

TRUST POWERS AND TAX LIABILITIES

“But I Just Wanted a Few Strings Over Trust Assets” – Effects of Trustee Powers of Grantors and Beneficiaries

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This outline addresses tax and non-tax factors that should be considered in selection of a trustee or co-trustees for various types of trusts. Clients typically like to keep as much control as possible, and often want to place as much control in their trust beneficiaries as possible. This desire must be balanced against management, tax, and creditor issues that may result in significant advantages in placing restrictions on the control of the donor or trust beneficiaries. This outline address trustee selection against the backdrop of a client’s desire to retain as many “strings” over the transfer as possible with causing the donor or beneficiaries to be “strung-up” by those other countervailing factors. As one court has expressed the issue, “the cost of holding onto the strings may prove to be a rope burn.” Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st Cir. 1970).

I. NON-TAX FACTORS

A. Legal Capacity.

1. General Statutory Requirements.
2. Requirements for Corporate Trustee.
3. Requirements for a Foreign Corporate Fiduciary.
 - a. Reciprocity Requirement.
 - b. Filing Requirement.
 - c. Not Doing Business.
 - d. National Associations.
4. Charitable Corporation.

- B. Personal Attributes of Trustee. The personal attributes of the trustee should be of paramount importance in the selection process. All too often, the tax factors predominate, but the planner must not lose sight of the personal attribute factors. The fact that the trust works for tax purposes will be of little benefit if a poorly selected trustee dissipates the trust assets through poor administration of the trust.

“Serving as an executor or trustee is neither an honor, nor a game for beginners to play. Acting as an executor or trustee requires technical skills, experience, and an ability to deal with the family members involved. Nevertheless, clients often choose an executor and the trustee without fairly evaluating the needs of the estate or trust against the named fiduciary’s abilities to meet those needs.” Schlesinger, Edward, Fifty-Two Questions to Ask Before Choosing Your Executor and Trustee, Successful Estate Planning Ideas and Method Service (1986).

Various personal attributes to be considered in selecting the trustee include sound judgment, impartiality (or desired partiality toward decedent's preferred beneficiaries), financial ability and responsibility, integrity and honesty, locality, permanence and continuity (particularly important for long-lived trusts), loyalty, trustworthiness, and experience as a trustee. Some of these attributes are explored in more detail.

1. Judgment; Experience. Attorneys are all too familiar with situations where trust assets have been dissipated due to the inexperience of the trustee. A good trustee can provide sound business judgment to the beneficiaries.
2. Impartiality; Objectivity; Lack of Conflict of Interest. The objectivity and lack of conflict of interest factor is very important in many family situations. Selecting an appropriate trustee can avoid conflict situations that may result in family tensions (or outright hostilities) that can never be repaired.
 - a. Beneficiaries Having Conflicting Interests. In situations where the beneficiaries have conflicting interests (the classic case being a split-family situation, where the settlor’s

spouse and children by a prior marriage are both involved as current or contingent beneficiaries.) One commentator suggests using an independent trustee in these types of situations:

“On our facts, the first thing that the estate planner should do is to convince the client to use the services of a truly independent trustee. In this respect, even though [certain approaches may] lessen the possibility of conflict between the client’s children and their stepmother, to a certain extent the objective will be undermined by having a child act as trustee. Because opinions will differ, there still will be circumstances in which the son-trustee does not accede to the stepmother’s requests, creating the possibility of a confrontation. This also might be the case if someone like a brother-in-law or other disinterested relative is appointed as trustee.

The use of an independent fiduciary—perhaps a corporate fiduciary such as a bank—removes the opinions, the underlying distrust, the misunderstandings, and most of all the personalities from the decision-making process. Consequently, there is a better chance of achieving the desired cooperation between the family members.” Tiernan, Creating an Amicable Estate Plan for the Decedent’s Children and the Second Spouse, 94 J. TAX’N (Feb. 2001).

- b. Avoiding Family Tension. Stephen Leimberg has summarized the various interpersonal relationships that can be affected by using a family member as trustee:

“How will the trustee react when faced with a choice that favors him at the expense of other beneficiaries—or favors others at this expense? What are the intra-family implications of those choices? For instance, will he alienate one family member by (even properly) denying a distribution, or ingratiate himself to another by being liberal in his policy of making distributions? Can he say no to one child and yes to another without causing a never-ending family feud? A trustee who is also a family member may be forced by conscience or by duty to make choices injurious to the harmony of family relationships.

Will the trustee (such as the grantor’s spouse) be subject to the influence of one or more children (or a second spouse or lover) to make distributions that may not be in the best interest of other beneficiaries? Is the family member-trustee easily persuaded or likely to show favoritism? The remarriage of a spouse or child who is named as trustee may result in less than impartial decisions—especially where the trustee has been given discretionary powers over trust income or principal—even if the new spouse is not included in the class of possible recipients.

A child/trustee may take on the role of a parent to his or her remaining parent or siblings. This may be positive, but it also may result in an attempt to control the lives of family members through the family finances as if that person were a parent rather than a child.

An independent professional trustee is not subject to such problems. Since the choice between no and yes may be one of the most important duties of a trustee, this ability of a professional trustee to be objective and impartial should be given high preference in the decision-making process.” S. Leimberg, The Tools and Techniques of Estate Planning 480 (11th ed. 1998).

3. Investment Sophistication; Track Record; Prudent Investor Act. The investment sophistication of the trustee is important with respect to the investment growth of the trust. The trustee’s experience in various types of investments should be considered. For example, does the trustee have experience in the increasingly important area of alternative investments (private equity, venture capital, and hedge funds) to increase returns while reducing overall portfolio volatility?

Under the Uniform Prudent Investor Act, which is being passed by many of the state legislatures, the trustee must evaluate the investments in the context of the entire trust and the risk and return objectives of the trust. In addition, the trustee has a duty to diversify the trust assets. Some commentators observe that the Prudent Investor Rule may increase the level of sophistication required of trustees. See Heisler & Butler, Trust Administration ch. 5 (Ill. Inst. For Continuing Legal Educ. 1999).

4. Permanence and Availability.

5. Sensitivity to Individual Beneficiaries' Needs. One of the important duties of a trustee is to make appropriate distributions to the trust beneficiaries, often within some degree of discretion. Being able to understand the beneficiaries and their circumstances is important. Some clients choose to use co-trustees, one of whom has experience in providing the myriad of fiduciary services, and one of whom has a personal relationship with the beneficiaries. In that situation, the co-trustees could be given exclusive responsibility for the administration vs. distribution responsibilities. However, even in that case, the client may want to have the trustee consent to distributions (with the obvious input of the related co-trustee), to get the benefits of having an objective voice who can "shield" the related individual from unreasonable requests for distributions.
6. Accounting; Tax Planning; Record-Keeping.
7. Fees. Fees that will be charged by the trustee are a factor. However, the client should not be "penny-wise and pound-foolish."
 "Relatives, beneficiaries, business associates, and close friends will often serve as trustee without charging a fee. The grantor should be careful to determine whether the individual will properly carry out his duties and give sufficient attention to the administration of the trust. One is easily lured away from his responsibilities by more lucrative endeavors. 'You get what you pay for.'" Malouf, Choosing a Trustee: Old Problems, New Problems, A Few Solutions, at 5, Presentation to Dallas Estate Planning Council (January 1991).
- C. Likelihood of Self-Dealing Transactions.
- D. Situs Selection Issues.
- E. Power to Allocate Gains to Income Under Section 104. Section 104 of the Uniform Act and most of the states adopting the provision stipulate that the discretion may only be exercised by an independent trustee. See Wolf, Total Return Trusts—Meeting Human Needs and Investment Goals Through Modern Trust Design, at 23, ACTEC 2002 ANNUAL MEETING.
- F. Ability of Beneficiary to Force Distributions.

II. DONOR TAX ISSUES

- A. Gift Tax Issues.
 1. Incomplete Gift—Structure Planning Based on Donor's Intent. The transfer to a trust may or may not be a completed gift, based on the terms of the trust and the identity of the trustee. The trust terms and trustee selection must be planned after taking into consideration whether the donor wishes to make a complete gift for gift tax purposes.
 If there is a completed gift initially, there could be immediate gift tax due, based on the size of the gift. However, if the gift is not complete initially, the assets—including subsequent appreciation—will still be included in the donor's estate under Sections 2036-2038 of the Code of 1986 (hereafter, references to "Sections" will be to sections of the Internal Revenue Code of 1986, as amended) for estate tax purposes until the gift has been completed. If the gift is "completed" sometime after the initial transfer, the gift tax will be calculated based on the value of the assets when the gift is subsequently completed.
 Section 2511 of the Code applies the gift tax to "direct or indirect" gifts of all kinds of property whether in trust or otherwise. The regulations add that a gift may be complete even if, at the time it is made, "the identity of the donee may not ... be known or ascertainable." Treas. Reg. § 25.2511-2(a). The regulations provide that various retained interests or powers by the donor will result in a transfer being an incomplete gift until the retained interest or power is relinquished. As a result, certain powers retained by the donor as a trustee, or in some situations as a co-trustee, will result in a transfer not being treated as a completed gift for gift tax purposes.
 2. Retained Right to Receive Distributions.
 - a. Overview.
 - b. **Summary of Selection of Trustee Issues as to Donor Retained Rights to Income In Order To Avoid Having Transfer Treated as Incomplete Gift.** If any distributions may be made to or for the donor's benefit, there must be an independent trustee making the distribution decision, and there cannot be an ascertainable standard that allows the donor to compel a distribution. Furthermore, the donor cannot be a co-trustee participating in such decisions unless the other co-trustee has a substantial adverse interest in the disposition of the transferred property. Treas.

Reg. § 25.2511-2(e). Even if there is an independent trustee or a co-trustee with an adverse interest, the trust should be located in a jurisdiction that recognizes spendthrift protection for self-settled trusts to assure that the retained discretionary interest does not cause the transfer to be treated as an incomplete gift because of the ability of the donor's creditors to reach the trust assets.

