-settled trust.

Relegation-of-Creditors Doctrine—Tax Context

The IRS has taken the position that the ability of the settlor-beneficiary of a self-settled trust to relegate trust assets to his or her creditors will prevent the making of a completed gift. The below cases and rulings are representative.

Paolozzi v. Commissioner (1954)—Tax Court holds that transfer of income interest to irrevocable self-settled discretionary trust was not completed gift

In *Paolozzi v. Commissioner*,[27] the grantor created a trust, of which she was the sole beneficiary, on June 21, 1938. The trustees had absolute discretion to distribute income to her during her lifetime, with excess income to be added to principal. The court described its inquiry as follows:[28]

> The only question presented is whether petitioner is taxable on the entire value of property transferred to her in trust, or whether she retained a life interest necessary to support a deduction therefor.

The government contended that the entire value of the assets transferred to the trust was subject to gift tax.[29] The grantor argued that she should be able to deduct the value of her income interest as follows:[30]

> Petitioner . . . argues that under the law of Massachusetts, by which the trust is governed, petitioner's creditors, both prior and subsequent, could reach the maximum amount, which, under the trust, the trustees could, in the exercise of their discretion, pay to her or apply for her benefit. Therefore, petitioner reasons that she could and can at any time realize all of the economic benefit of the income accruing to the trust during her lifetime by the simple expedient of borrowing money or otherwise becoming indebted, and then relegating the creditor to the trust income for reimbursement.

Agreeing with the grantor and relying on *Ware v. Gulda*, the court held:[31]

> It cannot be gainsaid that petitioner's creditors could at any time look to the trust of which she was

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[21] Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, *Scott and Ascher on Trusts* §15.4 at 954-55 (5th ed. 2007) (footnotes omitted). *See Generally,* Helene S. Shapo, George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* §223 (3d ed. 2007).

[22] 27 A.2d 166, 172 (Conn. 1942) (''If in such a [discretionary] trust the settlor is the sole person entitled to the income, that income can be reached by his creditors'').

[23] 117 N.E.2d 137, 139 (Mass. 1954) (''[T]he policy of our law does not protect the creator of a discretionary trust against the payment of a creditor in the circumstances of this case'').

[24] 116 F.2d 591, 594 (2d Cir. 1941).

[25] N.Y. Est. Powers & Trusts Law §7-3.1(a) (''A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator'').

[26] *Vanderbilt Credit Corp. v. Chase Manhattan Bank, NA*, 473 N.Y.S.2d 242, 246 (App. Div. 1984) (''It is against public policy to permit the settlor-beneficiary to tie up her own property in such a way that she can still enjoy it but can prevent her creditors from reaching it'').

[27] 23 T.C. 182 (1954).

[28] 23 T.C. at 183.

[29] 23 T.C. at 186.

[30] 23 T.C. at 186.

[31] 23 T.C. at 187.

ISSN 0886-3547

settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner, as she points out, could at any time obtain the enjoyment and economic benefit of the full amount of the trust income. Under the circumstances, therefore, we answer the question posed in the affirmative, and hold that petitioner correctly returned the transfer for gift tax purposes.

In re Uhl's Estate (1957)—Seventh Circuit holds that transfer of principal to irrevocable self-settled discretionary trust was completed gift

In *In re Uhl's Estate*,[32] which primarily involved estate tax (see below), the decedent had created an irrevocable inter vivos Indiana trust of personal property naming an Indiana bank as trustee. The decedent retained the right to receive $100 per month from income. In addition, the trustee could invade principal for his benefit. Relying substantially on *Herzog v. Commissioner*, which no longer is good law, the court held that a portion of the transfer was subject to gift tax on creation of the trust:[33]

> [T]he remainder of the corpus, over which the control of the settlor had ended, subject only to an uncontrolled discretion in the trustee, did not remain his property until his death but passed to the grantee at the time of the creation of the trust without hindrance or suspicion of any fraudulent intent.

Commissioner v. Vander Weele (1958)—Sixth Circuit holds that transfer to irrevocable self-settled discretionary trust was not completed gift

In *Commissioner v. Vander Weele*,[34] the grantor established an irrevocable inter vivos Michigan trust with stock, securities, and a contingent interest in her grandfather's trust on March 25, 1950. The trustees agreed at inception to exercise discretion to pay the grantor all trust income and as much principal as she needed for her comfort. The court observed:[35]

> The transfer in trust was in reality a transfer to preserve her property against waste by her own spendthrift actions, while reserving to herself the income and to the trustees the right to encroach upon the principal for her "comfortable well-being." Under controlling Michigan law, the donor's creditors could reach her distributable income. The trustees were granted almost unrestricted power to invade the corpus of the trust for the benefit of the settlor, with the possibility of the repayment of the entire trust fund to her. The trust conveyance in effect created no completed taxable gift to the remaindermen—the husband and children of the settlor. There was no assurance that anything of value would pass to the remaindermen. The settlor could in actuality retain the economic benefit and enjoyment of the entire trust income and corpus of the trust estate by borrowing money or by selling, assigning, or transferring her interest in the trust fund and relegating her creditors to the trust fund for payment.

Distinguishing the case from *Herzog v. Commissioner*[36] and *In re Uhl's Estate*,[37] the court therefore held:[38]

> [T]he settlor plainly made the transfers in trust for her own "comfortable well-being" and personal financial security in such fashion that there was no actual gift taxable, as such, at the time of the transfer.

Rev. Rul. 76-103 (1976)—IRS rules that transfer to irrevocable self-settled discretionary trust was not completed gift but recognizes that change of situs might cause gift to be complete

In Rev. Rul. 76-103, the grantor created an irrevocable inter vivos trust on September 2, 1975. The trustee had absolute discretion to distribute income and/or principal to the grantor, with undistributed income to be added to principal. On the grantor's death, any remaining principal was payable to the grantor's issue. Under the applicable state's governing law, the trust was a discretionary trust, which was subject to claims of the grantor's creditors whenever they might arise. The ruling addressed the following issue:[39]

> The question presented is whether the transfer in trust is an incomplete gift for Federal gift tax purposes because the assets of the trust are subject to the claims of creditors of the grantor.

Following *Paolozzi*, the ruling concluded:[40]

> As long as the trustee continues to administer the trust under the law of State X, the grantor retains dominion and control over the trust property.
>
> Accordingly, in the instant case, the grantor's transfer of property to the trust does not constitute a completed gift for the Federal gift tax purposes.

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32 241 F.2d 867 (7th Cir. 1957).
33 241 F.2d at 871.
34 254 F.2d 895 (6th Cir. 1958).
35 254 F.2d at 898 (citations omitted).
36 116 F.2d 591 (2d Cir. 1941).
37 241 F.2d 867 (7th Cir. 1957).
38 *Vander Weele*, 254 F.2d at 899.
39 Rev. Rul. 76-103.
40 Rev. Rul. 76-103.

ISSN 0886-3547

The ruling noted, though, that:[41]

> If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations. . . .

Rev. Rul. 77-378 (1977)—IRS rules that transfer to irrevocable self-settled discretionary trust was completed gift

In Rev. Rul. 77-378, the grantor conveyed one-half of the grantor's income-producing property to an irrevocable inter vivos trust on January 16, 1975. The trustee—a corporation—had absolute and uncontrolled discretion to distribute income and principal to the grantor. Undistributed income was to be added to principal. On the grantor's death, the trustee was to distribute the remaining principal to the grantor's spouse and children. The ruling described the applicable state law as follows:[42]

> [U]nder the applicable state law the trustee's decision whether to distribute trust assets to the grantor is entirely voluntary. The grantor can not require that any of the trust's assets be distributed to the grantor nor can the creditors of the grantor reach any of the trust's assets.

The ruling then described the pertinent inquiry as follows:[43]

> The question presented is whether the grantor has parted with dominion and control of the property transferred so that the Federal gift tax is applicable to the transfer, in view of the power of the trustee to return the property to the grantor.

The ruling noted:[44]

> Even though a trustee may have an unrestricted power to return all of the trust's assets to the grantor, if the grantor's interest in the trust is not enforceable either by the grantor or on the grantor's behalf, then the grantor has parted with dominion and control over the property transferred into trust. Furthermore, if the grantor retains such a mere expectancy that the trustee will distribute trust assets to the grantor rather than an enforceable interest in the trust, the expectancy does not prevent the completion or reduce the value of the gift.

Again, following *Herzog*, the ruling determined that the entire value of the assets contributed to the trust was a completed gift for the following reasons:[45]

> In the instant case, the grantor has parted with dominion and control over the property that the grantor transferred into trust. Although the trustee has an unrestricted power to pay trust assets to the grantor, the grantor cannot require that any of the trust's assets be distributed to the grantor nor can the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. Whether the grantor would enjoy any of the trust's assets is dependent entirely on the uncontrolled discretion of the trustee. Such a hope or passive expectancy does not lessen the value of the property transferred. Accordingly, the Federal gift tax is applicable to the entire value of the property transferred to the trust by the grantor.

Rev. Rul. 77-378 took the opportunity to clarify an earlier ruling—Rev. Rul. 62-13. The later ruling declared:[46]

> Rev. Rul. 62-13 may be read to imply that broad powers given to a trustee to invade trust income and corpus for the benefit of the grantor may be sufficient to render the gift incomplete even though the grantor's interest in the trust assets is unenforceable. Therefore, Rev. Rul. 62-13 is hereby clarified to remove any implication that an entirely voluntary power held by a trustee to distribute all of the trust's assets to the grantor is sufficient to render a gift incomplete either in whole or in part.

