FEATURE:
ESTATE PLANNING & TAXATION

By **William D. Lipkind, Martin M. Shenkman** & **Jonathan G. Blattmachr**

How ING Trusts Can Offset Adverse Effects of Tax Law: Part II

Gift tax and other issues

Incomplete non-grantor (ING) trusts, transfers to which aren't completed gifts and aren't grantor trusts for income tax purposes, may help to navigate the adverse income tax changes individuals face under the Tax Cuts and Jobs Act (the Act).

This two-part article explains how ING trusts can accomplish that goal. In Part 1 of this article,[1] we discussed the grantor trust issues relating to ING trusts. Now, the focus is on gift tax and other issues.

Gift Tax Issues

A taxpayer makes a gift for federal gift tax purposes to the extent the value of what the taxpayer transfers exceeds the value of what the taxpayer receives in money or money's worth in exchange.[2] A gift is complete (and therefore potentially subject to gift tax) to the extent the taxpayer has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another.[3] For example, a gift is incomplete if and to the extent that a reserved power gives the taxpayer the power to name new beneficiaries or to change the interests of the beneficiaries as among themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.[4]

The implication is that, if the taxpayer retains a lifetime power to distribute property pursuant to a fixed or ascertainable standard (such as a health, education, maintenance and support (HEMS) standard) held in a non-fiduciary capacity, that power alone renders the gift incomplete. As mentioned in Part I of this article, a power described in Internal Revenue Code Section 674(b)(5) to distribute corpus pursuant to a reasonably definite standard that's set forth in the trust instrument doesn't trigger grantor trust status, whether retained in a fiduciary or non-fiduciary capacity. Such a power held in a non-fiduciary capacity, as opposed to a fiduciary one, precludes any transfer to the trust from being a completed gift.[5] And, this power held only in a non-fiduciary capacity was retained in the trusts that are the subject of the most recent private letter rulings holding that transfers to the trusts weren't completed gifts and aren't grantor trusts.

In fact, these post-Release 2007-127 (the Release) PLRs state that this power alone precludes any portion of the gift with respect to both corpus and accumulated income from being complete. (In the Release, the Chief Counsel of the Internal Revenue Service requested comments on whether the PLRs holding that no member of the distribution committees (the committee) held general POAs were consistent with Revenue Ruling 76-503 and Rev. Rul. 77-145.) However, when such a limited power of appointment (POA) was provided as the sole reason for incomplete gift status, the IRS refused to rule the transfers to the trust were incomplete gifts.

There's a second power retained by the grantor in all the trusts that are the subject of the PLRs that renders at least part of the transfers (the remainder interest) to the trust as incomplete for federal gift tax purposes: the testamentary special POA. Although this power couldn't be exercised in favor of the grantor, the grantor's estate or creditors of the grantor's estate, such a power may render a gift incomplete. A gift is incomplete

(From left to right) **William D. Lipkind** is a partner at Wilson Elser Moskowitz Edelman & Dicker LLP in Florham Park, N.J., **Martin M. Shenkman** is an attorney in Fort Lee, N.J. and **Jonathan G. Blattmachr** is a former member of the New York law firm of Milbank, Tweed, Hadley & McCloy, LLP

if and to the extent that a reserved power gives the taxpayer the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves (unless the power is a fiduciary power limited by a fixed or ascertainable standard). This regulation seems to reflect the U.S. Supreme Court's decision in *Estate of Sanford v. Commissioner*.[6] In that case, the taxpayer created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust, in whole or in part, and to designate new beneficiaries other than him. Six years later, the taxpayer relinquished his power to revoke the trust. However, the taxpayer continued to retain his rights to change the beneficiaries. In 1924, the taxpayer relinquished his right to change the beneficiaries. The Court held that a donor's gift isn't complete, for purposes of the gift tax, until the donor relinquishes the power to determine those others who would ultimately receive the property. The IRS has taken the position that a testamentary POA alone renders only the corpus incomplete, not the income portion.[7]

> If the committee drops in membership from several to only one member, the draftsperson might provide that the trust automatically becomes a grantor trust with trustee discretionary language.