3. Powers to Change Beneficial Interests.

a. Powers to Change Beneficial Enjoyment That Cause Incomplete Gift. A transfer is generally incomplete to the extent that the donor retains the power to change the interests of the beneficiaries among themselves. Treas. Reg. § 25.2511-2(c); Sanford Estate v. Comm'r, 308 U.S. 239 (1939). The following are examples of retained powers, which if held by the donor alone or in conjunction with another trustee who does not have a substantial adverse interest, will cause a transfer to be incomplete (unless the ascertainable exception applies, as described immediately below):

- The power to shift benefits from one beneficiary to another, such as through a “sprinkling” power;
- The power to add one or more beneficiaries of the trust;
- The power to remove one or more beneficiaries of the trust;
- The power to distribute or accumulate income, thus affecting the amount passing to another person who is the remainder beneficiary. Treas. Reg. § 25.2511-2(c)

If the trustee has any of these powers either alone or in conjunction with a non-adverse party (and if the ascertainable standard exception does not apply), the trustee must be someone other than the donor, and the donor must not have the power to have himself or herself appointed as trustee.

b. Ascertainable Standard Exception. The regulations clarify that a power to change beneficial interests will not cause a transfer to be incomplete for gift tax purposes if the power is held in a fiduciary capacity and is subject to a “fixed and ascertainable standard.” Treas. Reg. § 25.2511-2(c) & 25.2511-2(g).

c. Power to Affect Time or Manner of Enjoyment, But Not to Shift Among Beneficiaries.

d. Power Exercisable In Conjunction With Others.

e. Contingent Powers. A donor is not deemed to retain a power that arises only upon a future contingency, even if the likelihood of the contingency can be calculated actuarially. Lasker v. Comm'r, 1 T.C. 208 (1942); TAM 8546001; PLR 8727031. For example, the mere possibility that the donor may become a trustee in the future (but outside the control of the donor) will not result in the donor being treated as holding the powers of the trustee for purposes of determining whether the transfer is a completed gift. Goldstein v. Comm'r, 37 T.C. 897 (1962), acq., 1964-1 C.B. (Part 1) 4; Rev. Rul. 54-537, 1954-2 C.B. 316 (contingency in donor's control, by removing the trustee and appointing himself as successor).

f. **Summary of Selection of Trustee Issues as to Retained Power to Change Beneficial Interests In Order To Avoid Having Transfer Treated as Incomplete Gift.** This paragraph summarizes powers that the donor can have (or not have) and still make a completed gift. If the donor is the trustee, the trustee cannot have the discretion to shift benefits among beneficiaries, unless the discretion is limited by a “fixed or ascertainable standard.” If the donor is a co-trustee or must consent to discretionary distributions that may shift benefits among beneficiaries, the other person must have a substantial adverse interest with respect to the discretion over the disposition of the transferred property. In that circumstance, the third party cannot have an express or implicit agreement regarding consent to the donor's exercise of the discretionary power. The donor may be a possible future trustee, as long as the donor cannot control his substitution as trustee (such as through a power to remove and appoint himself as successor trustee.) The donor may serve as trustee if the trustee's only discretion is to accelerate or delay distributions to a single beneficiary, with no ability to shift benefits in any way to any other persons.

B. Estate Tax Issues.

1. Who is the “Grantor”?

Sections 2036 and 2038 may estate inclusion where certain interests or powers are retained by the grantor of a trust. Therefore, determining who is the “grantor” for this purpose is important. Generally, the person who makes an actual transfer, for state law purposes, to the trust is considered a grantor for this purpose. Heasty v. U.S., 239 F. Supp. 345 (D. Kan. 1965), *aff’d*, 370 F.2d 525 (10th Cir. 1966). There are several exceptions, in which transfers made by others will be attributed to a grantor. See generally Stephens, Maxfield, Lind & Calfree, Federal Estate & Gift Tax’n ¶ 4.08[7] (2001); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M.. at 112-138 (2002).

a. Reciprocal Trust Doctrine. If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are “interrelated”, the trusts will be “uncrossed,” and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court said that the principal factor in determining whether trusts are sufficiently interrelated is “whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary.” Id. If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. Estate of Levy v. Comm’r, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; Letter Ruling 200426008 (citation to and apparent acceptance of Estate of Levy)).

The Grace case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. Estate of Bischoff v. Comm’r, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); Exchange Bank & Trust Co. of Florida v. U.S., 694 F.2d 1261 (Fed. Cir. 1984); but see Estate of Grace v. Comm’r, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

b. Indirect Transfers.

2. Retained Beneficial Interest in Donor.

a. Statutory Provision--Section 2036(a)(1). The gross estate includes the value of all property to the extent the decedent:

- Has made a transfer other than a bona fide sale for a full and adequate consideration;
- Under which he has “retained” the possession or enjoyment of, or the right to the income from the property;
- For his life or for any period ascertainable without reference to his death (example: income quarterly for life but income in the quarter of his death will not be paid) or for any period which does not in fact end before his death (example: retain income for five years and donor dies within that five year period).

b. Only Donative Transfers Are Subject to Section 2036.

c. Types of Retained Interests That Cause Estate Inclusion.

(1) Right to Use of Property or Income. A direction that the donor has the right to actual use of trust property or trust income clearly comes within the meaning of the statute, regardless of who is serving as trustee. If there is a retained right to receive only a portion of the income, only that corresponding part of the trust is included in the estate. Treas. Reg. § 2036-1(a)(last paragraph).

(a) Implied Understanding. The statute also applies if there is an implied understanding that the settlor will be allowed to use or receive income from the transferred property. Treas. Reg. § 20.2036-1(a) (last sentence).

(b) Continued Use of Residence. Estate inclusion under Section 2036 has been argued in many cases involving continued use of a transferred residence by the donor. The cases have generally tended to require more than just continued possession of a residence in order to find that an agreement existed at the time of the transfer. See Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001). In fact, the IRS concedes that continued co-

occupancy for interspousal transfers will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 78-409, 1978-2 C.B. 234; Ltr. Rul. 200240020. However, the IRS is not as lenient where the residence is given to family members other than the spouse. E.g., Estate of Trotter v. Comm’r, T.C. Memo. 2001-250. Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. Estate of Wineman v. Comm’r, T.C. Memo. 2000-193 (2000).

- (c) Payment of Rent by Donor. If the donor retains use of the transferred property under a lease agreement that provides for fair rent, it is not clear whether Section 2036 applies. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 162-163 (2002); Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor’s estate. However, the trend of the cases is not to apply section 2036 where adequate rental is paid for the use of the property. E.g., Estate of Barlow v. Comm’r, 55 T.C. 666 (1971); Estate of Giselman v. Comm’r, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. E.g., Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. See Tech. Adv. Memo. 9146002 (Barlow distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. E.g., Estate of Du Pont v. Comm’r, 63 T.C. 746 (1975).

(2) Payment of Grantor’s Debts.

(3) Support of Dependents

- d. Settlor as Totally Discretionary Beneficiary. Two different phrases/words in the statute suggest that naming the grantor as a beneficiary in the trustee’s discretion might not trigger Section 2036. First, the statute refers to the grantor keeping a “right to” income. Second, the statute requires that the grantor “retain” the income interest. As to the first argument, the legislative history indicates that the substitution of the phrase “right to the income” in 1932 was meant to broaden, not restrict the reach of Section 2036(a)(1) and to extend it to cases where the grantor had the right to income but did not actually receive it. See Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 56 (2002). The second argument does lend a credible argument that a totally discretionary interest might not be subject to Section 2036(a)(1). Professor Dodge lists four exceptions to the “general rule that discretionary trusts for the settlor are not included under §2036(a)(1)”:
- Where there was an agreement or understanding that the transferor would receive the income. Such an agreement may sometimes be inferred from the fact that the transferor in fact received (all of) the income. (See section II.B.2.c.(1)(a) of this outline, above.)
 - Where, under the law of creditor’s rights, the settlor’s creditors can reach the trust income to pay the transferor’s debt. (See Section II.B.2.d.(1) of this outline, immediately below.)
 - Where the settlor is herself trustee of such a discretionary trust. (See Section II.B.2.f. of this outline, below.)
 - Where the trustee’s discretion is limited by a standard that can be enforced by the settlor-beneficiary. See Blunt v. Kelly, 131 F.2d 632 (3d. Cir. 1941) (“support, care or benefit”); Estate of John J. Toeller, 165 F.2d 665 (7th Cir.1946) (“misfortune or sickness”); Estate of Boardman v. Comm’r, 20 T.C. 871 (1953), *acq.* 1954-1 C.B. 3 (trust provided distributions for grantor “as the trustee deems necessary for her

comfort, support and/or happiness”; held that these standards—especially “happiness”—gave grantor an enforceable right to demand income distributions and caused inclusion under Section 2036); Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 57 (2002).

- (1) Includible if Settlor’s Creditors Can Reach Trust Assets. If the donor’s creditors can reach the trust assets, because of the potential discretion to distribute assets to the donor, Section 2036(a)(1) would apply. UNIF. TRUST CODE §505 (2000) (settlor’s creditors can reach whatever “can be distributed to or for the settlor’s benefit”); RESTATEMENT (THIRD) OF TRUSTS § 60, Comment f (if settlor is discretionary beneficiary, creditors can reach maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor”); Rev. Rul. 77-378, 1977-2 C.B. 347 (gift complete, even though trust assets were distributable to settlor in trustee’s complete discretion, where donor’s creditors could not reach trust assets); Rev. Rul. 76-103, 1976-1 C.B. 293 (gift incomplete, where trust assets were distributable to settlor in trustee’s complete discretion and where donor’s creditor could reach trust assets; also trust assets included in donor’s estate under § 2038 because of donor’s control to terminate the trust by relegating the grantor’s creditors to the entire trust property); Estate of Uhl v. Comm’r, 241 F.2d 867 (7th Cir. 1957)(donor to receive \$100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce \$100 per month included in estate under §2036(a)(1) and not excess because of creditors’ lack of rights over other trust assets under Indiana law); Outwin v. Comm’r, 76 T.C. 153 (1981) (trustee could make distributions to settlor in its absolute and uncontrolled discretion, but only with consent of settlor’s spouse; gift incomplete because settlor’s creditors could reach trust assets, and dictum that grantor’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 creditor’s gross estate under Sections 2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985) (denied IRS’s motion for summary judgment, apparently based on §2036(a)(1), because settlor’s creditors could not reach trust assets where trustee could distribute assets to grantor in trustee’s uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of nonbeneficiaries).
 - (2) “Alaska Trusts”. Some states (Alaska was the first) have amended their trust and creditor laws to provide that creditors cannot reach trust assets merely because the trustee may, in its discretion, make distributions to the settlor, if certain procedural requirements are satisfied. Alaska, Delaware, Nevada, Rhode Island and Utah now have such laws, and Colorado and Missouri have had similar laws for some years. See section I.D. of this outline. A trust that meets those requirements apparently could include the donor as a beneficiary without causing estate inclusion, but there is no IRS ruling acknowledging this result. However, it is not clear that a person living in another state, who creates a trust governed by the laws of one of those states, would necessarily be exempted from creditors claims in the state of domicile.
 - (3) Grantor Trust Under Section 674(a).
- e. Transfer to Spouse With a Potential of Having Spouse Appoint the Assets Back to Grantor. If the grantor gives property in trust for his spouse (or anyone else), and gives the beneficiary of the trust an inter vivos or testamentary power of appointment to appoint the trust assets to anyone, including the grantor (but not to the beneficiary, his estate, his creditors, or the creditors of his estate), does the grantor have to include the assets in his estate under Section 2036(a)(1) because of the possibility of receiving the assets back from the trust? (The gift effects of this transfer will also be addressed in light of the unique nature of this type of transfer.)
- (1) Completed Gift for Gift Tax Purposes. Despite the fact that the property may eventually be returned to the donor, the transfer is a completed gift, because the donor has so parted with dominion and control as to leave him in no power to change its disposition whether for his own benefit or for the benefit of another. Reg. § 25.2511-2(b).