Outwin v. Commissioner (1981)—Tax Court holds that transfers to irrevocable self-settled discretionary trusts were not completed gifts notwithstanding spouse's veto power

In *Outwin v. Commissioner*,[47] husband created four irrevocable inter vivos Massachusetts trusts on December 24, 1969, under which the trustees had absolute and uncontrolled discretion to distribute income and principal to him. On the same day, wife created an irrevocable inter vivos Massachusetts trust with comparable provisions. In each case, the other spouse had to consent to discretionary distributions. The Tax Court said: ''[t]he only issue presented for decision is whether certain transfers in trust made by each peti-

[41] Rev. Rul. 76-103.
[42] Rev. Rul. 77-378.
[43] Rev. Rul. 77-378.
[44] Rev. Rul. 77-378.
[45] Rev. Rul. 77-378.
[46] Rev. Rul. 77-378.
[47] 76 T.C. 153 (1981).

ISSN 0886-3547

tioner during 1969 constituted taxable gifts for purposes of section 2501."[48]

The court observed:[49]

> Where the trust agreement specifies, as here, that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for gift tax purposes. A different result obtains, however, where State law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims.

The court dismissed the significance of the spouses' veto powers in the following way:[50]

> [I]t is our opinion that the veto power bestowed upon the grantor's spouse in connection with the trusts herein is insufficient to render the *Gulda* rule inapplicable. The *Gulda* opinion and the cases cited therein evidence a strong public policy in Massachusetts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors. That policy would be easily frustrated if creditors were prevented from reaching the trust assets merely because the settlor's spouse is given an interest in the trust and the right to veto discretionary distributions which might deplete that interest. It is not unreasonable to assume that, because of the marital relationship, the settlor could anticipate the complete acquiescence of his spouse in any discretionary distributions which he might receive, regardless of their effect on her interest as a remainderman. Thus, in the absence of unforeseen circumstances, such as divorce, the possibility of a spousal veto in such a situation may be at best a remote possibility. This is particularly true in the present cases, where the fact that each spouse has the right to veto distribution from the other's discretionary trust(s) could discourage the exercise of that authority through fear of reprisal. For these reasons, we think that the veto powers held by the petitioners do not, by themselves, place the trusts outside the scope of the *Gulda* decision.

The Tax Court held:[51]

> We hold, therefore, that creditors of the petitioners could reach the assets of their respective discretionary trusts for reimbursement under Massachusetts law, and under the holding of *Paolozzi* the petitioners have failed to surrender dominion and control over the trust assets.

Estate of German v. United States (1985)—Claims Court holds that transfers to irrevocable self-settled discretionary trusts were completed gifts where remainder beneficiaries' consent was required

In Estate of German v. United States,[52] the Claims Court stated the issue at the outset:[53]

> The question presented is whether the decedent divested herself of her interest in property in 1969 when she transferred such property to a trust with a proviso that the trustees might, in their absolute discretion, pay any or all of the income or principal to decedent at any time during her lifetime, if they received the written consent of the person who was entitled to receive the principal and accumulated income of the trust after her death, or, whether she continued to enjoy the right to the income or principal of the trust up to the date of her death, because under Maryland law if she chose to incur any debts her creditors could still attach or levy upon the trust assets to collect them.

The court ultimately determined that the trust was not includible in the decedent's gross estate (see below), but the decedent's estate conceded that gift tax was due.[54] The court justified reaching a different result from the *Outwin* court for the following reasons:[55]

> [D]efendant has cited no decision, either in the Maryland courts or elsewhere, where the creditor was held entitled to attach trust property where the trustee's discretion could only be exercised with the prior consent of those who would receive the property in default of such exercise. In *Outwin*, the Tax Court likewise confessed that it had been unable to find any authorities in any state which addressed the precise issue. However, it resolved that problem by reasoning that in view of the strong public policy of the Massachusetts courts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors the veto power of a spouse would not be a barrier to such creditors under Massachusetts law, because it assumed (1) that (in the absence of divorce) the possibility that the spouse would veto a disbursement by the trustee to her husband was remote, and (2) the fact that the

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48 76 T.C. at 153-54 (footnote omitted).

49 76 T.C. at 162 (citations omitted).

50 76 T.C. at 166.

51 76 T.C. at 168 (footnote omitted).

52 7 Cl. Ct. 641 (1985).

53 7 Cl. Ct. at 642.

54 7 Cl. Ct. at 646-47.

55 7 Cl. Ct. at 645 (citations omitted).

ISSN 0886-3547

husband might reciprocate by veto of disbursements to the wife under her similar trust would tend to further discourage her veto. This court finds no such strong public policy in the Maryland courts where there is a remainder interest. It finds no assumption by the Maryland courts that the wife may be deemed merely the husband's alter ego for purposes of insulating property from a settlor's creditors in a non-fraudulent conveyance transaction. . . . And the instant case does not involve reciprocal husband and wife trusts.

PLR 9332006 (1992)—IRS rules that transfers to irrevocable self-settled offshore trust were completed gifts where settlors' creditors could not access trust assets

In PLR 9332006, the settlors (siblings) established an offshore APT and transferred partnership interests to the trustee. Regarding gift tax, the IRS ruled:

> [T]he Settlors will part with dominion and control over the property being transferred into the trust. Although the Trustee has an unrestricted power to pay over trust assets to the Settlors, the Settlors cannot individually or together require that any of the trust's assets be distributed to themselves. Further, assuming taxpayers' representation regarding the law of Country X is correct, neither of the Settlors can utilize assets transferred to the Trust by incurring debt and relegating the Settlor's creditors to the trust.
>
> Accordingly, based on the taxpayers' representations regarding Country X law, the transfers of interests in the Partnership to the Trust are completed gifts and the entire value of the interests in the Partnership transferred to the Trust by the Settlors is subject to the federal gift tax.

PLR 9837007 (1998)—IRS rules that Alaska resident's transfer to Alaska APT was completed gift

In PLR 9837007, the donor, an Alaska resident, proposed to create an Alaska APT. The trustee had absolute discretion to distribute income and principal to the donor and her living descendants. Undistributed income would be added to principal. On the donor's death, the remaining principal would be divided into shares for her then-living descendants. Relying on Rev. Rul. 77-378, the IRS ruled:

> Donor proposes to create Trust, to be administered under the laws of State, for the benefit of herself and her living descendants. The trustee will have sole and absolute discretion to pay, during the Donor's lifetime, part or all of the income and/or principal of Trust to Donor and the Donor's living descendants. It is represented that there is no agreement, express or implied, between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries.
>
> In addition, under State Statute, because the trust contains certain language specified in the statute, a creditor of the grantor will be precluded from satisfying claims out of the grantor's interest in the trust.
>
> Based on the representation that there is no express or implied agreement between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries, we conclude that the proposed transfer by Donor of property to Trustee to be held under the Trust agreement will be a completed gift for federal gift tax purposes.

Rev. Rul. 2004-64 (2004)—IRS rules that payment of income taxes attributable to grantor trust were not gifts by grantor in three scenarios

Rev. Rul. 2004-64, addressed the following matters:[56]

> With respect to a trust whose grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), what are the gift tax consequences when the grantor pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax?

The ruling considered a grantor trust for the grantor's descendants and addressed three situations:

- situation 1—the settlor pays income taxes attributable to the trust;
- situation 2—the trustee reimburses the grantor for income taxes attributable to the trust as required by the governing instrument; and
- situation 3—the trustee reimburses the grantor for income taxes attributable to the trust pursuant to discretion conferred by the governing instrument.[57]

[56] Rev. Rul. 2004-64.
[57] Rev. Rul. 2004-64.

ISSN 0886-3547

Rev. Rul. 2004-64 gave the following gift-tax rulings:[58]

> In the present situations, Trust includes provisions that cause A to be treated as the owner of Trust under subpart E and, as a result, to be liable for any income tax attributable to Trust's income. Thus, even though A is not a Trust beneficiary, any income tax A pays that is attributable to Trust's income is paid in discharge of A's own liability, imposed on A by §671.
>
> In Situation 1, A's payment of the $2.5x income tax liability does not constitute a gift by A to Trust's beneficiaries for federal gift tax purposes because A, not Trust, is liable for the taxes. In contrast, in the situation presented in *Doerr v. United States*, cited above, the donor's payment was for the donee's tax liability and, as a result, the payment constituted an additional gift to the donee. . . .
>
> In Situation 2, the governing instrument of Trust requires the trustee to reimburse A from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. A's payment of the $2.5x income tax liability does not constitute a gift by A, because A is liable for the tax. The trustee's distribution of $2.5x to A as reimbursement for the income tax payment by A is not a gift by the trust beneficiaries to A, because the distribution from Trust is mandated by the terms of the trust instrument.
>
> In Situation 3, the governing instrument of Trust provides the trustee with the discretion to reimburse A from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. As is the case in Situation 1 and Situation 2, A's payment of the $2.5x income tax liability does not constitute a gift by A because A is liable for the income tax. Further, the $2.5x paid to A from Trust as reimbursement for A's income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to A.

Thus, the ruling concluded:[59]

> When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.

[58] Rev. Rul. 2004-64.

[59] Rev. Rul. 2004-64.

PLR 200944002 (2009)—IRS rules again that Alaska resident's transfer to Alaska APT was completed gift

In PLR 200944002, an Alaska resident proposed to create an Alaska APT, which would give the trustee discretion to distribute income and principal to the grantor, the grantor's spouse, and the grantor's descendants. On the death of the survivor of the grantor and the grantor's spouse, the principal would be divided among the grantor's then-living descendants. No power of appointment would be granted. The IRS ruled:

> Grantor has retained no power to revest beneficial title or reserved any interest to name new beneficiaries or change the interests of the beneficiaries. Consequently, we conclude that Grantor's transfer of $X to trust will be a completed gift of $X.

