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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1559

Date: 10-Dec-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: PLR 200949012 - Beneficiary Defective Trust(sm) Private Letter Ruling

"Private letter ruling 200949012 sets forth what appears to be a certain and correct way to allow one person (such as a parent) to create a trust for another (such as a child) in a manner to make the trust a grantor trust with respect to such other (such as the child), even after the power to withdraw all property without restriction lapses because the beneficiary's power to withdraw for health, education, maintenance and support does not lapse. That will permit this Beneficiary Defective TrustSM to grow free of income tax and without causing the beneficiary to be deemed to be making a gift by paying the income tax on the income imputed to him or her under Code Sec. 671 and 678. It also permits the beneficiary to sell assets to the trust without gain, under Rev. Rul. 85-13, while being able to benefit from and to maintain control over the assets sold without gross estate inclusion, if the sale is for full and adequate consideration in money or money's worth."

Trusts that are defective with respect to their grantors have long been popular with clients and their advisors. Trusts that are defective with respect to their beneficiaries are a relatively new development, and have become quite popular because of their creditor protection and estate exclusion features. As they draft these specialized trusts, a question some advisors have wrestled with is the extent to which a "lapse" will be treated as a "release" for section 678 purposes.

In their commentary, **Jonathan G. Blattmachr** and **Diana S. C. Zeydel** inform LISI members about a recent development that illustrates how to more assuredly create a trust that remains a section 678 trust, or a Beneficiary Defective TrustSM, even after the power to withdraw all property from the trust lapses. They also explain why this produces an important planning option for clients.

Jonathan G. Blattmachr is the author of five books and hundreds of articles and co-developer with **Michael L. Graham, Esq.**, of Dallas, Texas, of **Wealth Transfer PlanningSM** a software system for lawyers. Jonathan also was the principal drafter of the request for ruling that resulted in the issuance of PLR 200949012 which is the subject of this important LISI commentary.

Diana S. C. Zeydel is a shareholder of **Greenberg Traurig, P.A.** in Miami, and is a frequent lecturer and author.

Here is their commentary:

EXECUTIVE SUMMARY:

The IRS has just issued Private Letter Ruling 200949012. Although it may not, under section 6110(k)(3) of the Code, be cited or used as precedent, it appears correctly to conclude that a trust that is not a grantor trust with respect to its creator will be a grantor trust with respect to its beneficiary if the beneficiary is granted unilateral right to withdraw all trust corpus for any reason (or no reason at all) which lapses.

In the ruling, following the lapse, the beneficiary continues to have the right to withdraw all the trust property for his or her health, education, maintenance and support (HEMS). The HEMS power is used in the ruling to ensure that the power to withdraw is not treated as having been entirely released but only partially released consistent with the precise wording of Code Sec. 678(a)(2). The ruling was not predicated on the power to withdraw for HEMS being a Code Sec. 678(a)(1) power.

It is the authors' view that this represents the first such private letter ruling dealing with this issue.

FACTS:

Background

A grantor trust is one whose income, deductions and credits against tax are attributed under Code Sec. 671 to the grantor. The attribution of income, deductions and credits will occur with respect to the grantor if any of the conditions described in Code Sec. 673 to 677 or Code Sec. 679 is present.

Where those provisions apply, the grantor is treated as the "owner," in the parlance used in the Code and regulations, of the trust, for income tax purposes. In fact, such trusts are sometimes called "substantial owner trusts." Grantor trusts (also known as "defective trusts") are often the estate planner's best friend.

For example, one of the most powerful factors in financial planning, of which estate planning is a subset, is the income tax free compounding of wealth. Because the income of a grantor trust is received by the trust but is taxed for income tax purposes to the grantor, the trust grows on an income tax free basis.

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In Rev. Rul. 2004-64, 2004-2 CB 7, the Internal Revenue Service acknowledged that a grantor did not make a gift by paying income tax on the trust's income attributed to the grantor under the grantor trust rules. Some commentators have concluded, based upon "Monte Carlo" simulations, that such a tax free compounded for a grantor trust is a more significant wealth tax reduction strategy than a grantor retained annuity trust (GRAT), an installment-sale for a grantor trust (ISGT) or even a 30% discount in value of assets being transferred out of the property owner's estate is likely to be.⁽ⁱ⁾

In fact, a GRAT is an effective strategy in significant measure, in many cases, because the trust is a grantor trust. The GRAT can distribute appreciated assets back to the grantor in satisfaction of the grantor's right to the annuity payments without triggering gain for income tax purposes to the trust or to the grantor.⁽ⁱⁱ⁾

If the trust were not a grantor trust, the distribution of non-cash assets in satisfaction of the annuity (a pecuniary sum) would cause the trust potentially to recognize gain if the assets distributed in satisfaction of the annuity have a basis less than their fair market value.⁽ⁱⁱⁱ⁾ In PLR 200846001 (not precedent), the IRS ruled that the exercise of a power of substitution with respect to a GRAT does not have gift or income tax consequences.

