BENEFICIARY DEFECTIVE TRUST [SM] PRIVATE LETTER RULING

Jonathan G. Blattmachr is the author of five books and hundreds of article and co-developer with Michael L. Graham, Esq., of Dallas, Texas, of Wealth Transfer Planning[TM] 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 Alert. Diana S. C. Zeydel is a shareholder of Greenberg Traurig, PC in Miami and is a frequent lecturer and author including being a regular contributor to our Listserve. In this article, Diana and Jonathan tell us about a development with respect to how to more assuredly create a trust that remains a Code Sec. 678 trust, or a Beneficiary Defective Trust[SM], even after the power to withdraw all property from the trust lapses. They also explain why this produces an important planning option for some taxpayers.

EXECUTIVE SUMMARY

The IRS has just issued PLR 200949012. Although it may not, under Code Sec. 6110(k)(3) of the Code, be cited or used as precedent, it appears correctly to conclude that a trust someone else created for its beneficiary remains a "defective" trust with respect to the beneficiary even after the beneficiary's unilateral right to withdraw all trust corpus for any reason (or no reason at all) lapses, essentially because the beneficiary continues to have the right to withdraw all trust property for his or her health, education, maintenance and support (HEMS). The HEMS power is not used in the ruling to meet the requirement that, after a power is partially release or otherwise modified, the beneficiary, were he or she the actual grantor, would still be the trust's "owner" for grantor trust purposes. Rather, it is used to ensure that the power to withdraw is not treated as having entirely been released but only partially released. It is, in the view of the Jonathan and Diana, the first such private letter ruling dealing with that issue.

Background. A grantor trust, of course, 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 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 made 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. 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 are likely to be. *See, generally,* Blattmachr, Hatcher, Weinreb, Weiss & Zeydel, "Selected Comparisons of Selected Estate Tax Reduction Strategies," published in the ACTEC Fall 2007 Proceedings in Greenbriar, West Virginia.

In fact, GRATs are effective strategies 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. See Rev. Rul. 1985-13, 1985-1 CB 184. But for grantor trust status, the distribution of non-cash assets in satisfaction of the annuity would cause the trust to recognize gain. *See* Reg. §1.661(a)-2(f).

An installment sale to a grantor trust also may be an especially effective wealth tax reduction strategy. *See, generally,* Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Estate Planning 3 (Jan. 1996). The IRS has ruled that the existence of a grantor trust is ignored for Federal income tax purposes. *See* Rev. Rul.
85-13, *supra*. 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. *See* Blattmachr & Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?" 41st Annual Heckerling Institute on Estate Planning (2007).

Estate Tax "Problems" with Traditional Grantor Trusts. At least on account of the continuous income tax free compounding of wealth allowed by using grantor trusts, such trust status should be considered for virtually all trusts, including 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. The substantial owner status very effectively benefits the beneficiaries of the trust but does not directly benefit the grantor (except in the sense that it aids in estate tax planning).

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 is would be distributed to the grantor. *See, e.g.,* Rev. Rul. 2004-64, 2004-2 CB 7. 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. Rev. Rul. 77-378, 1977-2 CB 347. 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. *See, e.g.,* New York EPTL 7-3.1.

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 claim 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. *See, e.g., Estate of Skinner v. United States,* 316 F. 2d 517 (3d Cir. 1963). 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 Trust^SM^, which is a special trust described in Code Sec. 678 that is the subject of new private letter ruling (PLR) 200949012.

Beneficiary Defective Trust^SM^. 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 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. *See, generally,* Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Code Sec. 678," 35 ACTEC Journal 106 (Fall 2009); Zeydel, "A Complete Tax Guide for Irrevocable Life Insurance Trusts," 34 Estate Planning 6 (June 2007); Slade, "Personal Life Insurance Trusts," BNA Tax Mgt Portfolio 210-4th.

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 Secs. 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 or 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). *See* Code Secs. 2514(b) and 2041(a)(2). 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, entitled to income or a power of control causes estate tax inclusion.

But Code Secs. 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 at a calendar year rate of more than the greater of $5,000 or 5% of the value of the property over which the power is exercisable. 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 $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 it 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 is 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 Secs. 2514(e) and 2041(b)(2) "5 and 5" limitation) as a partial release. *See, e.g.,* 200747002, 9809005, 8342088. 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 Secs. 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 Code Sec. 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 with respect to its beneficiary.

Coupling a Unilateral Power of Withdrawal with a HEMS Power. In PLR 200949012, a trust was created for a beneficiary by someone else. The trust granted the beneficiary the unilateral right to withdraw all contributions made to the trust (1) for any reason and (2) for the beneficiary's health, education, maintenance and support (HEMS), as well as 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. *See* Code Sec. 2041(b). 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 $z and y% of the value of the Trust." ("$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, PLR 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."

A Little More Analysis. As explained in detail in Gans, Blattmachr & Lo, "A Beneficiary as Trust Owner: Decoding Code Sec. 678," 35 ACTEC Journal 106 (Fall 2009), it appears that a trust will not be a Code Sec. 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 Code Sec. 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 Code Sec. 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 tax income, not fiduciary accounting income. 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 Code Sec. 2041. 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 Code Sec. 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 Code Sec. 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 Code Sec. 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 Code Secs. 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 Code Secs. 673-677 or 679 are present (e.g., the trustee may distribute the corpus to the beneficiary), the trust remains a Code Sec. 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 Code Sec. 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 Code Sec. 2518) is to let it lapse under the 5%/$5,000 rule mentioned above. And, in this example, 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 Code Sec. 2041.

The bottomline is that in PLR 200949012 allow the unilateral power to lapse, thereby avoiding Code Sec. 2041, but for such lapse to be treated only as a partial release for purposes of Code Sec. 678 so defective trust status for the beneficiary continues. Again, the PRL 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."

COMMENTARY

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 not 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 can attach the trust property. *See, e.g.,* Restatement (Third) of the Law of Trusts, §58. 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." *Cf.* Rev. Rul. 76-103, 1976-1 CB 293.

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 Trust[SM]," *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, is not a general power of appointment. Code Sec. 2041(b). In fact, it may be best to use a "belt and suspenders" approach by using both solutions.

SUMMARY AND CONCLUSION:

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 Trust^{SM} 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 Secs. 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.

CITES: Code Secs. 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. §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 Ct. Cl. 641 (1985); New York EPTL 7-3.1; Restatement (Third) of Trusts §58.