CCA 201208026 (2011)—IRS advises that retention of nongeneral testamentary powers of appointment did not prevent completed gifts of beneficial term interests

In CCA 201208026, the donors created an irrevocable trust and named one of their children trustee. The trustee had absolute discretion to distribute income and principal to the donors' children, other lineal descendants, spouses of lineal descendants, and charitable organizations, for specified charitable purposes. The donors retained nongeneral testamentary powers of appointment. On the death of the surviving spouse, in default of appointment, the trustee would distribute the remaining principal to the donors' children. The guidance concluded that transfers to the trust were completed gifts notwithstanding the powers of appointment for the following reasons:

> In the case at hand, when each Donor transferred property to the Trust on Date, he or she retained a testamentary limited power to appoint so much of it as would still be in the Trust at his or her death. The Trust emphasizes that the Donors do not retain any powers or rights to affect the beneficial term interests of their children, other issue, and their spouses (and charities) during the Trust term. With respect to those interests, the Donors fully divested themselves of dominion and control of the property when they transferred the property to the trust on Date. Indeed, during the period extending from the creation of the Trust until the Donors' deaths, the trustee, Child A, has sole and unquestionable discretion to distribute income and principal to the beneficial term interests. He may even terminate the Trust by distributing all of the property.
>
> Accordingly, for gift tax purposes, the Donors' transfers to the Trust constituted a completed gift

ISSN 0886-3547

of the beneficial term interests. The Donors' testamentary limited powers of appointment relate only to the Trust remainder. Their relinquishment of their testamentary powers during the Trust term would affect only the ultimate disposition of the remainder and, as such would constitute a transfer of the remainder.

Exceptions to Relegation-of-Creditors Doctrine

In many of the cases and rulings summarized above, settlors' gifts were incomplete because they kept the ability to incur debt and to relegate creditors to trust assets. Cases, including some decided by the U.S. Supreme Court, and rulings determine that settlors' gifts are complete if they regain the ability to control the disposition of trust assets through the occurrence of events beyond their control. Those cases and rulings are summarized below.

Smith v. Shaughnessy (1943)—U.S. Supreme Court holds that possibility that grantor would survive wife does not prevent completed gift of remainder interest

In *Smith v. Shaughnessy*,[60] the grantor sought a refund of gift taxes paid. The grantor created an irrevocable New York trust and directed that the income be paid to his wife for life. On her death, the principal was to be returned to the grantor if living. If the grantor predeceased his wife, the stock was to go to such persons as she appointed by will or, in default of appointment, to her intestate successors.

Justice Black framed the controversy as follows:[61]

> Three interests are involved here: the life estate, the remainder, and the reversion. The taxpayer concedes that the life estate is subject to the gift tax. The government concedes that the right of reversion to the donor in case he outlives his wife is an interest having value which can be calculated by an actuarial device, and that it is immune from the gift tax. The controversy, then, reduces itself to the question of the taxability of the remainder.

He then summarized the positions of the parties:[62]

> The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.

The Court held:[63]

> In cases such as this, where the grantor has neither the form nor substance of control and never will have *unless he outlives his wife,* we must conclude that he has lost all 'economic control' and that the gift is complete except for the value of his reversionary interest.

Robinette v. Helvering (1943)—U.S. Supreme Court holds that possibility that daughter would survive mother and stepfather without adult issue would not prevent completed gift of remainder interests

In *Robinette v. Helvering*,[64] a companion case to *Smith v. Shaughnessy*, a daughter created an irrevocable trust in 1936 to pay the income to herself for life. The income then was to be paid to the daughter's mother and her husband (the daughter's stepfather), if living, with remainder to the daughter's issue. At the same time, the mother created a trust to pay the income to herself and the stepfather for life. The income then was to be paid to the daughter, if living, with remainder to the daughter's issue.

Justice Black described the controversy in the following way:[65]

> The parties agree that the secondary life estates in the income are taxable gifts, and this tax has been paid. The issue is whether there has also been a taxable gift of the remainders of the two trusts.

Following *Smith v. Shaughnessy*, the Court held that the values of the remainder interests were subject to gift tax,[66] where her reacquisition of the power of control "depends not alone upon the possibility of survivorship but also upon the death of the daughter without issue who should reach the age of 21 years."[67]

Estate of Kolb v. Commissioner (1945)—Tax Court holds that retention of power to add after-born grandchildren as trust beneficiaries did not prevent completed gift upon trust's creation

In *Estate of Kolb v. Commissioner*,[68] the decedent had created an irrevocable inter vivos trust for his grandchildren in 1923, which he funded in stages in

[60] 318 U.S. 176 (1943).
[61] 318 U.S. at 178.
[62] 318 U.S. at 180.
[63] 318 U.S. at 180 (footnote omitted; emphasis added).
[64] 318 U.S. 184 (1943).
[65] 318 U.S. at 186.
[66] 318 U.S. at 189.
[67] 318 U.S. at 188.
[68] 5 T.C. 588 (1945).

ISSN 0886-3547

subsequent years. He retained the right to designate additional grandchildren to benefit from the trust. The question was whether gifts were complete when the transfers were made or when the decedent relinquished his power to designate additional grandchildren in 1939. The Tax Court described the import of *Smith* and *Robinette* as follows:[69]

> The holding in those cases clearly is that where the grantor has surrendered all dominion and control of the property of the trust, which control the grantor can never again exercise except upon the happening of an event beyond his control—in the present case, the birth of an additional grandchild—there had been a completed gift.

The court contrasted the rights retained in *Smith* and *Robinette*, with those in the present case as follows:[70]

> The right to exercise the reserved control in each of the cited cases was equally contingent with that here. In those cases, as in this, that right depended upon the happening of an event beyond the control of the donor. It is true that the quantum of control reserved in each of the cited cases differed from that in the present case. But it was greater in the cited cases—not less. In the *Smith* case, if the contingency occurred, the trust property would then have reverted absolutely to the grantor, and in the *Robinette* case, the grantor would then have had the absolute right by will to dispose of the property of the trust. But in the present case, if the contingency happened, the donor would have had much more limited rights of control. He could merely add additional secondary life beneficiaries and remaindermen to benefit equally with those already named.

The Tax Court therefore held:[71]

> We therefore conclude that the several transfers of the decedent donor to the trust constituted completed gifts for gift tax purposes when the transfers occurred. It follows that no gift tax arose upon the relinquishment executed by the donor decedent on May 31, 1939.

Ellis v. Commissioner (1968)—Tax Court holds that possibility that settlor would fail to support his wife to cause trustee to exercise discretion in her favor did not prevent completed gift of life estate

In *Ellis v. Commissioner*,[72] the husband created a $200,100 irrevocable trust for his wife in 1963 pursuant to their antenuptial agreement. The question was whether gift tax was due on the gift of the wife's life estate upon creation of the trust or whether the husband had retained enough control over the trust to render the gift incomplete. The Tax Court framed the issue as follows:[73]

> The trust, settled by petitioner, provided that all corpus and accumulated income were to be distributed at Viola's death to one of two groups of individuals none of whom could be petitioner. The parties agree that the gift of the remainder interest in the trust was complete. The issue then is whether there was a completed gift to the trust of a life estate where the trustee, during the life of the petitioner, had the discretion either to accumulate the trusts' income and add it to the corpus of the trust or to distribute it to Viola for her 'care, comfort and support.'

The court summarized the parties' positions as follows:[74]

> Petitioner contends the trustee's discretion was limited to an ascertainable standard of 'care, comfort or support,' thus subjecting the trustee to an enforceable duty under Arizona law. Petitioner contends that the trustee would be required to pay over to Viola the trust's income for her support when she was not adequately maintained by petitioner. Thus, as it was solely within petitioner's power to withhold support and maintenance from Viola, petitioner argues he retained the requisite dominion and control over the disposition of the trust's income to render the transfer incomplete to the extent of the first life estate created therein.
>
> Conversely, the Commissioner asserts that petitioner did not expressly reserve any power or control over the distribution of the income from the trust. The control, i.e., the ability to force the trustee to exercise his discretion and make distributions to Viola, was not the type of control qualifying as a reservation of power under section 25.2511-2(b), Gift Tax Regs.

[69] 5 T.C. at 593 (footnote omitted).

[70] 5 T.C. at 595.

[71] 5 T.C. at 597 (citations and footnote omitted).

[72] 51 T.C. 182 (1968), *aff'd*, 437 F.2d 442 (9th Cir. 1971).

[73] 51 T.C. at 186 (footnote omitted).

[74] 51 T.C. at 187.

ISSN 0886-3547

The Tax Court found that the petitioner had not retained enough ''control'' over the wife's life interest to prevent the making of a completed gift. The court wrote:[75]

> [W]e do not believe that the dominion petitioner may have been able to exercise over the life estate in the trust was sufficient to cause the gift to be incomplete. Petitioner made no express reservation of a right to alter, amend, or revoke any provisions of the trust. Petitioner was not the trustee but merely might have been able to cause a situation to arise wherein the trustee might exercise his discretion in favor of Viola. In theory, this may appear to be control, but as a practical matter it would be extremely difficult for petitioner to exercise this ''power.'' *For petitioner to cause a situation to occur which would compel the trustee to distribute the trust's income to Viola, petitioner would have to create a major domestic crisis.* Thus, due to the undesirable consequences which would result, we believe it is extremely unlikely that petitioner would or could cut Viola off any time he so desired.
>
> Moreover, petitioner's obligation to support his wife during coverture is firmly established by Arizona law. A breach of this duty would be a violation of the Arizona Revised Statutes, sec. 13-803 (1956). Under these circumstances, petitioner should not be considered to have any control where to exercise the power it would be necessary to do any unlawful act. We find that petitioner failed to retain sufficient dominion over the trust, so as to render the gift to it incomplete.

Rev. Rul. 80-255 (1980)—IRS rules that possibility that settlor would have or adopt later children who would become trust beneficiaries did not prevent completed gift upon trust's creation

In Rev. Rul. 80-255, the settlor-decedent created an irrevocable trust for his issue in 1975. The trust instrument provided that the settlor's children born or adopted after the creation of the trust were to be additional beneficiaries. Regarding the gift tax, the ruling declared:[76]

> [A]t the time of creation of the trust, D is not treated as having reserved a power to change beneficial interests under section 25.2511-2(c) of the Gift Tax Regulations as a result of providing in the trust instrument that D's after-born or after-adopted children are to be trust beneficiaries. Therefore, D's establishment of the trust was a completed gift, because D did not retain dominion and control over the transferred property.