An installment sale to a grantor trust also may be an especially effective wealth tax reduction strategy.^(iv) The IRS has ruled that the existence of a grantor trust is ignored for Federal income tax purposes.^(v) Hence, the sale of appreciated assets to a grantor trust does not cause realization of gain or other income, nor does the payment of interest to the grantor by the trust cause the receipt of gross income if the assets were sold to the trust for a note.^(vi)

Estate Tax "Problems" with Traditional Grantor Trusts

Because a grantor trust permits its beneficiaries to experience tax free compounding of wealth a grantor trust should be considered for all wealth transfer strategies at least for as long as the grantor can endure paying tax on the wealth held in trust for the beneficiaries. This would include using a grantor trust to hold the remainder in a GRAT after the annuity term ends, after the retained use term in a qualified personal residence trust (QPRT) expires, and after indebtedness arising from an ISGT is paid in full.

Indeed, the grantor rarely will be a beneficiary of the grantor trust (other than, for example, during the annuity term of a GRAT but not thereafter). If the grantor remains a beneficiary of the trust, there may be a risk that the trust will be included in the grantor's gross estate for Federal estate tax purposes, thwarting the estate tax planning effectiveness of the arrangement. Such estate tax inclusion will occur if the grantor retains the right to the income of the trust or it is found that there was an implied understanding between the trustee and the grantor that it would be distributed to the grantor.^(vii)

Even if there is no implied understanding, estate tax inclusion nonetheless will occur if the grantor's creditors can attach the assets in the trust.^(viii) Under the law of most states, a trust an individual creates or "settles" and from which distributions may be made to himself or herself (a so-called "self-settled trust") is void with respect to his or her creditors and, therefore, is permanently subject to the claims of his or her creditors regardless of the motive for creating the trust and regardless of whether the claim arose before or after the trust was formed.^(ix)

Nonetheless, the trust could be created in a jurisdiction (such as Alaska or Nevada) where such a "self settled" trust is not subject to the claims of the grantor's creditors as long as, among other conditions, the grantor was not trying to defraud his or her creditors when creating the trust. Cf., e.g., *Estate of German v. United States*, 7 Cl. Ct. 641 (1985) (self-settled trust not included in the gross estate of the Florida decedent because the IRS could not establish that the trust was subject to the claims of her creditors under Maryland law which governed the trust). See, also, PLR 200944002 (not precedent), which held that a self-settled spendthrift trust created under Alaska law would not be included in the grantor's gross estate unless some other factor, such as an implied understanding between the trustee and the grantor that the grantor would benefit from the trust, were present.

Although creating the trust in a jurisdiction that does not permit the grantor's creditors access to the trust may prevent the property from being included in the grantor's gross estate, the grantor's access to the trust must be very limited as a practical matter. If, for example, the trustee makes regular distributions to the grantor, it is almost certain it will be found there was an implied understanding, causing gross estate inclusion.^(x) In addition, the grantor may neither retain nor hold at or within three years of death any control over the beneficial enjoyment of the trust property—otherwise the trust may be included in the grantor's gross estate under Code Sec. 2036(a)(2) and/or 2038.

What would be preferable is if the trust could be a grantor trust without concerns of creditor attachment or estate tax inclusion. For some, there is a way: a Beneficiary Defective TrustSM, which is a special trust described in Code Sec. 678 that was the subject of new private letter ruling (PLR) 200949012.