- (2) Application of Section 2702.
- (3) Inclusion in Spouse's Estate. Whether the trust is included in the spouse's estate depends on whether, under traditional planning principles, the spouse has a power over the trust that is taxable under Section 2041. Two letter rulings in 1991 addressed situations in which the donee-spouse had a power of appointment to appoint the trust property back to the donor. In Letter Ruling 9140068, the transfer was to an inter vivos QTIP trust, and the trust assets were includible in the donee spouse's estate under Section 2044. In Letter Ruling 9141027, the transfer was to a trust that was not included in the spouse's estate. Letter Ruling 9128005 involved an outright transfer from husband to wife, where the wife, on the same day as the gift, executed a codicil leaving the property back to a trust for the husband if she predeceased him. The property was obviously included in her gross estate.
- (4) Inclusion in Donor's Estate. The main issue is whether the trust assets are included in the donor's gross estate, (1) if the donor predeceases the spouse, or (2) if the spouse predeceases and in fact appoints the trust property to a trust for the benefit of the donor.

Section 2036(a)(1) includes in a decedent's gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise, under which the decedent has *retained* for the decedent's life or for any period which does not in fact end before the decedent's death the possession or enjoyment of, or the right to the income from the property. Has the donor *retained* an interest in the trust, if the spouse must later exercise the power to leave the assets back to the donor? Regulation § 20.2036-1(a) provides that an interest or a right is treated as being *retained* or reserved if at the time of the transfer there was an *understanding, express or implied*, that the interest or right would later be conferred.

The regulations address such a contingency with respect to Sections 2038 and 2036(a)(2), dealing with powers that the donor could regain upon the occurrence of contingencies, but does not address the effect of such a contingency under Section 2036(a)(1), which is the relevant section. Reg. §§ 20.2038-1(a)(3) & 20.2036-1(b)(3).

In one 1991 ruling, the donee-wife of an inter vivos QTIP would, on the same day the trust was funded, execute a codicil to her appointing the assets to a trust for the donor-husband. That ruling concluded that the trust assets would not be in the donor's estate, whether he died before donee-wife, or whether she died first after appointing the assets to a trust for his benefit. The ruling reasoned that the original donor-husband is not considered the transferor of the Subtrust for his benefit, so Sections 2036 or 2038 are inapplicable. Ltr. Rul. 9140069. However, the QTIP trust situation is distinguishable from other transfer situations. The QTIP regulations make clear that any interest retained by the donor-spouse in qualified terminable interest property will not cause the property subject to the retained interest to be includible in the gross estate of the donor-spouse—whether the donor-spouse dies before the donee-spouse or after the donee-spouse has died and the property has passed into a “bypass trust” for the benefit of the original donor-spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11.

In another 1991 ruling, where the original transfer was made to a trust that was not included in the spouse's estate for estate tax purposes, the IRS concluded that the trust assets would be included in the gross estate of the donor because the spouse intended to exercise the power of appointment to leave the assets to a trust for the donor's benefit. Ltr. Rul. 9141027. In that ruling, the donor-husband proposed transferring assets to an irrevocable trust for his wife's benefit, and the donee-wife proposed exercising her testamentary power of appointment (by a will executed on the same day the original transfer is made to the trust) to appoint the property, under a standard marital deduction formula approach, to a bypass trust for the benefit of the original donor-husband. The IRS concluded, based on these facts, that an implied agreement existed that the transferred property would later be transferred for the donor's use and benefit.

“A [the original donor] and B [the original donee] agreed that if A transfers property to the Spousal Trust for the benefit of B, B will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which A may be a beneficiary. This implied agreement between A and B results in A retaining benefits of property that he plans to transfer. It is not necessary that A has definite right to the property. In view of the facts presented, *the possibility that A may reacquire* an interest in previously transferred property after B dies constitutes a retained interest in the transferred property. Therefore, the value of the Spousal Trust will be includible in A’s gross estate under section 20.2036-1(a) of the regulations.” (emphasis added).

Under the facts of the ruling, finding an implied agreement to appoint the property back to the donor seems clear, based on the representation that the donee spouse planned to exercise the power of appointment by signing a revised will on the very day that the gift was made to the trust. The italicized words in the ruling suggest that the mere existence of the power caused the estate inclusion problem for the original donor, and not the actual exercise of the power of appointment.

Various other possible restrictions would help bolster the argument that the spouse’s power of appointment would not cause an estate inclusion problem for the donor. The actual exercise of the power, or even more conservatively, the manner in which the power of appointment could be exercised in favor of the donor-spouse, could be limited in the following possible ways. The appointment for the donor could be limited to payments for the health, support and maintenance of the donor. (Observe, however, that there are no cases suggesting an ascertainable standard exception for Section 2036(a)(1) like there are for Sections 2036(a)(2) and 2038.) Additionally, the permissible trust could require that distributions could be made to the grantor only after other income and assets of the donor had been exhausted, so that A’s creditors could not reach the property. See Covey, Current Developments, 1992 UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 115.8.

If case law subsequently becomes clear that the mere existence of the power causes estate inclusion problems for the original donor, the donee-spouse could release the power of appointment, but the release would have to occur more than 3 years before the donor’s death under section 2035.

- (5) **Summary. Giving the donee-spouse a testamentary power of appointment to appoint the assets back to the donor or to a trust for the benefit of the donor should not create inclusion problems for the donor as long as there is no express or implied agreement that the spouse would exercise the power of appointment for the donor. Do not have the spouse sign a new will exercising the power of appointment for some period of time. Make sure that the spouses understand that there really is no preconceived plan of whether the power of appointment will be exercised, but that it is just included to provide helpful flexibility. Other restrictions, discussed above, that could be added would help bolster a non-inclusion argument, but should not be necessary.**

f. Effect of Trustee Selection on Retained Right to Income.

- (1) Grantor as Trustee
- (2) Third Party as Trustee—General Rule
- (3) Third Party as Trustee—Discretion to Make Payments for Support of Grantor’s Dependents.
- (4) Third Party as Trustee—Discretion to Make Income Distributions to Grantor.
- (5) Nature of Relationship of Third Party Trustee to Grantor.
 - (a) Close Relationship of Grantor to Trustee. A variety of cases have recognized that a grantor did not retain a power held by a trustee, “just because the trustee is the settlor’s wife, young daughter, or golfing companion, or because the trustee tends to follow the settlor’s wishes in exercising discretion.” Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 159 (2002). An example is Estate of Beckwith v. Comm’r, 55 T.C. 242 (1970). In that case, the IRS contended that a variety of factors enabled the grantor to control the flow of

income from the trust, including “close business relationships between the settlor and the individual trustees.” The court rejected that position. 55 T.C. at 248-249.

- (b) De Facto Control. A few cases, in extreme circumstances, have suggested that a grantor is treated as holding powers of a third party trustee where the grantor actually controlled the trustee’s actions. See Estate of Klauber v. Comm’r, 34 T.C. 968 (1960) (reviewed)(dictum); see also Tech Adv. Memo. 9043074 (grantor controlled institutional trustee). However, courts have generally been reluctant to attribute powers of a trustee to the grantor. In an early case, the court refused to include assets in the settlor’s estate where the trustee in its discretion could make distributions to the settlor’s minor child, specifically rejecting notion that a court should presume that a trustee would do what the settlor asked of him:

“The Commissioner’s argument that these trustees would be likely to do what he asked of them about assigning income for the support of a minor child departs from the ‘practical’ and ‘realistic’ approach we are asked, in the same argument, to take. We have no notion what the trustees would have done had such a request been made. It is apparent, from the terms of the instrument, that the settlor could not direct or control the matter, once the trust settlement had become effective.” Comm’r v. Douglass Estate, 143 F.2d 961 (3rd Cir. 1944).

In Estate of Goodwyn v. Comm’r, 32 T.C.M. 740 (1973), the court reasoned that the trustee is obligated to adhere to fiduciary duties regardless how close the relationship of the trustee and the grantor, and as long as the trustee’s actions are consistent with those duties, the courts will not attribute the trustee’s powers to the grantor. If the trust allows distributions in the total discretion of the trustee, it will be difficult to show a violation of the trustee’s fiduciary duties. See McCabe v. U.S., 475 F.2d 1142 (Ct. Cl. 1973) (no estate inclusion even though trustee ignored interests of beneficiaries other than settlor). “In sum, the de facto control issue may be essentially dead.” Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 159 (2002).

- (c) Implied Agreement or Understanding. See section II.B.2.c.(1)(a) of this outline.

- (6) **Summary of Trustee Selection Issues With Respect to Retained Beneficial Interests in Donor**. The grantor cannot serve as trustee if there is any possible retained beneficial interest in the donor, or else the trust will be included in the donor’s estate. Similarly, if the donor has any possible beneficial interest, the donor cannot have the power to name himself as successor trustee (even if he could become a successor trustee only if a contingency occurs that is outside his control.)