Accordingly, the retention of the special POA exercisable by will (falling under the IRC Section 674(b)(3) grantor trust exception) together with lifetime power (falling under the Section 674(b)(5) grantor trust exception), held in a non-fiduciary capacity, to distribute corpus pursuant to the HEMS standard seems to render the gifts to the trusts incomplete. Some commentators believe that a PLR wouldn't be obtained solely on this basis because the Section 674(b)(5) power doesn't include the income interest of the trust (only an interest in the trust's corpus). Nonetheless, these powers will cause the trust to be included in the grantor's gross estate under IRC Sections 2036(a)(2) and 2038; however, avoiding estate tax isn't the goal of these trusts. The goal seems to be to provide a way to avoid state and local income taxes. Under Treasury Regulations Section 25.2511-2(e), a taxpayer is considered as having a power that would render any gift incomplete even if it's exercisable by the taxpayer in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The committee members aren't takers in default for purposes of Treas. Regs. Section 25.2514-3(b)(2). They're merely coholders of the power to distribute to the beneficiaries, including the grantor. The committee ceases to exist on the death of the grantor. Under Treas. Regs. Section 25.2514-3(b)(2), a coholder of a power is only considered as having an adverse interest when he may hold the power after the death of the current possessor of the power, and the coholder may then exercise it in favor of himself; his estate or creditors; or the creditors of his estate.[8] In the situations involved in the PLRs, the committee ceases to exist on the grantor's death. Accordingly, the committee members don't have interests adverse to the grantor under Treas. Regs. Section 25.2514-3(b)(2) and for purposes of Treas. Regs. Section 25.2511-2(e). Therefore, the grantor is considered as possessing the power to distribute income and principal to any beneficiary himself because he retained the power to distribute the trust property (with the consent of a majority of the committee members). The retention of these powers is the primary factor that causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes. The grantor also retained the power described in Section 674(b)(5) over the principal of the trust.[9]

Committee POA Issue

In most of the pre-Release PLRs, the IRS held that no member of the committee held general POAs. In the Release, the Chief Counsel to the IRS asked for comments on whether those holdings were consistent with Rev. Rul. 76-503 and Rev. Rul. 77-158.

The apparent concern of the IRS was whether the powers held by members of the committee to distribute corpus to themselves (as well as to the grantor and, perhaps, other beneficiaries) constituted a general power deemed held by each such member. IRC Sections 2514(c)(3)(B) and 2041(b)(1)(C)(ii) essentially provide that an individual isn't treated as holding a

general POA if the power is exercisable in his own favor only with the consent of someone with a substantial interest that's adverse to such exercise. Rev. Rul. 76-503 and Rev. Rul. 77-158 (which amplified the 1976 ruling) appear to hold that individuals who hold a joint power to distribute property to themselves aren't adverse to the exercise of the power by the others when surviving powerholders must continue to share the power with someone who succeeds to the joint power when one of the original powerholders dies.[10]

Almost all of the professional organizations that submitted comments concluded that no member of the committee held a general POA. However, the IRS hasn't issued any official or unofficial statement as to that matter. Nonetheless, the trusts that are the subject of the post-Release PLRs avoid the issue by providing that, at all times, the power of the committee to direct distributions (other than with the consent of the grantor) must be exercised unanimously and, although initially there were more than two committee members, the trust agreements require that, at all times, there must be at least two individuals (other than the grantor) who are members of the committee. Accordingly, the IRS has ruled in these post-Release PLRs that the members don't hold a general POA. If trust property is distributed back to the grantor, neither the committee members nor the grantor will be deemed to have made a gift but, to the extent any property is distributed to anyone else (even by direction of the committee and without the participation by the grantor), the grantor, but not the members of the committee, will be deemed to have made a completed gift.

Practice Pointers

If the committee drops in membership from several to only one member, the draftsperson might provide that the trust automatically becomes a grantor trust with trustee discretionary language. This approach would avoid a one-member committee from having a general POA. Another approach is for the draftsperson to consider including a provision by which the committee can expand its members by making a beneficiary, not yet a committee member, a member.