Beneficiary Defective TrustSM

Under Code Sec. 678, a beneficiary who is not the actual grantor nonetheless is treated as the trust's owner, causing the income deductions and credits against tax of the trust to be attributed to him or her, if the beneficiary holds the unilateral right to withdraw the property from the trust. In other words, such a trust is treated as substantially owned by the beneficiary so the grantor trust rule of attributing the income, deductions and creditors of the trust to the beneficiary occurs under Code Sec. 671. Beneficiaries are often given such a right unilaterally to withdraw the trust assets in so-called Crummey trusts, named after the famous case of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), in order to qualify transfers to the trust for the gift tax annual exclusion.^(xi)

The beneficiary's power of withdrawal not only causes the beneficiary to be treated as the trust's owner for income tax purposes but it also causes him or her to be treated as holding a general power of appointment within the meaning of Code Sec. 2514 and 2041. And that, of course, means that the property over which the beneficiary holds the general power will be included in the beneficiary's gross estate.

In addition, the law provides that if the beneficiary releases or exercises the power, the beneficiary will be treated as making a gift (to the extent the power is exercised in favor of someone other than the beneficiary) and/or treated as a transfer for estate tax purposes (such as where the beneficiary exercises it in further trust from which the beneficiary is entitled to income for life).^[xiii] Hence, from an estate tax perspective, such a beneficiary seems no better off than the grantor who creates a self-settled trust: in each case, entitlement to income or a power of control causes estate tax inclusion.

But Code Sec. 2514(e) and 2041(b)(2) provide that if the power of withdrawal lapses, it is not a gift (or a transfer for estate tax purposes) except to the extent the power lapses in excess of the greater of \$5,000 or 5% of the value of the property over which the power is exercisable in a given calendar year. Hence, and as is well known, the power granted in a "Crummey trust" (which allows the property transferred to the trust to qualify for the gift tax annual exclusion under Code Sec. 2503) is made to lapse at a rate of the greater of \$5,000 or 5% a year.

Over time, the beneficiary gradually will lose the power of withdrawal by reason of the "5 and 5" lapse, except to the extent additional property is transferred to the trust which is subject to the withdrawal power. The question is whether that lapse causes the beneficiary to lose the status as the trust's owner— that is, does the trust stop being a defective trust with respect to the beneficiary?

Code Sec. 678(a)(2) provides that the beneficiary remains the owner where the power of withdraw is "partially released or otherwise modified" by the beneficiary and the trust would be a grantor trust if the beneficiary had been the true grantor (e.g., the beneficiary is eligible to receive trust distributions from the trustee). Several private letter rulings (not precedent under Code Sec. 6110(k)(3)) indicate that the IRS may view a complete lapse (under the Code Sec. 2514(e) and 2041(b)(2) "5 and 5" limitation) as a partial release.^[xiv]

However, such a conclusion does not seem to be able to be reconciled with the language of Code Sec. 678 or its regulations. It is hard if not impossible to see how a complete lapse is a "partial release" or "other modification" of the power of withdrawal. First, it is unclear whether a "lapse" (which apparently is the disappearance or elimination of the power without any action by the powerholder) is a "release". Code Sec. 2514(e) and 2041(b)(2) provide that a lapse is a release for purposes of those sections although only to the extent the lapse exceeds the "5 and 5" level mentioned above.

This begs the question of whether a lapse is a release for purposes of section 678. Even assuming it is, it is hard to see how the complete lapse is a "partial release of other modification" of the power of withdrawal. Nevertheless, the new private letter ruling suggests there is a way in which lapse is treated as a partial release and the trust could remain "defective" for income tax purposes with respect to its beneficiary.

Coupling a Unilateral Power of Withdrawal with a HEMS Power

In private letter ruling 200949012, a trust was created for a beneficiary by someone else. The trust granted the beneficiary (a) the unilateral right to withdraw all contributions made to the trust (1) for any reason (or no reason at all) and (2) for the beneficiary's health, education, maintenance and support (HEMS), and (b) a testamentary special (non-general) power of appointment. A unilateral power to withdraw the property for any reason is a general power of appointment but a power to withdraw under HEMS is not.^[xv]

The IRS expressly notes that "This power [to withdraw under the HEMS standard] will not lapse." But the IRS also expressly notes that the unilateral "power [to withdraw for any reason] will lapse each calendar year in an amount equal to the greater of \$z and y% of the value of the Trust." (it seems clear "\$z" means "\$5,000" and "y%" means "5%.")

Even if the grantor contributed \$1,000,000 to the trust, the power to withdraw for any reason would lapse at least after 20 years— as 5% of \$1 million is \$50,000. If the trust grew in value, the power would lapse even faster because it would lapse at an annual rate of 5% of a greater sum than \$1 million. But the power of withdraw would have disappeared only in part. That is, the lapse would have been partial only: the power to withdraw for HEMS would remain.