As to support of dependents, if a third party trustee serves, the trust could authorize distributions to dependents of the donor as long as there is not a standard for distribution tied to support or maintenance of the donor’s dependents. (The more conservative approach is to always prohibit any distributions from a trust that would satisfy the donor’s legal obligation of support, regardless of who is the trustee.)

If there is any possibility for distributing assets to the donor at some point in the future, there must be a third party trustee to have any hope of excluding the trust assets from the donor’s estate. Even then, the trust must give the trustee complete discretion in making distributions to the grantor, the trust must be established in a jurisdiction that allows “self-settled trusts,” and the jurisdiction of the donor’s domicile must recognize the spendthrift protection of the self-settled trust.

A few older cases questioned whether a trustee who has a close relationship to the donor, and who always follows the donor’s directions, can avoid estate inclusion problems under Section 2036(a)(1). However, most cases have refused to apply a “de facto” control analysis. Regardless of who is the trustee, there must be no agreement or understanding with the trustee regarding how the trust assets will be distributed.

3. Retained Dispositive Powers in Donor.
- a. Statutory Provision--Section 2036(a)(2). The gross estate includes the value of all property to the extent the decedent:
- Has made a transfer other than a bona fide sale for a full and adequate consideration,
 - Under which he has “retained” the right either alone or in conjunction with any person
 - To designate the persons who shall possess or enjoy the property or the income from the property
 - For his life or for any period ascertainable without reference to his death or for any period which does not in fact end before his death.
- b. Statutory Provision—Section 2038. The gross estate includes the value of all property to the extent the decedent:
- Has made a transfer other than a bona fide sale for a full and adequate consideration
 - Under which the decedent had at the date of his death (regardless of when or from what source the decedent acquired a power)
 - The power (in whatever capacity exercisable), either by the decedent alone or in conjunction with any person
 - To alter, amend, revoke, or terminate enjoyment of the property,
 - Or where such power is relinquished during the 3-year period ending on the date of his death.
- c. Dispositive Powers that Trigger Application.
- (1) Sprinkling Power. The power to shift income or trust property among beneficiaries causes inclusion under either Section. Estate of McManus v. Comm’r, 172 F.2d 697 (6th Cir. 1949) (predecessor to Section 2036(a)(2)); Estate of Craft v. Comm’r, 608 F.2d 240 (5th Cir. 1980) (Section 2038 inclusion where decedent had power to change beneficiaries and change their respective shares). A power to add beneficiaries would cause inclusion. But see Rev. Rul. 80-255, 1980-2 C.B. 272 (decedent’s ability to have more children and add beneficiaries is not a power to change beneficial interests under Section 2038). A power exercisable to change the beneficiaries only in the decedent’s will causes inclusion. Adriance v. Higgins, 113 F.2d 1013 (2d Cir. 1940) (predecessor to Section 2038); Marshall v. U.S. 338 F. Supp 1321 (D. Md. 1971).
- (2) Power to Accumulate. The power to affect only the timing of distributions, and not the beneficiaries who receive distributions, clearly triggers inclusion under Section 2038. Lober v. U.S., 346 U.S. 335 (1953); Estate of Alexander v. Comm’r, 81 T.C. 767 (1983) (retained power to accumulate income for distribution every five years caused inclusion, even though all income eventually had to be distributed to the income beneficiary). The regulations under Section 2038 state explicitly that “Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected.” Treas. Reg. § 2038-1(a). The regulation illustrates this with an example where grantor has the power to accumulate income or distribute it to A and to distribute corpus to A, even though the remainder is vested in A or his estate. (In the example described in the regulation, it appears that only the value of the remainder interest would be includible under Section 2038, and not the value of the income interest. The grantor would not have the power to change when A receives the income. He would have to wait until the income is earned in any event before he could receive it. See Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 100 (2002).) A power to accumulate or distribute income causes inclusion under Section 2036(a)(2) where the income beneficiary is different from the remainder beneficiary, because accumulating income may shift the recipient from the income beneficiary to the remainderman. U.S. v. O’Malley, 383 U.S. 627 (1966), *rev’g* 340 F.2d 930 (7th Cir. 1964). (The briefs in O’Malley indicate that the trust lasted for a term of years. At termination, the trust assets would pass to the income beneficiary if living but if not, to a third party. See R. Stephens, G. Maxfield, S. Lind, & Calfree, Federal Estate and Gift Taxation ¶

4.08[5][c] n. 54 (6th ed. 1991). If the income beneficiary and the remaindermen are the same (if the assets pass to the income beneficiary's estate or if the income beneficiary holds a general power of appointment), neither the statutory language of Section 2036(a)(2) nor the regulations address whether Section 2036(a)(2) applies. An argument can be made that Section 2036(a)(2) should not apply because a power "to designate the persons who shall possess or enjoy" connotes some ability to choose among multiple "persons." The Tax Court has observed that "[w]hile this position is not without a certain superficial appeal, as well as some support from commentators, we conclude that the weight of logic and judicial precedent is to the contrary." Estate of Alexander, 81 T.C. 757 (1983), aff'd in unpub. Op. (4th Cir. 1985). The case cited the following commentators as supporting the opposite result. R. Stephens, G. Maxfield, & S. Lind, Federal Estate and Gift Taxation, ¶4.08[5][c] (5th ed. 1983); C. Lowndes, R. Kramer & J. McCord, Federal Estate and Gift Taxes, § 9.20 (3d ed. 1974). Cases have held that Section 2036(a)(2) applies even in the single vested beneficiary situation. Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955) (sole income beneficiary was remainder beneficiary at trust termination; trust contained no provision as to disposition if beneficiary predeceased trust termination; court determined that under state law the beneficiary's interest was vested and that the trust assets would pass to the beneficiary or to the beneficiary's devisees; predecessor to §2036(a)(2) applied); Ritter v. U.S., 297 F. Supp. 1259 (S.D. W. Va. 1968) (single income beneficiary/remainderman; trust assets pass to beneficiary at age 21 or if die before age 21, "to persons appointed by the beneficiary in his will or if there was no will, to the legal representative of the estate of the beneficiary," held that § 2036(a)(2) applies, relying primarily on O'Malley, which said that the power to deny beneficiaries the "privilege of immediate enjoyment and conditioning their eventual enjoyment upon termination of the trust" is sufficient to invoke § 2036(a)(2)); Estate of Alexander, 81 T.C. 757 (1983), aff'd in unpub. Op. (4th Cir. 1985)(§2036(a)(2) applied where grantor as trustee could accumulate income for sole beneficiary where the beneficiary or her estate was the sole remainder beneficiary); Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970) (child was sole beneficiary and remainderman was child or child's estate; §2036(a)(2) applied to power to accumulate funds). Cf. Joy v. U.S., 404 F.2d 419 (6th Cir. 1968) aff'g 272 F. Supp. 544 (E.D. Mich. 1967) (trust instrument includes contingent remainder if income beneficiary predeceases trust termination). Despite these cases, some commentators continue to believe that Section 2036(a)(2) should not apply to a mere power to accumulate without a power to shift benefits from one person to another. E.g., R. Stephens, G. Maxfield, S. Lind & Calfree, Federal Estate and Gift Taxation ¶4.08[5][c](6th ed. 1991).

- (3) Power to Invade Corpus. A power to invade corpus is a power to alter enjoyment under Section 2038. Estate of Yawkey v. Comm'r, 12 T.C. 1164 (1949). The power to terminate a trust by acceleration of the corpus distribution causes inclusion under Section 2038. Lober v. U.S., 346 U.S. 335 (1953); Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970). Similarly, under Section 2036(a)(2), an unlimited power to invade corpus for the income beneficiary or other beneficiary is subject to Section 2036(a)(2). See Commissioner v. Holmes, 326 U.S. 480 (1946).
 - (4) Power to Revoke. Unlike most states, Texas law provides that every trust is revocable unless it explicitly states that it is irrevocable. TEX. PROP. CODE §112.051. Accordingly, a trust established under Texas law must explicitly state that it is irrevocable, or else the trust assets will be included in the estate under Section 2038. Estate of Hill v. Comm'r, 64 T.C. 867 (1975), acq. 1976-2 C.B. 2; Tech Adv. Memo. 9032002.
- d. Similarities In Application of Sections 2036(a)(2) and 2038.
- (1) Triggering Powers. As discussed in the preceding section, the powers that trigger the two sections are very similar, with a great deal of overlap.
 - (2) Joint Powers. Even though the decedent holds the power jointly with another person, inclusion results under both sections. Unlike the treatment of powers of beneficiaries