Outwin v. Commissioner (1981)—Tax Court recognizes that divorce of settlor and spouse holding veto power over distribution to settlor might cause completed gift

In *Outwin v. Commissioner* ,[77] summarized above, the IRS Commissioner contended that the requirement to obtain the other spouse's consent for distributions rendered the grantors' gifts complete. The Tax Court described the Commissioner's argument as follows:[78]

> [H]e seeks to distinguish those cases [that permitted creditors to reach the assets of self-settled trusts in Massachusetts] on the ground that discretionary distributions from the trusts herein require the prior individual consent of the grantor's spouse, who is also a remainderman beneficiary thereof. The presence of such a veto power in an interested party, respondent contends, imposes a significant limitation on the trustees' discretion and thereby removes these cases from the general rule of *Gulda*. We disagree.

The court rejected the Commissioner's contention but recognized that the result might have been different in other circumstances:[79]

> [I]n the absence of unforeseen circumstances, *such as divorce*, the possibility of a spousal veto in such a situation may be at best a remote possibility.

Effect of Nongeneral Testamentary Power of Appointment

Practitioners long believed that retaining a nongeneral testamentary power of appointment would prevent a settlor from making a completed gift with respect to the income interest as well as the remainder interest in a domestic APT.[80] In CCA 201208026, however, the IRS signaled an apparent change of position on this point. Hence, the guidance opined:

> In *Chanler v. Kelsey*, 205 U.S. 466 (1907), the Supreme Court considered, in part, the legal interest that is subject to a testamentary power of appoint-

[75] 51 T.C. at 187-88 (footnotes omitted; emphasis added).

[76] Rev. Rul. 80-255.

[77] 76 T.C. 153 (1981).

[78] 76 T.C. at 166.

[79] 76 T.C. at 166 (emphasis added).

[80] *See* PLR 200731019, PLR 200729025, PLR 200715005, PLR 200647001, PLR 200637025, PLR 200612002, PLR 200502014, PLR 200247013, PLR 200148028.

ISSN 0886-3547

ment. In that case, a grantor created a trust providing a lifetime income interest for his daughter. The trust also provided the daughter with a testamentary limited power to appoint the trust property. If she failed to exercise the power when she died, the trust property was to be distributed to designated persons. The Court held that, for New York inheritance tax purposes, the daughter's execution of her testamentary power was considered ''the source of title'' to the remainder. As the holder of a testamentary power of appointment, she controlled the remainder passing at her death.

Though it predates the enactment of the gift tax, the *Chanler* opinion supports the proposition that a testamentary power of appointment relates to the remainder of a trust, not the preceding beneficial term interests. The testamentary power does not (and cannot) affect the trust beneficiaries' rights and interests in the property during the trust term. Rather, a trustee with complete discretion to distribute income and principal to the term beneficiaries may, in exercising his discretion, distribute some of all of the trust property during the trust term. The holder of a testamentary power has no authority to control or alter these distributions because his power relates only to the remainder, i.e., the property that will still be in the trust when the beneficial term interests are terminated.

It continued:

Consistent with *Chanler v. Kelsey*, the Service has maintained in litigation that a power holder's testamentary limited power of appointment relates only to the remainder of the respective trust.

Impact of §2702

Section 2702 took effect on November 5, 1990,[81] and its regulations are generally effective as of January 28, 1992.[82] Let's consider whether §2702 applies to a typical domestic APT in which the settlor establishes an APT with an independent trustee who is given broad discretion to use income and principal for the settlor, the settlor's spouse, and the settlor's issue.

Scope of §2702

Section 2702 contains gift-tax rules if a transferor makes a transfer of an interest in trust to or for a member of the transferor's family and the transferor or any applicable family member retains an interest in such trust.[83] A member of the transferor's family is:

(1) the transferor's spouse;

(2) an ancestor or lineal descendant of the transferor or his or her spouse;

(3) a brother or sister of the transferor;

(4) a spouse of an individual described in (2) or (3).[84]

An applicable family member is:

(1) the transferor's spouse;

(2) an ancestor of the transferor or the transferor's spouse; and

(3) the spouse of any such ancestor.[85]

Section 2702 is implicated in our scenario because the transferor has retained a discretionary interest in a trust for his or her spouse and issue.

Implications

Under §2702, the value of a retained interest which is not a qualified interest is treated as zero.[86] The transferor's retained interest is not a ''qualified interest'' because it's not a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest in a trust whose other interests are annuity or unitrust interests.[87]

Exceptions to §2702

For present purposes, two exceptions to §2702 are pertinent.

First, §2702 does not come into play if the transfer in trust is an incomplete gift.[88] Admittedly, this exception seems to beg the question.

Second, a regulation offers an exception for:[89]

The assignment of a remainder interest if the only retained interest of the transferor or an applicable family member is as the permissible recipient of distributions of income in the sole discretion of an independent trustee (as defined in section 674(c)).

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[81] Pub. L. No. 101-508, Title XI, §11602(a) (Nov. 5, 1990). *See* Jonathan G. Blattmachr, Georgiana J. Slade, Diana S.C. Zeydel, 836 T.M., *Partial Interests—GRATs, GRUTs, QPRTs (Section 2702)*.

[82] Reg. §25.2702-7.

[83] *See* Reg. §25.2702-1(a).

[84] §2702(e), §2704(c)(2). *See* Reg. §25.2702-2(a)(1).

[85] §2702(a)(1), §2701(e)(2).

[86] §2702(a)(2)(A). *See* Reg. §25.2702-2(b)(1).

[87] §2702(b). *See* Reg. §25.2702-1(b); Reg. §25.2702-2(a)(6)-§25.2702-2(a)(9); Reg. §25.2702-3.

[88] §2702(a)(3). *See* Reg. §25.2702-1(c)(1).

[89] Reg. §25.2702-1(c)(6).

ISSN 0886-3547

This suggests that the creation of the discretionary interest was a completed gift at the beginning.

Comment

Some uncertainty exists regarding the applicability of §2702 to self-settled trusts. Thus, commentators have written:[90]

> Although it is not certain, the Regs. §25.2702-1(c)(6) exception may undermine the purpose of §2702. It is the IRS's position—and, it appears, at least the position of some courts—that if an income interest in a trust may be attached by the grantor's creditors, the gift of the income interest is not complete. Hence, if a property owner creates a trust in which the income interest is attachable by the grantor's creditors, because, for example, the grantor is eligible to receive distributions of income in the discretion of an independent trustee, the gift of the income interest will be regarded as incomplete and, under this regulatory exception, will not be valued at zero. Thus, the remainder should be valued only at its ''normal'' actuarial value.

Guidance

The IRS has issued some guidance on the application of §2702.

—PLR 9141027 (1991)

In PLR 9141027, the husband created a trust for his wife. The ruling concluded that §2702 was inapplicable:

> Because any transfer of property to the Spousal Trust that A makes will constitute a completed gift for gift tax purposes, and because B will not have held an interest in the transferred property, *both* before and after the transfer, section 2702 will not apply to the transfer.

—Rev. Rul. 2004-64 (2004)

In Rev. Rul. 2004-64, summarized above, the IRS ruled that the ability of a settlor to be reimbursed for income taxes attributable to a grantor trust would not prevent the creation of the trust from being a completed gift. Although the ruling did not address the point, §2702 would not apply because that interest would not cause any portion of a transfer to be treated as an incomplete gift.[91]

—CCA 201208026 (2011)

In CCA 201208026, summarized above, the donors created a trust for their descendants but retained nongeneral testamentary powers of appointment. Although an opinion on §2702 had not been requested, the pronouncement provided the following guidance:

> It is our belief that §2702 applies in valuing the gifts in this case. Section 2702 provides special valuation rules with respect to transfers of interests in trusts. Generally, under §2702(a)(2), the value of any retained interest which is not a qualified interest shall be treated as being zero. Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under §25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors' gift is the full value of the transferred property.

Structuring a Domestic APT to Be an Incomplete Gift

For federal gift-tax purposes, an individual makes a completed gift when he or she parts with dominion and control over property.[92] The common-law rule against self-settled trusts prevented taxpayers from making taxable gifts because they could incur debt and relegate creditors to trust assets. The domestic APT statutes are intended to change this result.

Early private letter rulings involving domestic APTs concluded that the settlor's retention of a nongeneral testamentary power of appointment was sufficient, by itself, to prevent the making of a completed gift.[93] More recently, however, the IRS announced a change of position.[94] It now requires that the settlor be able to prevent the making of gifts from the trust

[90] Jonathan G. Blattmachr, Georgiana J. Slade, Diana S.C. Zeydel, 836 T.M., *Partial Interests—GRATs, GRUTs, QPRTs (Section 2702)* at A-9-A-10 (footnotes omitted).

[91] Reg. §25.2702-2(a)(3), §25.2702-2(a)(4).

[92] Reg. §25.2511-2(b).

[93] *See* PLR 200731019, PLR 200729025, PLR 200715005, PLR 200647001, PLR 200637025, PLR 200612002, PLR 200502014, PLR 200247013, PLR 200148028.

[94] *See* CCA 201208026. *See also* Diana Zeydel, *When is a Gift to a Trust Complete—Did CCA 201208026 Get it Right?,* 117 J. Tax'n 142 (Sept. 2012); Richard B. Covey & Dan T. Hastings, *Powers of Withdrawal; Gift Tax Annual Exclusion; Taxable Gifts; IRC Sec. 2702*, Prac. Drafting at 10770, 10773-76 (Apr. 2012).