Indeed, private letter ruling 200949012, the IRS concludes the "Beneficiary will be treated as the owner of Trust for federal income tax purposes under §§ 671 and 678 before and after the lapse of Beneficiary's power of withdrawal with regard to any transfer to Trust." This statement suggests that the IRS does equal "lapse" with "release" for purposes of section 678 and that, on account of the continuous non-lapsing power to withdraw to HEMS, it is a partial release.

A Little More Analysis

As explained in detail in Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Journal 106 (Fall 2009), it appears that a trust will not be a section 678 trust if the beneficiary's power to withdraw is limited to a standard such as HEMS. In other words, for the trust to be a section 678 trust, the beneficiary must be given the unilateral right to withdraw all income or corpus from the trust.

Yes, a trust may be defective in part but our goal is to make the trust a section 678 trust in its entirety. And, yes, "income" under the grantor trust rules, unlike the "normal" rules relating to the income taxation of estates, trusts and their beneficiaries, means income for tax purposes (including capital gains), not fiduciary accounting income. See Reg. §1.671-2(b). And it is possible that if the beneficiary was given only a power to withdraw all tax income from the trust, and no power over corpus, and that power never lapsed, only the unwithdrawn tax income would be included in the powerholder's gross estate under section 2041.

But see Rev. Rul. 66-161, 1966-1 C.B. 164 dealing with a power to withdraw capital gains for grantor trust purposes which holds that capital gains lose their character as such after the year they are earned and become merged into corpus such that in the subsequent year a fraction of the trust appears to become a grantor trust relating to the amount of capital gains subject to withdrawal in the prior year divided by the fair market value of the trust at the

beginning of the following year. But it would be preferable, in many cases, to prevent any portion of the trust to be included in the beneficiary's gross estate.

But giving the beneficiary a unilateral right to withdraw gives the beneficiary a general power of appointment for estate and gift tax purposes. So, to begin, granting the beneficiary a unilateral right to withdraw makes the trust a section 678 trust but it will cause estate and/or gift tax issues for the beneficiary. Now that power may be made to lapse at a calendar year annual rate of 5% or \$5,000 without, perhaps, adverse estate and gift tax purposes. But that seems to terminate section 678 status when the power has lapsed in its entirety.

In other words, once the power to withdraw lapses in full, it does not seem to be a "partial release or other modification" of the power. And Code Sec. 678(a)(2) states that a trust remains a section 678 trust if (1) the power is partially release or otherwise modified and (2) it would be a grantor trust with respect to the real grantor if the real grantor had retained an interest or power described in any of sections 673, 674, 675, 676, 677 or 679. So, by way of example, if the beneficiary has partially released or otherwise modified the power and if any of the conditions set forth in sections 673-677 or 679 are present (e.g., the trustee may distribute the corpus to the beneficiary), the trust remains a section 678 trust.

For example, let's suppose the trust gave the beneficiary a unilateral right to withdraw all trust corpus and it provided that the beneficiary could release the power in whole or in part. Let's assume the beneficiary released the power so he or she could only withdraw the property for his or her health, education, maintenance and support. That would certainly seem to be a "partial" release. Because a trust from which the real grantor could withdraw property for such reasons would be a grantor trust under Code Sec. 676, the trust for the beneficiary with respect to which he or she had made such a partial release would remain a section 678 trust.

But that affirmative release would not expunge the estate and gift tax general power of appointment problem the beneficiary had at the beginning. The only way "out" of a general power of appointment (other than by a disclaimer pursuant to section 2518) is to let it lapse under the 5%/\$5,000 rule mentioned above.

And, in the example above, it is a true release not a lapse. And that is true even though a power to withdraw for HEMS is not a general power of appointment for estate and gift tax purposes. The reason is that the beneficiary either made a gift by reason of partial release or is deemed to have retained sufficient power to continue to cause estate tax inclusion under section 2041. ^{(b)(2)}

The bottom line is that in PLR 200949012 the unilateral power is allowed to lapse, thereby avoiding section 2041, but for such lapse to be treated only as a partial release for purposes of section 678 so defective trust status for the beneficiary continues. Again, the private letter ruling expressly states,

"Beneficiary will be treated as the owner of Trust for federal income tax purposes under §§ 671 and 678 before and after the lapse of Beneficiary's power of withdrawal with regard to any transfer to Trust."