- under Section 2041, or the gift tax treatment of powers held by grantors, whether the person who holds the joint power has an adverse interest is irrelevant under Sections 2036(a)(2) and 2038. E.g., Treas. Reg. §20.2036-1(b)(3) (“whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest”).
- (3) Joint Power Holder Can Override Grantor’s Decision. Even if the joint power holders can override the grantor’s decision (such as where a majority vote controls), both Sections still apply. See Estate of Yawkey v. Comm’r, 12 T.C. 1164 (1949).
 - (4) Veto Power. Whether the grantor can act with the consent of another, or whether another person can act with the consent of the grantor makes no difference. Even if the grantor is not the trustee, but merely holds a veto power over actions of the trustee, both Sections would apply if the veto power affects a decision that triggers the Sections. See Rev. Rul. 70-513, 1970-2 C.B. 194 (only the value of the remainder interest is includible in decedent’s gross estate where the enjoyment of the son’s life estate was not subject to change through exercise of decedent’s reserved power to consent to or veto the trustees’ power to terminate the trust); Rev. Rul. 55-683, 1955-2 C.B. 603 (predecessor to Section 2038 applied where grantor’s wife could modify or revoke the trust only with the consent of the grantor). The court in Estate of Carrie Grossman v. Commissioner, 27 T.C. 707 (1957), noted that “it is irrelevant whether the decedent’s participation initiates the termination, or, as here, is in the nature of a consent after others have set the machinery in motion, it being sufficient under the statute merely that she act 'in conjunction' with the others * * *,” citing Thorp’s Estate v. Commissioner, 164 F.2d 966 (1947), cert. denied 333 U.S. 843; and Du Charme’s Estate v. Commissioner, 164 F.2d 959 (1947). The fact that the decedent does not take an active part in the trust management or administration does not matter. Biscoe v. U.S., 148 F. Supp. 224, 225 (D. Mass. 1957). The IRS agrees with the position that veto powers invoke Sections 2036 and 2038. E.g., Rev. Rul. 70-513, 1970-2 C.B. 194; Ltr. Rul. 8038014
 - (5) Disability of Grantor Disregarded. Under both sections, the inability of the grantor to exercise the problematic powers because of incompetency or other disability is disregarded. Tech. Adv. Memo. 8623004. This is similar to the rule under Section 2041 as to powers held by disabled beneficiaries. E.g., Pennsylvania Bank & Trust Co. v. U.S., 597 F.2d 382 (3d Cir. 1979); Fish v. U.S., 432 F.2d 1278 (9th Cir. 1970).
 - (6) Capacity in Which Power Is Held Is Irrelevant. Under both sections, estate inclusion results whether the power is held in an individual or a fiduciary capacity. As an example, if the grantor makes a transfer to a private foundation, and has the ability to control disposition of the donated funds as a director of the foundation, estate inclusion results. Rifkind v. U.S., 84-2 U.S.T.C. 13,577, 5 Ct. Cl. 362 (1984) (inclusion under Section 2036(a)(2)).
 - (7) Full Consideration Transaction Excluded. Both sections apply only to the extent that the grantor has made a transfer other than a “bona fide sale for an adequate and full consideration.”
- e. Differences Between Section 2036(a)(2) and 2038. See generally Dodge, Transfers with Retained Interests and Powers, 50-5th T.M. at 97-98 (2002).
- (1) Retention of Power Over Income Only; Amount of Inclusion. A retention of power over distributing or accumulating income alone is enough to cause inclusion of the entire trust property under Section 2036(a)(2). However, under Section 2038, only the actual property over which a power is held is included in the estate. Therefore, a power over only income would require inclusion of only the income interest under Section 2038. Similarly, a power over only the remainder interest would require inclusion of just the remainder interest and not the income interest under Section 2038. Rev. Rul. 70-513, 1970-2 C.B. 194.
 - (2) Retained Power vs. Power Held At Death For Whatever Reason. Under Section 2036(a)(2), only powers “retained” by the decedent cause inclusion. Under Section 2038, it is sufficient that the decedent holds the power at death, regardless of “at what time or from what source the decedent acquired his power.” Treas. Reg. §

20.2038-1(a). For example, if a decedent did not retain the power to control distributions, but acquired the power only through appointment as trustee by another person, Section 2038 would apply.

- (3) Contingent Power. Under Section 2036(a)(2), “whether the exercise of the power was subject to a contingency beyond the decedent’s control which did not occur before his death (e.g., the death of another person during the decedent’s lifetime)” is irrelevant. Treas. Reg. § 20.2036-1(b)(3). In Revenue Ruling 73-21, the decedent reserved the power to name a successor trustee (which, under state law, included himself) upon the death, resignation or removal of the trustee. The Ruling concludes that Section 2036(a)(2) applied even though a vacancy had not occurred by the time of the decedent’s death. Rev. Rul. 73-21, 1973-1 C.B. 405. At least one case has disagreed with the government’s position, holding that a contingent power to determine who enjoys property or the income from property is not subject to Section 2036(a)(2), based on an interpretation of the predecessor statute in the 1939 Code. Estate of Kasch v. Comm’r, 30 T.C. 102 (1958). However, most cases have supported the IRS’s position regarding contingent powers under Section 2036(a)(2). E.g., Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977).

In contrast, under Section 2038, the power must actually be possessed at death. “Section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent’s control which did not occur before his death (e.g., the death of another person during the decedent’s life).” Treas. Reg. §20.2038-1(b).

The contingency rule under Section 2036(a)(2) creates a trap—estate inclusion can result if there is the possibility that the grantor might at some point be appointed as the successor trustee if a vacancy occurs, even if the grantor does not hold the power to fire a trustee and appoint himself. Estate of Gilchrist v. Comm’r, 630 F.2d 340 (5th Cir. 1980) (power of grantor to appoint himself as trustee if vacancy occurs).

- f. Exception for Powers Held By Third Party Trustee. Powers held by a third party rather than by the grantor will not cause estate inclusion. As discussed in section II.B.2.f.(5)(a) of this outline, the IRS’s “de facto” control argument has not been well received by the courts. However, the grantor must be careful not to have an agreement or understanding regarding the trustee’s decisions. Also, the reciprocal trust doctrine might apply to uncross powers held by trustees of “interrelated trusts.” See section II.B.1.a. of this outline.

- g. Ascertainable Standard Exception. If the distribution powers held by the grantor are limited by a determinable external standard, enforceable in a court of equity, the grantor arguably does not have any power to alter the distributions from the terms of the trust, because the standard sufficiently limits the grantor’s discretion. However, there is no explicit ascertainable standard exception in the statutory provisions or regulations to Sections 2036 and 2038. (Regulations under various other sections give guidance on what standards would constitute an ascertainable standard or a definite external standard. Treas. Reg. §§ 20.2041-1(c)(2), 25.2511-1(g)(2), and 1.674(b)-1(b)(5)(i).)

The seminal case establishing the ascertainable standard exception for a donor controlled power over disposition is Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947). In that case, the grantor retained the power as trustee to make distributions to enable the beneficiary to keep himself and his family in comfort “in accordance with the station in life to which he belongs.” The court held that power would not cause inclusion under the predecessor to Section 2038. Since that time, many courts have ruled on whether particular standards are sufficient to avoid inclusion under Section 2036 and 2038. Standards relating to “health education, support and maintenance” are invariably held to avoid estate inclusion, by analogy to the standards exception in Section 2041. E.g., Estate of Weir v. Comm’r, 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4 (“the education, maintenance and support” and “in the manner appropriate to her station in life”).

The courts have been lenient in recognizing standards as being ascertainable for purposes of Section 2036 and 2038, as long as some definite standard (other than amorphous terms such as “pleasure,” “well-being,” or “happiness”) are used. Darin

Digby, of San Antonio, Texas, has provided the following outstanding compilation of cases that have recognized standards as being ascertainable. Digby, Drafting Donor-Trustee Irrevocable Trusts Without Adverse Income, Gift or Estate Tax Consequences to the Donor and Drafting Defective Grantor Trusts, STATE BAR OF TEXAS 6th ANN. ADV. DRAFTING: ESTATE PL. & PROB. COURSE, at H-5 (1995). Blunt v. Kelly, 131 F.2d 632 (3d Cir. 1941) (“support, care or benefit”); Estate of John J. Toeller, 165 F.2d 665 (7th Cir. 1946) (“misfortune or sickness”); Industrial Trust Co v. Comm’r, 165 F.2d 142 (1st Cir 1947), *aff’g in part and rev’g in part*, 7 T.C. 756 (1946) (“in case of sickness or other emergency”); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947), *rev’g*, 63 F. Supp 834 (income—“benefit, support, maintenance or education”; corpus—“suffer prolonged illness or be overtaken by financial misfortune which trustees deemed extraordinary”); Estate of Wilson v. Comm’r, 187 F.2d 145 (3d Cir 1951), *aff’g*, 13 T.C. 869 (“in case of need for educational purposes or because of illness or for any other good reason”); State Street Trust Co. v. U.S., 263 F.2d 635 (1st Cir. 1959), *aff’g*, 160 F. Supp 877 (D.C. Mass.); (“comfortable maintenance and/or support”; United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (“maintenance, welfare, comfort, education or happiness”); Estate of Ford v. Comm’r, 450 F.2d 878, *aff’g*, 53 T.C. 114 (1969) (“illness, infirmity ... or support, maintenance, education, welfare and happiness”); Leopold v. U.S., 510 F.2d 617 (9th Cir. 1975) (“support, education, maintenance and general welfare”); United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (“maintenance, welfare, comfort, or happiness”); Pardee v. Comm’r, 49 T.C. 140 (1967) (“education, maintenance, medical expenses, or other needs ... occasioned by emergency”); Seasongood v. U.S., 331 F. Supp. 486 (S.D. Ohio 1971) (“as [beneficiary] may require”); Estate of Klaffer v. Comm’r, 32 T.C.M. 1088 (1973) (income—“to maintain [beneficiary’s] standard of living in the style to which she has been accustomed;” corpus—“support, maintenance, health, education and comfortable living”); Estate of Gokey v. Comm’r, 72 T.C. 721 (1979) (children—“support, care, welfare and education;” spouse—“care, comfort, support or welfare”).

The following, including a compilation of cases by Mr. Digby, summarizes cases where the stated standard was too broad, and where estate inclusion resulted under Section 2036 or 2038. Old Colony Trust Co. v. U.,S., 423 F.2d 601 (1st Cir. 1970) (“changed circumstances” standard was acceptable, but “for his best interests” standard was not); Hurd v. Comm’r, 160 F.2d 610 (1st Cir. 1947) (“the circumstances so require”); Michigan Trust Co. v. Kavanagh, 284 F.2d 502 (6th Cir. 1960) (“a special emergency”); Estate of Yawkey v. Comm’r, 12 T.C. 1164 (1949) (“best interests”); Estate of O’Connor v. Comm’r, 54 T.C. 969 (1970) (“for the benefit of”); Estate of Bell v. Comm’r, 66 T.C. 729 (1976) (“for purposes of providing [‘beneficiary’] with funds for a home, business ... or for any other purpose believed by the Trustee to be for [beneficiary’s] benefit ...”); Estate of Carpenter v. U.S., 80-1 U.S.T.C. ¶13,339 (Wis.) (“trustees are authorized but not required” “in the sole discretion of the Trustees”). *Cf.* Merchants Nat’l Bank v. Comm’r, 320 U.S. 256, 64 S. Ct 108 (1943) (“happiness” not an ascertainable standard for purposes of allowing charitable deduction); Industrial Trust Co. v. Comm’r, 151 F.2d 592 (1st Cir. 1945), *cert. denied*, 327 U.S. 788 (“pleasure” not an ascertainable standard for purposes of charitable deduction).