ISSN 0886-3547

during lifetime. Thus, in many recent rulings,[95] the IRS has said that a settlor will not make a completed gift to a self-settled trust if he or she keeps a nongeneral lifetime power of appointment and/or a power to prevent trustees, advisers, or protectors from making distributions to other beneficiaries as well as a nongeneral testamentary power of appointment.[96]

Several of the early rulings in the second round of guidance were issued under Nevada law because, for a time, it was the only state that permitted a settlor to keep a nongeneral inter vivos power of appointment.[97] The same structure currently is available in Alaska, Delaware, and South Dakota which now permit settlors to have such a power.[98]

Structuring a Domestic APT to Be a Completed Gift

As described above, the IRS ruled in 1998 and again in 2009 that transfers of assets by Alaska residents to Alaska APTs were completed gifts.[99] Alaska, Delaware, Nevada, and South Dakota do allow the assets of APTs to be reached by creditors in certain circumstances. Although some commentators have opined that Nevada has no exception creditors,[100] Nevada permits the assets of APTs to be accessed not only to pay fraudulent-transfer claims but also if ''the transfer violates a legal obligation owed to the creditor under a contract or a valid court order that is legally enforceable by that creditor.''[101]

The author of the Chief Counsel Advice memorandum summarized above, observed that:[102]

> The Supreme Court considered various situations in which a trust instrument purported to divest the respective grantor of all dominion and control over property to the extent that the property could not be returned to the grantor except by reason of contingencies beyond his control. In these cases, the Court noted that the respective grantor lost all economic control upon making the transfer, which he would not regain unless certain contingencies occurred. The Court concluded that the respective gifts were complete. . . .

To support the above proposition, the writer of that guidance cited the two U.S. Supreme Court cases and the Tax Court case described above.[103] The foregoing authorities indicate that completed-gift treatment should be available in all of these states.[104]

In 2011, the author's organization—Wilmington Trust Company—engaged counsel to attempt to obtain a Delaware private letter ruling comparable to the Alaska rulings. Late in the year, counsel learned that the IRS was not willing to do so. According to counsel, the IRS's unwillingness to rule was not attributable to Delaware's family or other exceptions. Rather, the IRS was troubled by the 2011 *In re Mortensen* bankruptcy case in Alaska.[105] An IRS representative said that the Alaska ruling probably would not have been issued post-*Mortensen* and that the IRS since had declined other Alaska ruling requests.

Report Gift

A settlor who creates a domestic APT that is designed to be a completed gift and excludible from the gross estate should report the transfer on a timely gift-tax return. Adequate disclosure of the transfer will commence the running of the period of limitations for assessment of gift tax even if the transfer is ultimately determined to be an incomplete gift. Once the period of assessment expires, the transfer will be subject to inclusion in the settlor's gross estate only to the extent that a completed gift would be so included.[106]

The author is aware of instances in which a settlor reported the creation of a Delaware APT as a com-

[95] *See, e.g.*, PLR 202007010, PLR 202006002-006, PLR 201925005-010, PLR 201908008, PLR 201908003-007, PLR 201852009, PLR 201852014, PLR 201850001-006, PLR 201848002,PLR 201848009, PLR 201838002-007, PLR 201836006; PLR 201832005-009.

[96] *See* Gideon Rothschild & Daniel S. Rubin, *Minimize Creditor Challenges to Self-Settled Spendthrift Trusts*, 157 Tr. & Est. 14, 16 n.12 (Nov. 2018).

[97] Nev. Rev. Stat. §166.040(2)(b).

[98] Alaska Stat. §34.40.110(b)(2); Del. Code Ann. tit. 12, §3570(11)(b)(2); S.D. Codified Laws §55-16-2(2)(b).

[99] PLR 9837007, PLR 200944002.

[100] *See* Gideon Rothschild, et al., *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate,* 37 Est. Plan. 3, 12 (Jan. 2010).

[101] Nev. Rev. Stat. §166.170(3).

[102] CCA 201208026.

[103] *See Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943) (''grantor has neither the form nor substance of control and never will have unless he outlives his wife''); *Robinette v. Helvering*, 318 U.S. 184, 187 (1943) (property ''could not be returned to them except because of contingencies beyond their control''—whether daughter had children); *Estate of Kolb v. Commisioner.*, 5 T.C. 588, 596 (1945) (''the donor decedent had no power to modify the trust in any way and never could have except upon the happening of an event beyond his control''—birth of more grandchildren).

[104] *See United States v. Byrum*, 408 U.S. 125, 150 (1972); *Ellis v. Commissioner.*, 51 T.C. 182, 187-88 (1968), *aff'd*, 437 F.2d 442 (9th Cir. 1971); *Estate of Tully*, 528 F.2d 1401 (Ct. Cl. 1976); TAM 8819001; PLR 9141027.

[105] No. A09-00565, 2011 BL 387653 (Bankr. D. Alaska Jan. 14, 2011); Adv. No. A09-90036, 2011 BL 180087 (Bankr. D. Alaska July 8, 2011); No. A09-00565, 2011 BL 139744 (Bankr. D. Alaska May 26, 2011).

[106] Reg. §301.6501(c)-1(f)(5). *See* FAA 20172801F (disclosure was adequate), FAA 20152201F (disclosure was inadequate). *See also* Kevin E. Packman, *Windfall From Abroad Brings Home IRS*

ISSN 0886-3547

pleted gift, the settlor then died, and the IRS did not seek to include the trust in the gross estate before issuing its closing letter.

ESTATE TAX

Background

To determine whether a domestic APT is includible in the settlor's gross estate for federal estate-tax purposes, the planner must consider §2033, §2036(a)(1), §2036(a)(2), §2037, §2038(a)(1), §2041, and §2042(2). Estate-tax inclusion can be triggered under any of these sections.

Section 2033

The domestic APT will be includible in the gross estate if the settlor has an interest at death within the meaning of §2033.

Section 2036(a)(1)

A trust will be included in the settlor's gross estate if, at death, the settlor has ''the possession or enjoyment of, or the right to the income from, the property'' within the meaning of §2036(a)(1).[107] If the settlor of a domestic APT retains the right to receive current income distributions (not all domestic APT statutes permit this), then the trust will be included in the settlor's gross estate under this section. If the settlor of a domestic APT may receive distributions only upon the exercise of absolute discretion, however, the issue is whether or not this trust provision is enough, by itself, to cause estate-tax inclusion.

Section 2036(a)(2)

A trust will be included in the settlor's gross estate if, at death, the settlor has ''the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom'' within the meaning of §2036(a)(2).[108] The issue under this section is whether or not the settlor has retained too much power to enable others, including creditors, to reach trust assets.

Section 2037

The domestic APT will be includible in the gross estate if the settlor has a reversionary interest within the meaning of §2037.

Section 2038(a)(1)

A trust will be included in the settlor's gross estate under §2038(a)(1) if, at death, the settlor has a power to alter, amend, revoke, or terminate the trust.[109] Whether or not §2038(a)(1) prevents estate-tax exclusion depends on whether or not the settlor retains enough power to enable creditors to reach trust assets so as to fall within §2038(a)(1)'s scope.

Section 2041

The domestic APT will be includible in the gross estate if the settlor holds a general power of appointment at death within the meaning of §2041.

Section 2042(2)

The domestic APT will be includible in the gross estate if the settlor has an incident of ownership within the meaning of §2042(2).

Relegation-of-Creditors Doctrine

As in the gift-tax context, a domestic APT will be includible in the gross estate if the settlor retains the ability to incur debt and to relegate creditors to trust assets.

In re Uhl's Estate (1957)—Seventh Circuit holds that portion of irrevocable self-settled trust over which trustee had uncontrolled discretion to use for settlor was not includible in gross estate under predecessors of §2036 and §2038

In *In re Uhl's Estate*,[110] summarized above, the Seventh Circuit concluded:[111]

> Here, that part of the estate the income from which the settlor did not enjoy was not held for his use. Therefore, it was not within the statute of Indiana. The Indiana case had to do with a trust where the enjoyment of all the trust property was retained in the settlor. In the present case that part of the estate other than the part necessary to produce the $100.00 a month income was not put in trust for the benefit, use or enjoyment of the settlor. He

Compliance Issues, 43 Est. Plan. 3 (May 2016); Scott A. Bieber & Sarah J. Chang, *Filing Form 709—Beyond the Basics of Gift Tax Returns*, 43 Est. Plan. 3, 4-6 (Apr. 2016).

[107] *See* Henry J. Lischer, Jr., 877 T.M., *Retained Beneficial Interests (Sections 2036(a)(1) and 2037)*. *See also* Leslie M. Levy, *Section 2036 of the Internal Revenue Code: A Practitioner's Guide*, 51 Real Prop., Tr. & Est. L.J. 75 (Spr. 2016).

[108] *See* Henry J. Lischer, Jr., 876 T.M., *Retained Powers (Sections 2036(a)(2) and 2038)*.

[109] *See* Henry J. Lischer, Jr., 876 T.M., *Retained Powers (Sections 2036(a)(2) and 2038)*.

[110] 241 F.2d 867 (7th Cir. 1957).

[111] 241 F.2d at 871-72.

ISSN 0886-3547

parted with dominion over it forever. Even granting that, under the Indiana authorities, that part of the estate which produced his $100.00 a month might have been reached by his creditors, the statute itself does not apply, under its express terms, to property or the income therefrom over which the settlor retained no dominion and no control. All that part of the corpus of the estate was, after the creation of the trust, the property of the beneficiaries, subject only to an uncontrolled discretion in the trustee to divert to the settlor something the settlor could not have compelled the trustee to give him. Consequently, on the face of the record, the Indiana Statute has no application. It should be observed also that, in Indiana, in order to avoid a transfer, fraud must be proved as a fact. Here there is not the slightest inference to be drawn from the record that any part of the corpus of the estate was conveyed for the purpose of defeating creditors.

> We conclude that the Commissioner properly levied a deficiency estate tax for that part of the corpus necessary to produce the $100.00 a month. But the remainder of the corpus, over which the control of the settlor had ended, subject only to an uncontrolled discretion in the trustee, did not remain his property until his death but passed to the grantee at the time of the creation of the trust without hindrance or suspicion of any fraudulent intent.