Thus, the ruling, at least, seems to accept a "lapse" as a "release" so that the lapse to a HEMS standard falls within Code Sec. 678(a)(2) as a "partial release" even though as to the unilateral right to withdraw there is a lapse not a release.

A Comment about the Portion Rule

Howard Zaritsky has raised an additional issue not analyzed in the ruling. Reg. § 1.671-3(a)(3) deals with the issue of when only a portion of a trust is treated as owned by the grantor or another person. If a portion of a trust treated as owned by the grantor or another person consists of an undivided fractional interest in the trust, or a interest represented by a dollar amount, only a pro rata share of each time of income, deduction and credit is normally allocated to the portion.

Where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus such as capital gain) is attributed to the portion.

"The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question."

How would this regulation affect the analysis? If the beneficiary had a right to withdraw 100% of the trust corpus at the time the trust is funded (there being no income) and 100% lapsed, it would seem the beneficiary should be treated as owning 100% of the trust for income tax purposes.

But in the facts of the ruling only the greater of \$5,000 and 5% lapses and the balance would continue to be subject to withdrawal in the following year. In that case, it would seem that if 5% lapses, the beneficiary is the owner of 5% of the trust going forward.

But what about the *unlapsed* portion? It seems possible that the beneficiary would be treated as owning a fraction of the trust the numerator of which is the amount currently subject to withdrawal and denominator of which is the fair market value of the trust. That fraction would seem to be added to the 5% owned by reason of the lapse. If the trust estate appreciates, this means that in the second year less than the entire trust will be treated as owned by the beneficiary.

If the foregoing analysis is correct, the trust would be wholly grantor at least by the 20th year of administration ($5\% \times 20 = 100\%$).

Alternatively, if the power of withdrawal were as to a fraction, and were to hang as to a fraction, then the two fractions would always add up to 100%. So in year 1 the beneficiary may withdraw 100% which lapses as to 5% and continues as to 95%. In that way, if the trust appreciates, the entire trust would remain a wholly grantor trust as to the beneficiary.

A negative is that this could cause a greater portion of the trust to be included in the beneficiary's gross estate for a longer period of time, assuming appreciation, because as the trust appreciates, so would the power of withdrawal or the unlapsed portion.

As previously indicated, the ruling does not analyze the cited regulation. The ruling appears to conclude that if at any time the beneficiary had the power to withdraw 100% of the trust, then the beneficiary owns 100% of the trust thereafter for income tax purposes.

Additionally, the power of withdrawal in the ruling was not limited to corpus, and a power limited to corpus is what literally invokes the fraction analysis under the regulation. However, grantor trust status is a year in year out determination. And by the second year the determination of grantor trust status appears to be a two part analysis: part one relates to the power of withdrawal that was partially released, which invokes at least a 5% fraction under Code Sec. 678(a)(2), and part two relates to the unlapsed power of withdrawal under Code Sec. 678(a)(1), possibly invoking the fraction analysis because the remaining amount subject to withdrawal is pecuniary.^(xvii)

COMMENT:

Enhancing Estate Planning for the Powerholder Beneficiary

As mentioned above, grantor trust status provides significant opportunities for estate planning for the grantor such as by allowing the trust to grow on an income tax free basis and permitting the grantor to sell assets to the trust without gain and in exchange for low (Applicable Federal Rate) interest charge. By making the trust a grantor trust with respect to the trust beneficiary under Code Sec. 678 provides that beneficiary with similar and, to some degree, even enhanced estate planning opportunities.

For example, a grantor cannot be a beneficiary of the trust unless the trust is created in a jurisdiction (such as Alaska or Nevada) where the grantor's creditors are not given access to the trust property. Even if it is created and administered in such a jurisdiction, the grantor cannot retain the right to trust distributions or have any control over the beneficial enjoyment of the trust property or the trust will be included in his or her estate under Code Sec. 2036 and/or 2038.

But with a Beneficiary Grantor Trust(sm) or BGT(sm), the Beneficiary can hold both interests and powers without gross estate inclusion because the Beneficiary is not the person who transferred property to the trust. Of course, to the extent the Beneficiary's power of withdrawal has not lapse by his or her death, the trust property will be included in his or her gross estate under Code Sec. 2041.