The analysis must extend beyond just looking to see if “magic” unacceptable words are used in the description of standards. An excellent discussion of this principle is provided by a Tax Court case that was affirmed by the Second Circuit Court of Appeals. Estate of Ford v. Comm’r, 53 T.C. 114 (1969), *nonacq.* 1978-2 C.B. 3, *aff’d per curiam*, 450 F.2d 878 (2d Cir. 1971). In that case, the instrument included the following clause regarding distributions:

“If any time or from time to time it shall appear to the satisfaction of the Trustee that the said [beneficiary] *shall be in need of funds* in excess of the income which may then be available for his benefit from the trust estate and from any other source or sources of which the Trustee has knowledge, for the purpose of defraying expenses occasioned by illness, infirmity or disability, either mental or physical, or for his *support, maintenance, education, welfare and happiness*, then the Trustee may relieve or contribute toward the relief of any such need by paying to him or using and applying for his benefit such sum or

sums out of the principal of the trust estate as the Trustee deems to be reasonable and proper under the circumstances. *The Trustee, in considering at any time whether or not to make any disbursements of principal under the terms hereof, shall consider primarily the welfare of the said [beneficiary],* and shall not unduly conserve the principal for later distribution to him or to others having contingent remainder interests.” 53 T.C. 114, at 120-21 (emphasis added).

The court acknowledged that “the word 'happiness' standing alone, or in conjunction with language exhorting the trustee to administer the trust liberally for the benefit of one beneficiary over another, does not provide an ascertainable standard enforceable in a court of equity.” 53 T.C. at 125. However, the court observed that the invasion provision contains a clause advising the trustee that he should “consider primarily the welfare” of the beneficiary. In addition, the invasion power is prefaced with the clause that it applies when the trustee is satisfied that the income beneficiary is “in need” of funds in excess of the income which may then be available, and that invasion is permitted to “relieve or contribute toward the relief of any such need.” The instrument placed a fiduciary responsibility on the trustee to determine “need” before he could invade principal for any of the prescribed reasons.

In response to the IRS’s argument that the term “happiness” afforded unbridled discretion to the grantor-trustee, the court responded:

“To the contrary, we do not accord this single word such as talismanic effect. A word, such as 'happiness,' must be construed in the context in which it appears 'because its meaning may be affected by the words it accompanies.' *Estate of Marvin L. Pardee*, 49 T.C. 140, 144 (1967). Viewing the invasion provision in its entirety, we conclude that its emphasis on 'need' delimits 'happiness' as well as the other enumerated terms, and provides an external, objective standard enforceable against the grantor-trustee in a court of equity. *United States v. Powell*, 307 F.2d 821, 826-828 (C.A. 10, 1962). It is well settled that where the trust instrument contains such a standard, the grantor-trustee is not deemed to have retained sufficient dispositive discretion to activate the operative provisions of either section 2036 or section 2038. *Jennings v. Smith*, 161 F.2d 74, 77-78 (C.A. 2, 1947). *Estate of C. Dudley Wilson*, 13 T.C. 869, 872-873 (1949), affirmed per curiam 187 F.2d 145 (C.A. 3, 1951); and *Delancey v. United States*, 264 F.Supp. 904, 907 (W.D. Ark. 1967). Moreover, an examination of the applicable State law reveals that an aggrieved beneficiary could indeed enforce his rights against an imprudent or wrongdoing trustee. ...

Thus, although we deem the question to be a close one, we conclude that the grantor-trustee herein did not have untrammelled discretion to invade corpus at his own whim or that of the income beneficiary. Consequently, the presence of the invasion power in the trust indenture does not in our view operate to trigger the provisions of sections 2036(a)(2) and/or 2038(a)(1).” 53 T.C. at 126-27.

This extended discussion of the *Ford* decision is included to emphasize that the ascertainable standard issue will be resolved in the context of the overall provisions for distributions in the trust instrument.

- h. Summary of Planning for Ascertainable Standard Exception. To be conservative in the planning process, if the trust instrument reserves for the grantor any dispositive powers, the instrument should apply a strict “health, education, support and maintenance” standard. Using any other words is taking a risk that the IRS might question whether Sections 2036 or 2038 should apply. E.g., Rev. Rul. 73-143, 1973-1 C.B. 407 (power to make payments early “in case of need for education purposes or because of illness or for any other good reason” is not an ascertainable standard). Even though the courts have generally recognized other reasonable standards as being ascertainable, why place yourself in the position of having to argue with the IRS and possibly face an adverse court decision?**
- i. Effect of Adding That Trustee Makes Decision “In His Sole Discretion”. Various cases have held that adding that a trustee may decide in his sole or uncontrolled discretion

whether the stated standards have been satisfied does not change the result. E.g., Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) (“in their absolute discretion”); State Street Trust Co. v. U.S., 160 F. Supp 877 (D. Mass 1958) (power to invade capital for the “comfortable maintenance and/or support” of each beneficiary, in the trustee’s “sole and uncontrolled discretion”), aff’d, 263 F.2d (1st Cir. 1959); Estate of Budd v. Comm’r, 49 T.C. 468 (1968) (“suitable support, education and maintenance of any such beneficiary, the Trustee may, in his uncontrolled discretion, apply...”).

- j. **Summary of Trustee Selection Issues With Respect to Grantor Powers Over Dispositive Provisions.** If the grantor has the power, either as trustee or otherwise, to add beneficiaries, change the disposition among beneficiaries, accumulate or distribute income, invade corpus, or revoke the trust, Sections 2036 and/or 2038 will apply. (Under Section 2038, it is not necessary that the grantor “retain” the power; Section 2038 applies if the grantor holds the power at his death, regardless of how the grantor acquired the power.) Estate inclusion also occurs if the grantor has the right to appoint himself as trustee, either currently or (under Section 2036, but not Section 2038) upon the occurrence of a future contingency even if the contingency is out of the grantor’s control (such as a vacancy in the office of trustee.) The Sections apply whether the grantor serves alone or as a co-trustee, or if the grantor just has a veto power, or may act only subject to another person’s veto power. The Sections apply if the grantor keeps the dispositive power in any capacity (for example, as director of a private foundation that receives a gift from the grantor), not just as trustee.

Estate inclusion will not occur if the dispositive power is subject to a determinable standard (despite the absence of an ascertainable standard exception in the statutes or regulations under Section 2036 and 2038.) A wide variety of standards have been approved by courts, but if the grantor holds (or may in the future hold) any dispositive powers, the conservative course of action would be to use a pure “health, education, support and maintenance” standard, without further embellishment. For example, to be conservative, if the grantor might possibly acquire dispositive powers, do not provide that the trustee may make dispositive decisions under the standard in the trustee’s sole or uncontrolled discretion. If a third party trustee has powers that would trigger estate inclusion if held by the grantor, the grantor should not have the unlimited power to remove and replace the trustee. (See Section III.B.5.g. & h. of this outline.)

4. Retained Administrative and Management Powers.
- a. Administrative Powers Can Affect Distributions. Certain administrative decisions may have the effect of shifting benefits from one beneficiary to another. For example, the power to allocate receipts and disbursements between income and principal can affect the amounts distributed to income beneficiaries and remaindermen. Similarly, a trustee’s investment powers to invest in high-growth non-income producing assets may shift benefits from the income beneficiary to the remaindermen. Courts have long recognized that “standard” administrative powers would not invoke the predecessors of Section 2036 and 2038. E.g., Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). However, the IRS has argued (with some success in early cases) that various broad administrative powers would cause estate inclusion under Sections 2036 and 2038. E.g., State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a “very close” case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply).
- b. Key Issue: Is Exercise of Power Subject to Review By Court? As the courts have sifted through these types of cases, the emerging principle is that a grantor’s broad management powers will not invoke Section 2036 or 2038 as long as the grantor’s actions are subject to review by a court of equity (for example, if the exercise of the power is subject to fiduciary standards.) See Dodge, 50-5th T.M., Transfers With Retained Interests and Powers 101 (2002). This is particularly true if the grantor’s actions are subject to a standard that, as a practical matter, can be enforced by a court as

opposed to actions taken under a “sole discretion” standard. See Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, Tax Notes 1153, 1157 (Sept. 1, 2003). However, some courts have applied this principal regarding management powers even if the grantor has very broad discretion. The court that ruled in favor of the IRS in the State Street case changed its position in 1970, specifically overruling the result in State Street, and adopting a position under Massachusetts law that no amount of administrative discretion prevents judicial supervision of the trustee. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970). In Old Colony, a provision that the trustees could “do all things in relation to the Trust Fund which the Donor could do if living” did not cause Sections 2036 or 2038 to apply. See also United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (trustee-grantor had power to invest assets as he deemed “most advisable for the benefit of the trust estate”; held that trustee’s acts were subject to review by court of equity and did not invoke the predecessor to Section 2038). Some courts have even held that a grantor’s non-trustee powers were reserved in a fiduciary capacity, thus invoking the general rule that administrative powers subject to court review do not trigger application of Section 2036 or 2038. Estate of King v. Comm’r, 37 T.C. 973 (1962), *nonacq.* 1963-1 C.B. 5

The absence of a fiduciary duty was the determining factor in finding that a grantor who retained controls over Illinois land trusts was subject to Sections 2036(a)(2) and 2038. Estate of Bowgren v. Comm’r, 105 F.3d 1156 (7th Cir. 1997) (decendent had no duty to seek agreement of other beneficiaries to deal with their interests and had no fiduciary duty to the donee who received an assignment of an interest in a land trust).

- c. Supreme Court’s Pronouncement in Byrum. The Supreme Court held that retained rights to vote the transferred stock of a closely held corporation does not constitute a Section 2036(a)(2) power over the property. U.S. v. Byrum, 408 U.S. 125 (1972).

The Court reasoned, first, that management powers generally are not powers subject to Section 2036(a)(2):

“At the outset we observe that this Court has never held that trust property must be included in a settlor’s gross estate solely because the settlor retained the power to manage trust assets. On the contrary, since our decision in Reinecke v. Northern Trust Co., 278 U.S. 339, 73 L Ed 410, 49 S. Ct. 123, 66 ALR 397 (1929), it has been recognized that a settlor’s retention of broad powers of management does not necessarily subject an inter vivos trust to the federal estate tax.”

Second, the Court held that Mr. Byrum did not have a retained “right” as described in Section 2036(a)(2), because of the fiduciary duty that Mr. Byrum owed to the corporation:

“It must be conceded that Byrum reserved no such “right” in the trust instrument or otherwise. The term “right,” certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O’Malley. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to “regulate the flow of dividends” to the trust. That “right” was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation. However great Byrum’s influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum’s desires with respect thereof.” 408 U.S. at 136-138.