The court relied, in large part, on the Second Circuit's *Herzog v. Commissioner*[112] decision which, as noted above, has been disavowed by later authorities

Rev. Rul. 76-103 (1976)—IRS rules irrevocable self-settled trust would be includible in gross estate under §2038

In Rev. Rul. 76-103, summarized above, the IRS concluded:[113]

> [I]f the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

Outwin v. Commissioner (1981)—Tax Court suggests that irrevocable self-settled trust would be includible in gross estate under §2036(a)(1) and/or §2038(a)(1)

In *Outwin v. Commissioner*,[114] summarized above, the Tax Court declared:[115]

> Although the transfers in trust in these cases are not subject to gift tax, the settlor'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 settlor's gross estate under secs. 2036(a)(1) or 2038(a)(1).

Retained Powers Not Resulting in Estate-Tax Inclusion

A domestic APT might be susceptible to the claims of certain creditors without causing estate-tax inclusion.

United States v. Byrum (1972)—U.S. Supreme Court holds that retention of voting control over stock in a closely held corporation did not cause inclusion in gross estate under §2036

In *United States v. Byrum*,[116] the decedent created an irrevocable trust for his issue in 1958 and appointed an independent trustee. He retained the following powers:[117]

> (i) to vote the shares of unlisted stock held in the trust estate; (ii) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (iii) to approve investments and reinvestments; and (iv) to remove the trustee and designate another corporate Trustee to serve as successor.

The Court held that he had not kept enough control to cause inclusion in the gross estate under §2036(a)(1) or §2036(a)(2), saying:[118]

> Even if Byrum had transferred a majority of the stock, but had retained voting control, he would not have retained substantial present economic benefit. The Government points to the retention of two benefits. The first of these, the power to liquidate or merge, is not a present benefit; rather, it is a speculative and contingent benefit which may or may not

[112] 116 F.2d 591 (2d Cir. 1941).

[113] Rev. Rul. 76-103.

[114] 76 T.C. 153 (1981)

[115] 76 T.C. at 168 n.5 (citations omitted).

[116] 408 U.S. 125 (1972).

[117] 408 U.S. at 127.

[118] 408 U.S. at 149-50 (footnotes, citation, and internal quotation marks omitted).

ISSN 0886-3547

be realized. Nor is the probability of continued employment and compensation the substantial enjoyment of the transferred property within the meaning of the statute. The dominant stockholder in a closely held corporation, if he is active and productive, is likely to hold a senior position and to enjoy the advantage of a significant voice in his own compensation. These are inevitable facts of the free-enterprise system, but the influence and capability of a controlling stockholder to favor himself are not without constraints. Where there are minority stockholders, as in this case, directors may be held accountable if their employment, compensation, and retention of officers violate their duty to act reasonably in the best interest of the corporation and all of its stockholders. Moreover, this duty is policed, albeit indirectly, by the Internal Revenue Service, which disallows the deduction of unreasonable compensation paid to a corporate executive as a business expense. We conclude that Byrum's retention of voting control was not the retention of the enjoyment of the transferred property within the meaning of the statute.

Following *Byrum*, §2036 was amended to provide for gross estate inclusion for a decedent who retained 20% voting control.[119]

Estate of Tully (1976)—Claims Court holds that decedent's ability to terminate his wife's interest in employee-benefit plans did not cause inclusion in gross estate under §2038(a)(1) or §2033

In *Estate of Tully*,[120] the IRS sought to include a decedent's death benefit plan benefits in his gross estate under §2038(a)(1) and §2033 by reason of his ability to change the disposition of the benefits by divorce. The court discussed this issue as follows:[121]

> Tully did not retain a section 2038(a)(1) power to revoke or terminate the transfer to his wife by virtue of the possibility that he could have divorced her. The contract called for T & D to make the death benefit payments to Tully's widow. It might be argued that Tully could have divorced his wife to terminate her interest in the death benefits, but again such an argument ignores practicalities, reduces the term power to the speculative realm, and is not in accord with prior cases. In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd. Further, in various cases, death benefits payable to the widow or wife were not thereby held includable in the gross estate. The possibility of divorce in the instant situation is so de minimis and so speculative rather than demonstrative, real, apparent and evident that it cannot rise to the level of a section 2038(a)(1) power. Thus the use of widow in the death benefit contract did not give Tully a real power to revoke or terminate the death benefit transfer to his wife.

The court held:[122]

> If controls over property cannot rise to the dignity of section 2038(a)(1) powers they equally cannot create section 2033 interests. In the instant case, having failed to establish that corporate stock ownership, pegging the benefits to Tully's salary and naming the widow as beneficiary created section 2038(a)(1) powers. Defendant equally fails to demonstrate that the same facts create section 2033 interests.

PLR 8037116 (1980)—IRS rules that retention of administrative power over and potential receipt of assets from an irrevocable self-settled discretionary trust did not cause inclusion in gross estate under §2036(a)(2) or §2037

In PLR 8037116, the IRS sought to include a grantor trust that a nonresident alien created for his mother's issue (including himself) under §2036(a)(2) and §2037. The ruling rejected inclusion under §2036(a)(2) as follows:

> Section 2036(a)(2) requires inclusion where the decedent retained the right to designate beneficiaries of property transferred. In this case, the decedent gave the trustee sole discretion to distribute principal and income to the beneficiaries designated in Paragraph First of the trust agreement. Paragraph Fifth provides the decedent with the right to settle accounts and release the trustees from all liability, responsibility, or accountability for their acts or omissions as trustees, thereby binding all income beneficiaries, remaindermen, and other interested parties. We conclude that this power is not the same as giving the decedent the right to designate beneficiaries but is a more limited power retained by the decedent for purposes of administrative convenience. Thus, the trust property is not includible under section 2036(a)(2) of the Code.

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[119] *See* §2036(b).

[120] 528 F.2d 1401 (Ct. Cl. 1976).

[121] 528 F.2d at 1406 (footnotes, citations, and internal quotation marks omitted). The court also held that the decedent's ability to alter his wife's interest by persuading others or changing his compensation did not result in §2038(a)(1) inclusion. 528 F.2d at 1404-05.

[122] 528 F.2d at 1406-07 (internal quotation marks omitted).

ISSN 0886-3547

Similarly, PLR 8037116 found no inclusion under §2037:

> With respect to section 2037 of the Code, all beneficiaries (including the decedent) were eligible to possess or enjoy principal and income from the trust during the decedent's lifetime, at the trustee's discretion. This provision falls outside the language of section 2037(a)(1) where a beneficiary could assume ownership of trust property only by surviving the decedent. Furthermore, we conclude that the decedent did not retain a reversionary interest subject to the decedent's power of disposition, or to benefit himself or his estate, since Paragraph First of the trust agreement provides an irrevocable distribution of property to the trustee during the decedent's life, upon death to others, and any benefits that the decedent could have received would have been at the sole discretion of the trustee. These provisions are not enough to constitute a reversionary interest in the decedent. Consequently, the value of the trust property is not includible in the gross estate under section 2037(a) or (b) of the Code.

Rev. Rul. 80-255 (1980)—IRS rules that possibility that settlor would have or adopt later children who would become trust beneficiaries did not cause estate-tax inclusion under §2036(a)(2) or §2038(a)(1)

In Rev. Rul. 80-255, summarized above, after-born and after-adopted grandchildren would become trust beneficiaries. The ruling rejected inclusion under §2036(a)(2) and §2038(a)(1) in the following manner:[123]

> D did not retain a power to change the beneficial interests of the trust, for purposes of sections 2036(a)(2) and 2038(a)(1) of the Code, notwithstanding that all of D's after-born and after-adopted children were to become beneficiaries. Therefore, the trust property is not includible in D's gross estate.

Estate of Wells v. Commissioner (1981)—Tax Court holds that irrevocable self-settled discretionary trust was not includible in gross estate under §2036(a)(1)

Estate of Wells v. Commissioner[124] was an estate-tax case only, the lifetime gift-tax exemption having been applied. The IRS contended that the decedent and the trustee had agreed that the decedent would receive distributions when requested so as to cause inclusion in the gross estate under §2036(a)(1).[125] The Tax Court rejected the IRS's argument as follows:

> [P]etitioner has sustained his burden of proving that decedent transferred the property to the trust absolutely, unequivocally, irrevocably, and without possible reservations and that she did not receive the trust income pursuant to an agreement entered into contemporaneously with the transfer of the property to the trust. Respondent's various contentions must fail, since the mere receipt of trust income is not enough to trigger section 2036(a)(1) and the record is devoid of any other factual support for his position.

Estate of German v. United States (1985)—Claims Court holds that irrevocable self-settled discretionary trusts were not includible in gross estate under §2036 or §2038

In Estate of German v. United States,[126] summarized above, the IRS sought estate inclusion of the decedent's self-settled discretionary trusts under §2036 and §2038. The Claims Court found no inclusion, declaring:[127]

> [D]efendant has not established that under Maryland law creditors of the settlor could have reached the trust income or principal of her discretionary trusts up to the time of her death.

Estate of Paxton v. Commissioner (1986)—Tax Court holds that irrevocable self-settled discretionary trust was includible in gross estate under §2036(a)(1)

In *Estate of Paxton v. Commissioner*,[128] the Tax Court described the trust arrangement in the following way:[129]

> As we read the PFO and IDT declarations of trust and related instruments, they created discretionary trusts subject to certain retained interests discussed below. Decedent and Grace Paxton transferred property to the trustees of PFO and IDT, respectively, and the trustees accepted the property as trust assets for which they assumed fiduciary responsibilities. As consideration for the transfers, decedent and Grace Paxton, and others who transferred Kwik Lok stock to the trusts, received beneficial interests in the trusts evidenced by certifi-

[123] Rev. Rul. 80-255.

[124] T.C. Memo 1981-574.

[125] *See* Leslie M. Levy, *Section 2036 of the Internal Revenue Code: A Practitioner's Guide,* 51 Real Prop., Tr. & Est. L.J. 75, 80-86 (Spring 2016).

[126] 7 Cl. Ct. 641 (1985).

[127] 7 Cl. Ct. at 645.

[128] 86 T.C. 785 (1986).

[129] 86 T.C. at 804 (footnotes and internal quotation marks omitted).