Because the Beneficiary may be able to hold powers over the trust without causing estate tax inclusion, this provides an opportunity of the Beneficiary inadvertently making a gift when selling property to the trust (whether or not for a note). As explained in detail in the ILS Newsletter "Safety Nets for Installment Sales to Grantor Trusts," which can be downloaded on the Home Page at www.interactivelegal.com, if a beneficiary holds the power to veto distributions to trust property to others and holds a special power of appointment at death, any gift made to the trust (by sale for less than full and adequate consideration or otherwise) will be incomplete, thereby foreclosing the possibility of gift tax being imposed on it.

Although any gift element transferred to the trust by the beneficiary (such as a sale for less than full value) could result in a portion of the trust being included in the beneficiary's estate, the beneficiary may report the sale on his or her own gift tax return (Form 709) and take the position the sale was for full value. As long as full disclosure set forth in Reg. § 301.6501-1(f)(3) is made on the gift tax return, any transfer reported as a full value sale can only be challenged by the IRS within, as a general rule, within three years of the filing of the return.

If the IRS does not make a successful challenge, it not only will be unable to later claim that the sale was, in whole or in part, a taxable gift, but also will be foreclosed from contending the property is included in the selling-beneficiary's gross estate (except to the extent the beneficiary holds a general power of appointment over the trust property) and from contending that the amount of the property exempted from generation-skipping transfer tax by allocation of GST exemption is incorrect.

More on Creditor Rights and Beneficiary Rights of Withdrawal

Whether or not a trust remains one that is treated as substantially owned by the beneficiary after the right to withdraw property from the trust lapses, it may remain subject to the claims of creditors of the beneficiary. Not only may that be adverse if a creditor holds a claim against the beneficiary that may be satisfied with trust assets, it also may cause the trust assets to be included in the beneficiary's gross estate under Code Sec. 2041. The reason is that a general power of appointment under that section includes one that the beneficiary can appoint to his or her creditors. Code Sec. 2041(b)(1).

To the extent the beneficiary has allowed his or her power of withdrawal to lapse, the beneficiary may be treated as the trust's grantor triggering the self-settled trust rules under state law. In other words, it may be that, under state law, the beneficiary who allows his or her withdrawal power to lapse may be treated as the trust's grantor because he or she has, in effect, turned his or her back to the property. And, if that is the case, the beneficiary is now treated as the "settlor" who has created (to the extent of the lapse) a "self-settled trust."

As mentioned above, a self-settled trust under the law of most states, is void with respect to the grantor's creditors—that is, the "settlor's" creditors cannot attach the trust property.^(xviii) Hence, the beneficiary would hold the power, under state law, to relegate his or her creditors to the assets of the trust, thereby making it a general power of appointment—because, as mentioned above, a general power of appointment for tax purposes includes one where the powerholder may appoint the property "in favor of the decedent[']s creditors."^(xviii)

Even if one may conclude, which seems difficult, that the powerholder has not made a contribution to a self-settled trust by allowing his or her withdrawal power of the trust assets to lapse, the trust likely would be considered self-settled to the extent the powerholder makes a sale of property to the trust for less than fair value. As mentioned above, a beneficiary may sell an asset to the trust, for cash, for a low AFR interest note or for some other asset.

Even if the IRS does not successfully challenge that the sale was for less than full and adequate consideration in money or money's worth, a state court may conclude that the sale was for less than full value and, to that extent, the beneficiary has made a transfer to a self-settled trust. As mentioned above, that may cause estate tax inclusion under Code Sec. 2041 because the beneficiary may relegate his or her creditors to the trust.

The IRS may be foreclosed from attempting to include the property in the beneficiary's gross estate under Code Sec. 2036 or 2038 (because the IRS did not challenge that the sale was for full value) but it will not be foreclosed from arguing that the beneficiary holds a general power of appointment because he or she, under applicable local law, may relegate his or her creditors to the trust assets which, as explained above, will cause the beneficiary to hold a general power of appointment under Code Sec. 2041.

As explained in Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter TrustSM," *Probate & Property*, July/August 2007, pg. 52, there are two potential solutions to block that general power of appointment problem from arising. First, the trust could be created in a jurisdiction (again, such as Alaska or Nevada) which would foreclose the creditors of the selling-beneficiary from attaching the trust property even if it is sold to the trust for less than its full value. Second, distributions to the selling-beneficiary could be limited to an ascertainable standard relating to health, education, maintenance and support. Distributions pursuant to that standard, even if held by the beneficiary, are not a general power of appointment.^(ix) In fact, it may be best to use a "belt and suspenders" approach by using both solutions.