Requesting a ruling is a time-consuming and expensive undertaking. It can take six months or longer to obtain a PLR, but the ruling will be retroactive to the beginning of the tax year during which it's submitted (not to the date of submission). Some practitioners and clients may feel that the reasoning expressed in the post-Release PLRs is sufficiently accurate and the rulings so consistent that it isn't imprudent to adopt such an arrangement without a ruling. A benefit of obtaining a PLR might be to bind (assuming the U.S. Constitution precludes a state from characterizing a federal tax consequence other than as the federal government rules) state taxing authorities who might otherwise argue that the trust is a grantor trust. However, no one but the taxpayer who obtained a PLR may rely on it. Even though practitioners may view the risk of the IRS taking a contrary position, other than on a prospective basis, as remote, it could happen. As indicated above, some practitioners believe that it isn't possible to create a trust so that gifts to it are incomplete for federal gift tax purposes and for the trust not to be a grantor trust.

As a general rule, a trust instrument must be construed to carry out the grantor's intent, and it appears the tax courts will follow that intent in determining the tax effects of the trust.

As a general rule, a trust instrument must be construed to carry out the grantor's intent, and it appears the tax courts will follow that intent in determining the tax effects of the trust.[11] Accordingly, the trust should recite that the grantor intends no gift made to the trust to be complete for federal gift tax purposes and that it isn't a grantor trust. The trust should direct that the trust instrument must be construed to achieve those intentions but that, if it isn't possible to achieve both, it must be construed so no gift to the trust is a completed gift. If the trust is found to be a grantor trust, the grantor is in the same position as if the transfer hadn't been made. But, if the gift is complete, the result, especially if considerable value has been transferred to the trust, could be viewed as quite adverse.

ING trusts should become more popular now that

the costs to most taxpayers of state and local income taxes will be greater than before the Act until 2026 when the limitation of non-business taxes sunsets. And, the concern expressed in the immediately preceding paragraph about making a taxable gift when creating an ING will be reduced for many because of the enhanced gift tax exemption. A single individual who hasn't previously used any lifetime exemption could transfer up to $11.18 million to an ING and not worry about paying any gift tax. A taxpayer whose spouse also has used no lifetime exemption could transfer up to $22.36 million to an ING without gift tax concerns, if the spouse will gift split under IRC Section 2513, although the spouse couldn't be a beneficiary of the ING, as gift splitting isn't permitted with respect to transfers to the spouse or a trust of which the spouse is a beneficiary in most cases.[12] Alternatively, each spouse could create his own ING but without the other spouse as a beneficiary.

However, that's a lot of lifting to avoid the state and local taxes. Rather, as suggested earlier, the taxpayer could simply make a complete gift of income-producing assets to a non-grantor trust (for example, one just for descendants while navigating around the grantor trust rules, which usually isn't too difficult to do).[13] With the enhanced gift tax exemption, the concern about making a complete gift should be diminished. But, two concerns will remain for some: (1) wasting the exemption if the grantor dies after the exemptions are reduced back to their pre-Act levels beginning in 2026, and (2) not being able to access the property placed in the trust. Can these hurdles be overcome? Can a taxpayer create a non-grantor trust of which he's a beneficiary? It seems it can be done. That brings us to the next step: non-grantor trusts formed with complete gifts of which the grantor is a beneficiary.

Completed Gifts to Trust

An individual can create a non-grantor trust of which he's a beneficiary and without causing the asset to be brought back into the grantor's tax estate simply by making a complete gift to the trust and permitting distributions to the grantor (and/or the grantor's spouse) only with the consent of an adverse party, while avoiding all other grantor trust rules (for example, not permitting someone to substitute property of equivalent value for the trust assets, which is probably the most common way to make the trust fall into grantor trust status).[14]

There are two potential downsides:

- First, the meaning of "adverse" for purposes of the grantor trust rules can never be certain, although the IRS has consistently found that the members of the committee are adverse so this ruling can be relied on without significant concern of an IRS challenge.[15] Some draftspersons might opt to grant all members of the committee a remainder interest as well as an income interest. (Of course, the settlor using a testamentary POA can eliminate these, but that would render the gift of the remainder interest incomplete.) Perhaps a state would challenge it so the trust would be a grantor trust, but most states must follow federal income tax law in administering their own. Although it might be possible for a state court to rule that its tax commission isn't bound by a PLR, there would seem to be a significant hurdle in successfully doing so: (1) the state would have to establish that it had the right to make the challenge, and (2) it would have to show that the PLRs are wrong.
- Second, an adverse beneficiary who permits distributions to the grantor or the grantor's spouse might be treated as making a gift in doing so. The later ING rulings conclude that there would be no gift in such a case so that structure (but with a completed gift by the grantor) could be followed. The ING rulings may not provide a basis to conclude that the taxpayer would obtain the same result on a completed gift trust. The IRS might argue that the gift consequences in the ING rulings flow from the IRS believing that until the grantor has a completed gift, the committee members shouldn't be deemed to have made a gift. Even if the beneficiaries are deemed to have made a gift to the grantor by directing distributions to him, the beneficiary likely will have such a large gift tax exemption (at least until 2026) that no gift tax would be owed. So long as the beneficiary discloses on a timely filed gift tax return (Form 709) that he permitted the distribution to the grantor to be made, no penalty should be imposed. And, if there was no gift tax due even if the distribution was a gift, it seems doubtful the IRS would claim that a gift was made.[16]

An alternative is to tweak an ING trust so the gift to it is complete but still not a grantor trust. Since this is such a fine needle to thread, savings language indicating that, notwithstanding any provisions in the trust to the contrary, if any power exercisable by the grantor alone or in conjunction with a non-adverse party or a

related or subordinate party could characterize the trust as a grantor trust, then the consent of an adverse party designated in the trust instrument shall be required to negate that result.[17]

The retention of the special POA exercisable by will (falling under the Section 674(b)(3) grantor trust exception) together with a lifetime power (falling under the Section 674(b)(5) grantor trust exception), held in a non-fiduciary capacity, to distribute corpus pursuant to the HEMS standard, renders at least most of the gifts to the trusts incomplete. If those powers aren't retained by the grantor, the transfers to the trust presumably will be completed gifts (and still not be a grantor trust). (As mentioned above, members of the committee aren't default takers in the event of the grantor's death. Retaining the testamentary special power, the grantor could appoint the remainder to them. But, if it isn't retained, the grantor couldn't do so; however, the power to appoint the property to the committee members could be given to some trusted person, such as the grantor's legal counsel.) Some might view legal counsel as an agent for the grantor, thus creating another risk factor. The power of the committee (which will include neither the grantor nor the grantor's spouse) to distribute to the grantor or to the grantor's spouse may continue to be retained and their interests still be regarded as adverse for income tax purposes and, according to the later PLRs, the exercise of the power to distribute not be a gift by them.

The elimination of those powers held by the grantor and not retaining the right to make distributions, with a member of the committee, to himself and other members of the committee, shouldn't prevent the trust from avoiding grantor trust status. Moreover, by also eliminating the Section 674(b)(3) and 674(b)(5) powers, it doesn't seem that the trust should be included in the grantor's gross estate at death, meaning that the use of the lifetime exemption won't be wasted (except to the extent assets from the trust are distributed back to the grantor). INGs historically have been formed in

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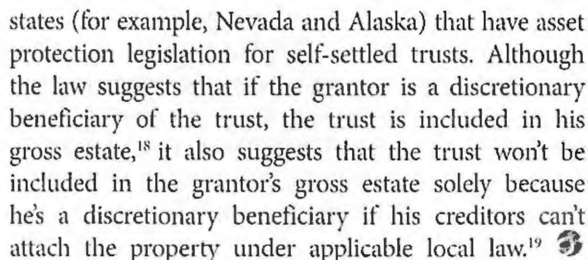

states (for example, Nevada and Alaska) that have asset protection legislation for self-settled trusts. Although the law suggests that if the grantor is a discretionary beneficiary of the trust, the trust is included in his gross estate,[18] it also suggests that the trust won't be included in the grantor's gross estate solely because he's a discretionary beneficiary if his creditors can't attach the property under applicable local law.[19]