ISSN 0886-3547

cates of interest. The trust declarations expressly provide that the certificates of interest evidence the equitable interest contributing to the Trust Estate. The PFO trustees, as explained by the Yakima County Superior Court, were given discretion to distribute both income and corpus to the certificate holders and the distributions were not required to be proportionate to the holdings of such certificates. In our view, the certificate holders, including decedent, were, thus, the beneficiaries of the trusts.

No gift-tax return was filed in connection with the establishment of the trust.[130] The Tax Court held that the trust was includible in the gross estate because the settlor and the trustees had an agreement regarding distributions:[131]

> Based on all of the foregoing circumstances, we think it was understood between decedent and his son, Jerre, at or before the execution of the PFO and IDT trusts, that decedent would receive distributions of income or corpus or both upon demand or at the expiration of decedent's patent licensing agreement. Given the agreement of the parties that the certificates of interest that he received had no fair market value, we can find no other explanation for Mr. Paxton's statement that he received something of value equal to the value of the property he transferred to the trusts. Accordingly, we hold that decedent retained for his life possession or enjoyment of the property he transferred to the trusts; and, therefore, the value of the property transferred to the PFO and IDT trusts is includable in his gross estate under section 2036(a)(1).

The court also found inclusion under the creditor-relegation theory of §2036(a)(1):[132]

> As settlor-beneficiary, decedent retained the economic benefit and enjoyment of the entire trust income and corpus because he could borrow money or otherwise incur indebtedness and relegate his creditors to the trust for payment. Retention of the right to use the trust as a form of security for his indebtedness in this manner left Mr. Paxton with a significant interest in the property. In our opinion, that is sufficient to require his transfers to the trusts to be included in his gross estate under section 2036(a)(1).

[130] 86 T.C. at 809.

[131] 86 T.C. at 813-14 (footnote omitted).

[132] 86 T.C. at 814 (citation omitted).

TAM 8819001 (1988)—IRS advises that decedent's ability to terminate a spouse's interest in a life-insurance trust through divorce was not an incident of ownership under §2042

TAM 8819001 considered whether the ability to divorce a spouse was an incident of ownership under §2042(2) that would cause an insurance policy held by a trustee to be included in the gross estate. The guidance indicated that it would not as follows:

> We believe the *Estate of Tully* and Rev. Rul. 80-255 are more closely analogous to the situation here than is *Estate of Thacher v. Commissioner*. The act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust. Thus, we do not believe the decedent possessed an ''incident of ownership'' in the insurance policy as a result of the trust provision which would terminate the interest of the decedent's spouse in the event of a divorce.

The advice therefore concluded:

> The value of the life insurance policy is not includible in the decedent's gross estate under section 2042 of the Code, because the trust provision terminating the decedent's spouse's interest in the trust in the event of a divorce is not an ''incident of ownership.''

PLR 9141027 (1991)—IRS rules that ability to terminate a trust through divorce or legal separation did not cause inclusion in gross estate under §2041

PLR 9141027 involved §2041. The ruling describes the controversy and its conclusion as follows:

> Under the Spousal Trust, B has a power to terminate the trust and receive all of the trust assets if A and B divorce or are legally separated. Assuming A and B are not divorced or legally separated when B dies, B's termination power will not constitute a general power of appointment in the existence of decedent's death that would cause the value of the Spousal Trust to be included in B's gross estate. A power that is exercisable only in the event of divorce or legal separation constitutes an act of independent significance.

PLR 9332006 (1992)—IRS rules that irrevocable self-settled offshore discretionary trust was not includible in gross estate under §2036, §2037, or §2038

In PLR 9332006, summarized above, the IRS found no reason to include the offshore APT in question in the settlors' gross estates. The ruling concluded:

> [T]he property transferred to the Trust will not be included in the gross estate of either Settlor under

ISSN 0886-3547

section 2033, since the gift to the Trust will be complete and neither Settlor will have the right to compel a distribution from the trust. Similarly, interests in the Partnership transferred to the Trust by either Settlor will not be included in that Settlor's gross estate under sections 2036, 2037, or 2038, since under the facts presented, the Trustee's discretion to make distributions to a Settlor is not a retained interest or power for purposes of those sections.

PLR 9837007 (1998)—IRS declines to rule on whether Alaska APT would be includible in settlor's gross estate under §2036 or §2038

In PLR 9837007, the first Alaska APT ruling mentioned above, the IRS declined to opine on the estate-tax implications of the arrangement as follows:

> We are expressly not ruling on whether the assets held under the Trust agreement at the time of Donor's death will be includible in Donor's gross estate for federal estate tax purposes.

Rev. Rul. 2004-64 (2004)—IRS rules on estate-tax consequences of payment of income taxes attributable to grantor trust in three scenarios under §2036(a)(1)

Rev. Rul. 2004-64, the gift-tax issues of which were discussed above, also had estate-tax implications. Regarding Situation one, under which the grantor pays income taxes attributable to a grantor trust, the ruling stated:[133]

> [N]o portion of Trust is includible in A's gross estate for federal estate tax purposes under §2036, because A has not retained the right to have trust property expended in discharge of A's legal obligation.

Regarding Situation two, under which the governing instrument or state law requires the trustee to reimburse the settlor for income taxes attributable to a grantor trust, the ruling said:[134]

> If pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under §2036(a)(1).

Finally, regarding Situation three, under which the governing instrument or local law gave the trustee discretion to reimburse the settlor for income taxes attributable to a grantor trust, the ruling concluded that there would not be estate inclusion with some caveats:[135]

> [A]ssuming there is no understanding, express or implied, between A and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy A's obligation would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses A from Trust assets for the amount of income tax A pays that is attributable to Trust's income. The result would be the same if the trustee's discretion to reimburse A for this income tax is granted under applicable state law rather than under the governing instrument. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes.

PLR 200944002 (2009)—IRS rules that Alaska APT would not be includible in settlor's gross estate under §2036 with caveats

In PLR 200944002, the second Alaska APT ruling summarized above, the IRS gave a favorable estate-tax ruling as follows:

> [T]he trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036.

The ruling cautioned, though:

> We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036.

Commentary

Shortly after the Alaska Act became law in 1997, commentators described its transfer-tax implications

[133] Rev. Rul. 2004-64.

[134] Rev. Rul. 2004-64.

[135] Rev. Rul. 2004-64.

ISSN 0886-3547

in the following way: "If the grantor's retained interest is discretionary, his creditors cannot reach the trust property, except as provided in the statute. Thus, under existing estate tax authority, the trust property would not be includible in the grantor's gross estate."[136]

Another authority comments on the same issue as follows:[137]

> *Example*: X transfers property irrevocably in trust, naming as trustee a person other than X, with income, during X's lifetime, to be paid to X or accumulated in the trustee's discretion, then remainder to C. From the date of the lifetime transfer up to the date of X's death, X has received various irregular amounts equal to 40% of the income from the trust over that time period. The general rule in such a case, with exceptions described below, is that nothing is includible in X's gross estate under §2036(a)(1), not even 40% of the corpus. Any income actually received from the trustee will augment X's potential §2033 gross estate (to the extent not consumed before death).

In discussing this issue, other commentators conclude that "[i]f some meaning is to be accorded the word 'retained,' some showing of an arrangement, more than the fact that income was paid to the decedent, should be required."[138] An interest or right is treated as having been retained or reserved if, at the time of the transfer, an express or implied understanding existed that distributions would be made[139] and, if a pattern of distributions can be established, it is likely that an arrangement will be inferred.[140] Put differently, an objectively observable pattern or set of transactions can support an inferential finding that an understanding existed. As noted above, some domestic APT laws expressly provide that such an understanding is invalid.[141]

[136] Richard B. Covey & Dan T. Hastings, *Discretionary Trust With Grantor as Beneficiary; Ability of Creditors of Grantor to Reach Trust Property; Alaska Law,* Prac. Drafting at 4889, 4891 (July 1997).

[137] This example is from Henry J. Lischer, Jr., 877 T.M., *Retained Beneficial Interests (Sections 2036(a)(1) and 2037)* at A-12 (footnotes omitted).

[138] Richard B. Stephens, et al., *Federal Estate and Gift Taxation* ¶4.08[4][c] at 4-154 (8th ed. 2002).

[139] Reg. §20.2036-1(a), §20.2036-1(c)(1)(i). *See also* Reg. §20.2036-1(b)(3).

[140] *See Skinner Est. v. United States*, 316 F.2d 517 (3d Cir. 1963); *Green Est. v. Commissioner*, 64 T.C. 1049, 1058-64 (1975).

[141] *See* Alaska Stat. §34.40.110(i); Del. Code Ann. tit. 12, §3571; S.D. Codified Laws §55-16-8.

ASSESSING CREDITORS WHO MAY REACH DOMESTIC APT ASSETS

The foregoing authorities indicate that the issue is not whether a creditor may reach the assets of a domestic APT. Instead, the issue is whether the settlor has kept enough control so that he or she may incur debt after transferring assets to a domestic APT that will enable creditors to access the transferred assets. At least three categories of potential creditors must be considered:

- possessors of fraudulent-transfer claims;
- possessors of federal claims;
- possessors of claims as "exception creditors."

All domestic APT statutes allow creditors to set aside transfers to domestic APTs that are fraudulent transfers. But, the determination as to whether a transaction is a fraudulent transfer is made as of the date of the transfer—not at some later time—so that the settlor's post-transfer activity is irrelevant. Hence, good creditor planning should produce good tax planning.

Post-transfer conduct might affect domestic APTs if federal claims are involved. Thus, the IRS might step in if the settlor doesn't pay federal taxes, the SEC might step in if the settlor cheats investors, the FTC might step in if the settlor misleads consumers, a bankruptcy trustee might step in if the settlor ends up in bankruptcy, and those representing minor children might step in if the settlor fails to support them. Nevertheless, claims of this type do not seem to have emerged in authorities involving transfer-tax planning.