Summary

Private letter ruling 200949012 sets forth what appears to be a certain and correct way to allow one person (such as a parent) to create a trust for another (such as a child) in a manner to make the trust a grantor trust with respect to such other (such as the child), even after the power to withdraw all property without restriction lapses because the beneficiary's power to withdraw for health, education, maintenance and support does not lapse.

That will permit this Beneficiary Defective TrustSM to grow free of income tax and without causing the beneficiary to be deemed to be making a gift by paying the income tax on the income imputed to him or her under Code Sec. 671 and 678.

It also permits the beneficiary to sell assets to the trust without gain, under Rev. Rul. 85-13, while being able to benefit from and to maintain control over the assets sold without gross estate inclusion (if the sale is for full and adequate consideration in money or money's worth).

In order to ensure the beneficiary will not be treated as having made a gift by such a sale, the beneficiary should hold a power to veto distributions to others and to appoint the property at death to persons other than himself or herself, his or her creditors or estate or creditors of his or her estate.

However, the trust likely should be created under the law of a state that denies creditors access to a self-settled trust and, perhaps, distributions, even in the discretion of a trustee other than the beneficiary, should be permitted to be made to the beneficiary only under an ascertainable standard relating to health, education, maintenance and support.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jonathan Blattmachr

Diana Zeydel

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CITES:

Sections 671, 673, 674, 675, 676, 677, 678, 679, 2036, 2038, 2041, 2514 and 6110(k)(3) of the Internal Revenue Code of 1986, as amended; Reg. § 1.661(a)-2(f), Reg. § 25.2511-2(c), Reg. § 20.2041-3(d), Reg. § 301.6501-1(f)(3); Private Letter Rulings 200747002, 9809005, 8342088, 200944002 and 200949012; Rev. Rul. 77-378, 1977-2 CB 347, Rev. Rul. 2004-64, 2004-2 CB 7; *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); *Estate of Skinner v. United States*, 316 F. 2d 517 (3d Cir. 1963); *Estate of German v. United States*, 7 Cl. Cl. 641 (1985); New York EPTL 7-3.1; Restatement (Third) of Trusts § 58.

CITATIONS:

⁽ⁱ⁾ See, generally, Blattmachr, Hatcher, Weinreb, Weiss & Zeydel, "Selected Comparisons of Selected Estate Tax Reduction Strategies," published in the *A Fall 2007 Proceedings in Greenbriar, West Virginia*.

⁽ⁱⁱ⁾ See Rev. Rul. 1985-13, 1985-1 CB 184.

⁽ⁱⁱⁱ⁾ See Reg. § 1.661(a)-2(f).

^(iv) See, generally, Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 *Estate Planning* 3 (Jan. 1996).

^(v) See Rev. Rul. 85-13, *supra*.

^(vi) See Blattmachr & Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?" 41st Annual Heckerling Inst. Estate Planning (2007).

^(vii) See, e.g., Rev. Rul. 2004-64, 2004-2 CB 7.

^(viii) Rev. Rul. 77-378, 1977-2 CB 347.

^(ix) See, e.g., New York EPTL 7-3.1.

^(x) See, e.g., *Estate of Skinner v. United States*, 316 F. 2d 517 (3d Cir. 1963).

^(xi) See, generally, Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 *ACTEC Journal* 106 (Fall 2009); Zeydel, "A Com"

Guide for Irrevocable Life Insurance Trusts," 34 Estate Planning 6 (June 2007).

^[xiii] See Code Sec. 2514(b) and 2041(a)(2).

^[xiii] See, e.g., 200747002, 200104005, 200147044, 200022035, 9809005, 8342088.

^[xiv] See Code Sec. 2041(b).

^[xv] See Reg. § 25.2511-2(c) and Reg. 20.2041-3(d).

^[xvi] See generally, J. Blattmachr & L. Boyle "Income Taxation of Estates and Trusts," Chapter 4, PLI; J. Horn, "Flexible Trusts and Estates for Uncertain Chapter 9 (3rd Edition); L. Schmolka, "Selected Aspects of the Grantor Trust Rules," Chapter 14, 9th Annual Heckerling Institute on Estate Planning (1977); Zaritsky, "Grantor Trusts: Sections 671-679" 858 T.M. Portfolio.

^[xvii] See, e.g., Restatement (Third) of the Law of Trusts, § 58.

^[xviii] Cf. Rev. Rul. 76-103, 1976-1 CB 293.

^[ix] Code Sec. 2041(b).

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