Endnotes

1. William D. Lipkind, Martin M. Shenkman and Jonathan G. Blattmachr, "How ING Trusts Can Offset Adverse Effects of Tax Law: Part I," *Trusts & Estates* (September 2018).
2. Internal Revenue Code Section 2512(b).
3. Treasury Regulations Section 25.2511-2(b) (first sentence). *See generally* Diana S.C. Zeydel, "When Is a Gift to a Trust Complete: Did CCA 201208026 Get It Right?" *Journal of Taxation* (September 2012).
4. Treas. Regs. Section 25.2511-2(c) (second sentence).
5. Treas. Regs. Section 25.2511-2(c).
6. *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939).
7. Chief Counsel Advice 201208026.
8. *See* Revenue Ruling 79-63 ("In this case, A is a taker in default not of the lifetime power in which A has a power of consent but rather of the testamentary power exercisable solely by the decedent. In such a situation A would not have necessarily been in a better economic position after the decedent's death by refusing to exercise the power in favor of the decedent during the decedent's lifetime. Thus, the fact that A might survive the decedent and receive an interest in the property, if the decedent failed to exercise the testamentary power in favor of persons other than A, does not elevate A's interest as a consenting party of the lifetime power to a substantial adverse interest.")
9. The grantor retains dominion and control over the income and principal of the trust unless and until the distribution committee (committee) members exercise their power to make distributions, which, if the grantor doesn't consent, must be exercised unanimously. This power held by the committee doesn't appear to cause the transfer of property to be complete for federal gift tax purposes. *See Goldstein v. Comm'r*, 37 T.C. 897 (1962); *Estate of Goelet v. Comm'r*, 51 T.C. 352 (1968).
10. A taxpayer isn't treated as having a general power if it's exercisable only with the consent of the person who granted the power. IRC Sections 2514(c)(3)(A) and 2041(b)(1)(C)(i). One of the powers a member of the committee holds is to exercise the power with the consent of the grantor. Hence, that power held by members of the committee isn't a general power of appointment for gift or estate tax purposes.
11. *See, e.g., Matter of Lepore*, 128 Misc.2d 250 (Surr. Ct. Kings Cty 1985); *cf. Reid Est. v. Comm'r.*, T.C. Memo. 1982-532.
12. *See* discussion in Zeydel, *supra* note 3.
13. *See* Stephen R. Akers, Jonathan G. Blattmachr and F. Ladson Boyle, "Creating Intentional Grantor Trusts," 44 *Real Property, Trust and Estate Law Journal* 207 (2009).
14. *See* IRC Section 675(4)(C).
15. *See* discussion in Lipkind, Shenkman and Blattmachr, *supra* note 1.
16. The Internal Revenue Service may claim a gift was made even if no gift tax would be due if the IRS is successful. Under IRC Section 7477, the IRS may send the taxpayer the equivalent of a statutory notice of deficiency (commonly called a "90-day letter") claiming there was a gift and its value. That letter is binding unless the taxpayer challenges it in Tax Court. The court will render an opinion that will be binding on both the IRS and the taxpayer. Section 7477 was added to the IRC in 1997, but there's no reported decision made to date by the Tax Court under it.
17. *See* Treas. Regs. Section 1.676(a)-1.
18. *See, e.g.*, Rev. Rul. 76-103; *Estate of Paxton v. Comm'r*, 86 T.C. 785 818 (1986).
19. Rev. Rul. 76-103; Private Letter Ruling 200944002 (July 15, 2009).

SPOT LIGHT

Fruity

The Green Table by Joseph Barrett sold for $11,250 at Doyle's Fine Paintings auction on Oct. 10, 2018 in New York City. Barrett is known for his unique, self-designed handmade frames almost as much as he's known for the paintings inside of them. His work predominantly features landscapes.