Finally, "exception creditors" recognized by a domestic APT statute must be assessed.

In Delaware, for example, the assets of an APT are vulnerable:[142]

> To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such

[142] Del. Code Ann. tit. 12, §3573(1) (emphasis added). It should be noted that " 'Spouse' and 'former spouse' means only persons to whom the transferor was married at, or before, the time the qualified disposition is made." (Del. Code Ann. tit. 12, §3570(9). The corresponding South Dakota exception—S.D. Codified Laws §55-16-15(1)—is based on an earlier version of the Delaware exception and does not have the above italicized language. Thus the assets of a South Dakota APT may be reached by "any person to whom at the time of transfer the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of the transferor's spouse, former spouse, or children, or for a division or distribution of property in favor of the transferor's spouse or former spouse, to the extent of the debt." The Alaska and Nevada statutes do not have comparable exceptions.

ISSN 0886-3547

> transferor's spouse, former spouse or children, or for a division or distribution of property *incident to a judicial proceeding with respect to a separation or divorce* in favor of such transferor's spouse or former spouse, but only to the extent of such debt. . . .

Theoretically, the settlor of a Delaware APT could enable such a spouse to reach trust assets by divorcing the spouse. But the authorities discussed above indicate that this should not prevent transfers to the APT from being completed gifts or from removing the trust assets from the gross estate. Thus, in PLR 9141027, the IRS said, ''[a] power that is exercisable only in the event of divorce or legal separation constitutes an act of independent significance.''[143]

Concerning a current spouse, a former spouse, or a minor child, failing to live up to court-ordered support or alimony would be a drastic way to give settlors access to trust funds and might involve punishment by the legal system. Again, this is a far cry from incurring debt and relegating creditors to trust assets. In *Ellis v. Commissioner*,[144] summarized above, the Tax Court held that the settlor's ability to fail to support his wife and thereby cause the trustee to make distributions to her was not the type of power that causes transfers to be incomplete gifts.[145]

The protections of the Delaware Act also do not apply:[146]

> To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the tortious act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable but only to the extent of such claim against such transferor or other person for whom such transferor is or was vicariously liable.

Given that such a claim relates to pre-transfer conduct, it should be taken into account in fraudulent-transfer planning. The settlor's post-transfer activity is irrelevant so the creditor-relegation theory is inapplicable.

The Alaska Act[147] and the South Dakota Act[148] recognize that a surviving spouse may access the assets of an APT by electing against the will. Accordingly, the settlor may alter the disposition of the trust assets by leaving so little to the surviving spouse that the latter exercises elective-share rights. This seems dangerously close to being able to relegate trust assets to creditors, particularly since the settlor won't be around to bear the consequences.

PLANNING CONSIDERATIONS

Besides being mindful of the types of creditor claims to which the settlor of an APT might be vulnerable, the biggest challenge to removing trust assets from the gross estate is insuring that there will be no express or implied understanding regarding distributions so as to cause inclusion under §2036. At least two steps should be taken to minimize this risk. First, the governing instrument should put an independent trustee rather than a family member, friend, etc., in charge of distributions. Second, the settlor should not expect to receive regular distributions from the trust. If regular distributions are made, a pre-existing arrangement is likely to be inferred.

Also, if the settlor wishes to exclude trust assets from the gross estate, he or she should not keep a nongeneral testamentary power of appointment.[149]

DOMESTIC APT DEVELOPMENTS

In 1998, the IRS ruled that a transfer by an Alaska resident to an Alaska APT was a completed gift but refused to rule on whether or not assets in the trust at the settlor's death would be subject to estate tax.[150] A few months later, the IRS confirmed that transfers to seven irrevocable California self-settled trusts were not completed gifts and that the trusts were includible in the settlor's gross estate because California did not recognize self-settled trusts.[151]

In 2009, the IRS again ruled that the transfer of assets by an Alaska resident to an Alaska APT was a completed gift.[152] This time, the IRS concluded that the trustee's discretion to pay income and principal to the settlor, the settlor's spouse, and the settlor's de-

[143] *Accord Outwin v. Commissioner*, 76 T.C. 153, 166 (1981); *Estate of Tully*, 528 F.2d 1401, 1406 (Ct. Cl. 1976); TAM 8819001.

[144] 51 T.C. 182 (1968), *aff'd,* 437 F.2d 442 (9th Cir. 1971).

[145] 51 T.C. at 187-88.

[146] Del. Code Ann. tit. 12, §3573(2).

[147] Alaska Stat. §13.12.205(a)(2)(A).

[148] S.D. Codified Laws §29A-2-202, §29A-2-205(2).

[149] *See* CCA 201208026.

[150] *See* PLR 9837007.

[151] *See* TAM 199917001.

[152] PLR 200944002. *See* Gideon Rothschild, et al., *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate,* 37 Est. Plan. 3 (Jan. 2010).

ISSN 0886-3547

scendants was not sufficient, by itself, to cause inclusion of the trust's assets in the settlor's gross estate.[153]

STRUCTURING A DOMESTIC APT TO BE AN INCOMPLETE GIFT AND A NONGRANTOR TRUST: THE ING TRUST

Most domestic APTs are grantor trusts for federal income-tax purposes under §677(a) because the trustee may distribute income to—or accumulate it for—the settlor without the approval of an adverse party. However, a client might use a type of domestic APT known as the incomplete gift nongrantor trust (ING Trust) to eliminate income tax on undistributed ordinary income and capital gains imposed by Pennsylvania, which has not adopted the federal grantor-trust rules for irrevocable trusts, or, if clients are willing to subject distributions to themselves to the control of adverse parties, to eliminate income tax on such income imposed by one of the 43 states that have adopted the federal grantor-trust rules. In dozens of private letter rulings issued since 2013,[154] the IRS has ruled that domestic APTs that followed the ING-Trust approach qualified as incomplete gifts and as nongrantor trusts. Most—if not all—of the early rulings involved Nevada law because, at the time, Nevada was the only domestic APT state that allowed a settlor to keep a nongeneral lifetime power of appointment. Alaska, Delaware, and South Dakota now offer that option as well.[155] The settlor of an ING Trust might be able to receive tax-free distributions of the untaxed income in later years.[156]

Given that, since 2014, ING Trusts are no longer available for New York domiciliaries,[157] New Yorkers who are interested in reducing New York State and New York City income tax should consider establishing domestic APTs as completed gifts and nongrantor trusts. In addition, because New York's anti-ING-Trust provision applies to taxpayers who create "resident trusts"[158] and because resident trusts are trusts created by New York domiciliaries,[159] the ING Trust option should be available to "statutory residents" (i.e., individuals who maintain a permanent place of abode and spend more than 183 days in New York State and/or New York City during a tax year).[160] Furthermore, the ING Trust technique is still viable for residents of other states. In 2015, Wilmington Trust Company successfully resisted the California Franchise Tax Board's efforts to tax an ING Trust, thus saving the settlor millions of dollars of California income tax.

The author of a 2015 article concluded:[161]

> Few advisers are likely to say that the NING or DING trust is guaranteed to provide the desired results. A better question is: Are they worth the effort? This can be debated, but in some cases they will be.
>
> With every i dotted and t crossed, the informed and non-risk-averse client may go from the certainty of paying significant state income tax to the reporting position of paying little. Of course, the facts, documents, and details matter. The entire exercise can also be a helpful push into the related and often uncomfortable topic of estate planning.

In January of 2020, the IRS announced that it will not issue Private Letter Rulings concerning:[162]

> Whether any portion of the items of income, deduction, and credit against tax of the trust will be included in computing under §671 the taxable income, deductions and credits of grantors when distributions of income or corpus are made—(A) at the direction of a committee, with or without the participation of the grantor, and (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse; or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee or (B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A) of this section).

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[153] PLR 200944002.

[154] *See, e.g.,* PLR 202007010, PLR 202006002-006, PLR 201925005-010, PLR 201908008, PLR 201908003-007, PLR 201852009, PLR 201852014, PLR 201850001-006, PLR 201848002, PLR 201848009, PLR 201838002-007, PLR 201836006, PLR 201832005-009.

[155] Alaska Stat. §34.40.110(b)(2); Del. Code Ann. tit. 12, §3570(11)(b)(2); Nev. Rev. Stat. §166.040(2)(b); S.D. Codified Laws §55-16-2(2)(b).

[156] *See* Gordon P. Stone, III, *Tax Planning Techniques for Client Selling a Business,* 43 Est. Plan. 3 (Oct. 2016); Robert Wood, *Sellers and Settling Litigants Lured By Tax Savings of NING and DING Trusts,* 77 State Tax Notes 565 (Aug. 10, 2015).

[157] *See* NY Tax Law §612(b)(41).

[158] NY Tax Law §612(b)(41).

[159] NY Tax Law §605(b)(3)(B)-(C).

[160] NY Tax Law §605(b)(1)(B).

[161] Robert Wood, 77 State Tax Notes at 568.

[162] Rev. Proc. 2020-3.

ISSN 0886-3547

Practitioners should design ING Trusts with the above guidelines in mind.

GST TAX

The settlor's allocation of GST exemption from the federal generation-skipping transfer tax (GST tax) to transfers to a domestic APT will not be effective as long as the trust is subject to an estate-tax inclusion period, i.e., as long as the trust is includible in his or her gross estate,[163] and that issue may not be resolved conclusively until after the settlor's death (when the IRS, with hindsight as to patterns of distribution and claims of creditors, may establish estate-tax inclusion). Consequently, settlors might want to fund trusts to which GST exemption is to be allocated with assets that they will not need and in which they reserve no interest. They might then place the balance of the assets to be protected in domestic APTs that are not structured to be completed gifts or excludible from the gross estate.

[163] §2642(f); Reg. §26.2632-1(c). *See* Howard Zaritsky, *Using the Newly Increased GST Exemption,* 45 Est. Plan. 46 (May 2018). *See also* Carol A. Harrington, 850 T.M., *Generation-Skipping Transfer Tax.*

ISSN 0886-3547