The IRS summarized its understanding of the Byrum holding and reasoning as follows: “The court concluded that because of the fiduciary constraints imposed on corporate directors and controlling shareholders, the decedent ‘did not have an unconstrained *de facto* power to regulate the flow of dividends, much less the right to designate who was to enjoy the income.’ ” Rev. Rul. 81-15, 1981-1 C.B. 457. This is despite the Supreme Court’s acknowledgement in footnote 25 that its conclusion was not based just on the premise that “the general fiduciary obligations of a director are sufficient to eliminate the power to designate with the meaning of §2036(a)(2).”

An interesting position urged by the IRS in one private ruling is that the fiduciary duty doctrine of the Byrum case only applies if there are minority adverse interests who might question decisions made by the fiduciary. The IRS's view was that "interests of family members, employees, agents or other related or non-adverse persons do not represent minority interests, since whatever legal rights they may be perceived to have under Byrum are apt not to be exercised. Conversely, the presence of a single truly adverse minority interest would make the Byrum rationale applicable." Ltr. Rul. 8038014. This factor was also mentioned in Strangi (discussed below).

Several cases involving controls by a decedent over a family limited partnership have provided further discussion of the impact of Byrum on retained powers. In Kimbell v. U.S., 91 AFTR 2d 2003-585 (N.D. Tex. 2003), the court found that the decedent retained the rights to possession of the economic benefits of the property (§ 2036(a)(1)) and the right to designate who would benefit from the income of the property (§2036(a)(2)). There is no need in this case to search for an implied agreement, because the decedent had the right under the agreement to remove the general partner at any time and appoint herself as the general partner. As the general partner, she could then control distributions. The estate contended that even if the decedent were the general partner, she still would not have sufficient powers to require inclusion under section 2036 because her powers would be held in a fiduciary capacity. The Supreme Court held in U.S. v. Byrum, 408 U.S. 125 (1972) that section 2036 did not apply to a decedent who retained voting interests in several corporations. The Kimbell court reasoned that "Byrum ... was expressly overruled by Congressional enactment of § 2036(b)." Furthermore, even if Byrum were applicable, the partnership agreement expressly provides that the general partner will not owe a fiduciary duty to the partnership or to any partner. This last factor makes the Kimbell case clearly distinguishable, and the court's statement that the Byrum case is overruled by § 2036(b) is just wrong.

In Strangi v. Comm'r, T.C. Memo 2003-145 (2003), the court had an extended analysis rejecting a broad fiduciary duty exception under Byrum. The court pointed to various distinguishing factual distinctions, in its case involving a family limited partnership in which an agent of the decedent held a 47% interest in a corporation that served as the general partner of the partnership and that gave the general partner the sole discretion to determine distributions. The court's distinctions include the following.

(1) Independent Trustee. In Byrum, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an independent trustee who had the sole authority to pay or withhold income. In Strangi, distribution decisions were made by the corporation. The decedent owned 47% of the stock and was the largest shareholder. All decisions were ultimately made by decedent's attorney-in-fact as the manager of the corporation and partnership.

(2) Economic and Business Realities. The flow of funds in Byrum was dependent on economic and business realities of small operating enterprises that impact the earnings and dividends. "These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets."

(3) Fiduciary Duties. Fiduciary duties in Byrum were distinguished because there were unrelated minority shareholders who could enforce these duties by suit. "The rights to designate traceable to decedent through [the corporation] cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of [the corporation's] directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of [the corporation], and his own children held 52 of the remaining 53%. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, *supra*, scenario." The fact that there was a 1% shareholder of the corporation was "no more than window dressing." "A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight." (OBSERVATION: Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties seems

inconsistent with cases that have held that very broad administrative powers retained by a donor as trustee do not invoke section 2036, primarily because of the restriction imposed by the fiduciary duties. Those cases involve trust transactions that do not involve any unrelated parties. E.g. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could “very substantially shift the economic benefits of the trust” did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review). In addition, several earlier Tax Court cases relied on the fiduciary duty exception regarding powers that may affect distributions. Estate of Gilman, 65 T.C. 296 (1975), *aff’d per cur.* 547 F.2d 32 (2nd Cir. 1976)(no estate inclusion; decedent was co-trustee with power to vote stock; there was active conduct of a business and 40% of voting shares of corporation were held by sisters and there was family disharmony); Estate of Cohen, 79 T.C. 1015 (1982)(§2036(a)(2) did not apply to decedent as co-trustee of Massachusetts real estate trust; because courts hold business trustees to a “fair standard of conduct,” the decedent and his sons [as co-trustees] did not have the power to withhold dividends arbitrarily.) One commentator has observed that interpreting Byrum to apply only if there are unrelated parties involved means that “Byrum would not apply to the vast majority of closely held corporations owned entirely by related parties. It may be questioned whether the Supreme Court intended its decision in Byrum to be so limited in its precedential value.” Mulligan, Courts Err in Applying Section 2036(a) to Limited Partnerships, EST. PL. (Oct. 2003). E.g., Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, Tax Notes 1153, 1157-58 (Sept. 1, 2003) (“It is true that, in Byrum, in the course of discussing the constraining nature of the fiduciary duty imposed on the grantor and the corporate directors he could select, the Court did allude to the fact that there were minority shareholders unrelated to the decedent. This raises the question whether the presence of these shareholders was critical to the Court’s holding. The structure of the decision, as well as the backdrop of a well-accepted exception grounded in fiduciary duty principles, suggests it was not.... This reading is consistent with Rev. Rul 73-143, which implicitly adopts the principle that a fiduciary duty owed to a family member can so circumscribe the grantor’s retained discretion so as to preclude it from being characterized as a right.... In Rev. 81-15, invoking Byrum’s fiduciary-duty analysis, the Service concluded that section 2036(a)(2) did not apply in the case of corporate stock where the decedent had retained voting rights even though the only shareholders were apparently the decedent and a family trust created by the decedent.”)

Strangi’s interpretation of the Byrum case is far more restrictive than the IRS’s published interpretation of Byrum in Rev. Rul. 81-15, 1981-1 C.B. 457, which suggests a general fiduciary duty analysis as the rationale for the Supreme Court’s decision in Byrum. (Interestingly, the court cites the IRS’s unpublished rulings interpreting Byrum with respect to partnerships [PLRs 9415007, 9310039, & TAM 9131006] and discounts those rulings as having no precedential force, but does not cite the IRS’s published position interpreting the fiduciary duty analysis in Byrum. Under CC-2003-014, Chief Counsel attorneys cannot argue contrary to “final guidance.” Final guidance includes Revenue Rulings. Accordingly, Chief Counsel attorneys cannot argue contrary to positions in Revenue Rulings that have not been modified or withdrawn. The fact that subsequent cases have been more favorable to the government is irrelevant.

For discussions of the “fiduciary exception” under Byrum in light of these recent family limited partnership cases, see Hellwig, Estate Tax Exposure of Family Limited Partnerships Under Section 2036, 38 REAL PROP., PROB. & TR. J. 169 (Spring 2003)(view that Byrum does not create a broad fiduciary duty exception); Gans & Blattmachr, Strangi: A Critical Analysis and Planning Suggestions, TAX NOTES 1153 (Sept. 1, 2003); Korpics, The Practical Implications of Strangi II for FLPs—A Detailed Look, 99 J. TAX’N 270 (Nov. 2003); Mezzullo, Is Strangi a Strange Result or a Blueprint for Future IRS Successes Against FLPs?, J. TAX’N (July 2003).

- d. Broad Powers to Allocate Between Income and Principal. Even broad authority to allocate receipts and disbursements between income and principal will not trigger

Sections 2036 or 2038. E.g., Old Colony Trust Co. v. U.S., 423 F.2d 601, 604 (1st Cir. 1970); Estate of Budd v. Comm’r, 49 T.C. 468 (1968); cf. Treas. Reg. § 20.2056-5(f)(4) (“power to determine the allocation or apportionment of receipts and disbursements between income and corpus” will not disqualify spouse’s income interest from qualifying for marital deduction).

- e. Broad Investment Authority. Various cases recognize that authorizing the trustee to invest in investments that would not otherwise be permissible under state law or to sell or exchange trust assets does not invoke Sections 2036 or 2038. E.g., United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Ford v. Comm’r, 53 T.C. 114 (1969), *nonacq.* 1978-2 C.B. 3, *aff’d per curiam*, 450 F.2d 878 (2d Cir. 1971).
- f. “All Powers As I Would Have If Trust Not Executed”. A rather common catch-all administrative power is to say that the trustee can exercise any powers that the settlor could have exercised over the property if it had not been transferred to the trust. This type of common catch-all provision has been found not to trigger application of Sections 2036 or 2038. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970) (reasoning that such language does not protect trustees from accountability to the court for exercise of the power).
- g. Substitution Powers. A power of the grantor to substitute assets of equivalent value does not cause Section 2036 or 2038 to apply where it is held in a fiduciary capacity. State Street Co. v. U.S., 263 F.2d 635 (1st Cir. 1959) (court concluded, in a “very close” case, that broad management powers, including the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to Section 2036 to apply). Despite the State Street decision (where the court barely found the predecessor to Section 2036 to apply when the donor, albeit as a fiduciary, could exchange assets with the trust *without regard to values*), the IRS again argued that a substitution power *for equal value* held by the grantor-trustee constituted a power to alter amend or revoke the instrument in Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975). The court disagreed, reasoning that any property substituted should be ‘of equal value’ to property replaced, so the grantor was thereby prohibited from depleting the trust corpus. The court viewed that as being no different than the case where a settlor retains the power to direct investments. The IRS subsequently acquiesced in the case. 1977-2 C.B. 1.

What if the grantor retains a substitution power in a *nonfiduciary* capacity (to cause the trust to be a grantor trust under Section 675(4)(C))? In Jordahl, the grantor who held the substitution power was a trustee, and held the power in a fiduciary capacity. However, the court’s reasoning suggests that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity. The IRS has issued various private letter rulings agreeing with this conclusion. See Section II.C.3.e of this outline.

- h. Management Powers Over Partnership.
- i. Effect of Exculpatory Clause Limiting Trustee’s Personal Liability.
- j. Effect of Guarantees.
- k. Administrative Powers That CANNOT Be Retained by Grantor. The prior subsections have addressed various administrative powers that do not cause inclusion under Sections 2036 or 2038. There are two situations where administrative powers cannot be retained by the grantor. (In addition, certain controls over the appointment of trustees, such as removal powers, may have adverse consequences. They are addressed in section II.B.5. of this outline.)
 - (1) Voting Powers. The IRS argued in the past that retaining voting powers over stock that is transferred to a trust constitutes a power causing inclusion under Section 2036(a)(2). The Supreme Court ultimately rejected this argument in U.S. v. Byrum, 408 U.S. 125 (1972). (The Byrum case is discussed in detail in section II.B.4.c. of this outline.) In response, the IRS (nine years later) withdrew an earlier ruling that stated that a power to control dividends by the right to vote nontransferred stock constituted a Section 2036(a)(2) power. Rev. Rul. 81-15, 1981-1 C.B. 457, *rev’g*, Rev. Rul. 67-54, 1967-1 C.B. 269.

In 1976, Congress passed the “anti-Byrum” amendment, enacting the predecessor to Section 2036(b). That Section provides that a grantor’s retention of the power to vote shares in a “controlled corporation” is deemed to be the retention of the enjoyment of the property for purposes of Section 2036(a)(1). Interestingly, this legislative response to the issue leaves undisturbed the Byrum holding as to Section 2036(a)(2).

Section 2036(b) imposes two requirements: (1) there must be a controlled corporation, and (2) the decedent must have retained voting rights.

As to the first requirement, a corporation is a “controlled corporation” if at any time after the transfer of stock and during the three year period ending on the date of the decedent’s death, the decedent owned (taking into account the attribution rules of Section 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock. I.R.C. § 2036(b)(2).

As to the second requirement, the grantor must retain the right to vote (directly or indirectly) the stock that is transferred. The right to vote nontransferred stock does not count, and the grantor may give non-voting stock and retain even all of the voting stock of the corporation. Prop. Reg. § 20.2036-2(a). Proposed regulations (that have been outstanding for years) take the position that the grantor retains the right to vote, for this purpose, if the power is merely exercisable in a fiduciary capacity as trustee or co-trustee, or where the grantor may appoint himself as trustee. Prop. Reg. § 20.2036-2(c). There is a right to vote “indirectly” if there is any agreement, either express or implied, as to how the shareholder will or will not vote the stock. *Id.* However, the mere fact that persons whose ownership of stock would be attributed to the grantor under Section 318 have the right to vote stock will not be treated as a retention of voting power by the grantor. *Id.*

In addition, the IRS takes the position that if stock of a controlled corporation is transferred to a partnership of which the grantor is a general partner and has the right to vote the stock as general partner, Section 2036(b) applies. That is the case even if the voting rights are subject to the fiduciary duties of a general partner. Tech. Adv. Memo. 199938005, docketed in the Tax Court as Estate of Coulter v. Comm’r, Docket No. 17458-99. . Some commentators disagree with the conclusion, because under state law a partner has no direct or indirect rights with respect to the property of the partnership. Under this argument, the insured-transferor who is the general partner “has no individual right to vote that stock. Only the partnership has the right to vote that stock.” Eastland, The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES, at p.107-10 (Nov. 2003).

Observe that Section 2036(b) has its own three-year rule, rather than just using the three-year rule in Section 2035. The difference is that the Section 2036(b) provision applies if the grantor held the power to vote at any time within three years prior to death, whereas Section 2035 does not apply as long as the relinquishment of any problematic power occurs automatically under the agreement without any volition on the part of the grantor. Accordingly, any right that the grantor has as trustee (or otherwise) to vote stock in a controlled corporation must be relinquished at least three years before the grantor dies, or else estate inclusion will result under Section 2036(b). For example, if the grantor of a GRAT is the trustee during the initial term of the GRAT, the grantor would have to survive at least three years after relinquishing any voting power over controlled corporation stock. Therefore, if stock of a controlled corporation is being contributed to a GRAT, (1) the grantor either should not serve as trustee at all, (2) the grantor should resign as trustee or in some other manner give up the right to vote the stock at least three years before the GRAT terminates, or (3) there must be a co-trustee who would hold all of the voting power with respect to stock of any controlled corporation and the grantor must be precluded from ever holding any power to vote such stock.

(2) Incidents of Ownership Over Life Insurance. Section 2042 provides that life insurance proceeds are included in the insured's estate if (i) the proceeds are payable to or for the benefit of the insured's estate, or (ii) if the insured, at his death, possessed any incidents of ownership in the policy, exercisable either alone or in conjunction with any other person. The term "incidents of ownership" has been interpreted very broadly, and includes just about any power over the policy, including the following powers: to change the beneficiary; to surrender or cancel the policy; to assign the policy; or to pledge the policy for a loan or obtain a loan on the policy from the insurer. Treas. Regs. § 20.2042-1(c)(2). In addition, incidents of ownership include the power to elect a settlement option, *In Re Estate of Lumpkin*, 474 F.2d 1092 (5th Cir. 1973), or to veto the owner's right to assign the policy or designate policy beneficiaries, Rev. Rul. 75-70, 1975-1 C.B. 301. However, the insured's merely making a loan to a trust to enable it to pay premiums is not an incident of ownership in the policy as long as it is not used as collateral for the loan. Ltr. Rul. 9809032.

Any such powers held by the insured in a fiduciary capacity will be treated as if the insured held the incidents of ownership for purposes of Section 2042. Treas. Reg. § 20.2042-1(c)(4); *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert denied*, 427 U.S. 977 (1976); *Freuhauf v. Comm'r*, 427 F.2d 80 (6th Cir. 1970); *but see Bloch v. Comm'r*, 78 T.C. 850 (1982). Under Revenue Ruling 84-179, an insured who holds powers over a policy in a fiduciary capacity will avoid Section 2042 only if all of the following are satisfied: (i) the powers are held only in a fiduciary capacity, (ii) the powers are not exercisable for the insured's personal benefit, (iii) the insured did not transfer the policy to the trust and did not transfer to the trust from personal assets any of the consideration for purchasing or maintaining the policy by the trust, and (iv) the insured did not obtain his trustee powers through some prearranged plan in which the insured participated. 1984-2 C.B. 195. The last two requirements would not be satisfied where the insured transfers an insurance policy to a trust and serves as the trustee or became trustee through some prearranged plan.

Even if the insured is not the initial trustee, if the insured can appoint himself as trustee, the insured will be treated as holding incidents of ownership in the policy. Furthermore, if the insured just has the power to remove and appoint a replacement trustee, the insured may be treated as holding any incidents of ownership held by the trustee. The general effects of trustee removal powers are addressed in section II.B.5.g. of this outline. The effects of removal powers for purposes of Section 2042 are discussed in section II.B.5.h. of this outline.

- I. **Summary of Trustee Selection Issues With Respect to Administrative Powers.** Administrative or management powers of the trustee will generally not cause inclusion under Section 2036 or 2038, even if the grantor is the trustee or has the power to become trustee. The cases have reached this conclusion by relying on the authority of a court to review the trustee's actions under its fiduciary duty; therefore the trustee does not have unfettered control. Accordingly, if the grantor is or may become the trustee, be wary of including language giving extremely broad management powers that are purportedly to be exercised solely in the trustee's discretion without any court control. (That type of language is probably not enforceable anyway, but why push the envelope?) Similarly, be wary of using extremely broad exculpatory provisions if the grantor is or may become the trustee.

Two powers that the grantor cannot have without adverse tax consequences are (1) the right to vote stock of a "controlled corporation" that the grantor contributes to the trust, and (2) any incidents of ownership over life insurance policies on the grantor's life. As an example, if the grantor of a GRAT serves as trustee during the initial term, he should not have the power to vote stock if "controlled corporation" stock is conveyed to the GRAT—because the grantor would have to survive at least three years after ceasing to serve as trustee (with

the power to vote) before the assets would be excluded from the grantor's estate for estate tax purposes.

5. Trustee Removal and Appointment Powers.

- a. Power to Appoint Self at Any Time. The grantor will be treated as holding any dispositive or management powers held by the trustee if the grantor can appoint himself as the trustee at any time. Treas. Reg. § 20.2036-1(b)(3) (power to remove trustee and appoint himself); Estate of McTighe v. Comm'r, 36 T.C.M. 1655 (1977) (power to substitute self as trustee and power of trustee to make distributions in satisfaction of grantor's support obligations).
- b. Contingent Power to Appoint Self as Successor Trustee. If the grantor has a contingent power to appoint himself as trustee upon the occurrence of an event that is out of his control (such as a prior trustee ceasing to serve due to his death or resignation), Section 2038 does not apply, but Section 2036(a) does apply. Estate of Farrel v. U.S., 553 F.2d 637 (Ct. Cl. 1977) (trustees, under provisions of irrevocable trust, had right to designate persons who would possess trust property and income; settlor could designate herself as trustee if vacancy occurred in office of trustee during her life, and settlor had opportunity to appoint two successor trustees before her death; held, right of trustee to designate beneficiaries would be attributed to settlor); Estate of Alexander v. Comm'r, 81 T.C. 757 (1983); Rev. Rul. 73-21, 1973-1 C.B. 405; See Treas. Reg. § 20.2036-1(b)(3). (At least one case has disagreed with this position, but most have agreed with it. See section II.B.3.e.(3) of this outline.)
- c. Power to Appoint Self as Co-Trustee. Sections 2036 and 2038 apply to powers held jointly with someone else. Therefore, the ability to add one's self as a co-trustee would be just as damaging as being able to become sole trustee—unless the trust instrument reserved the problematic power just for the co-trustee other than the grantor. See section II.B.3.d.(2) of this outline.
- d. Veto Power. A corollary to the co-trustee rule is that a power reserved by the grantor to veto actions of the trustee will cause the grantor to be treated as holding the powers of the trustee over which the veto power may be exercised. See section II.B.3.d.(4) of this outline.
- e. Power to Appoint a Series of Successor Trustees. Is the power to appoint a series of trustees in effect a power to "amend" the trust that would be subject to Section 2038? No case has directly addressed that argument, although that type of power has been present in a variety of reported cases that have addressed Section 2036 and 2038. E.g., Estate of Budd v. Comm'r, 49 T.C. 468 (1968) ("power to appoint a successor trustee or trustees by instrument in writing lodged with said successor trustee or trustees, and specifying the date or event upon which the appointment of such successor trustee or trustees shall take effect").
- f. Power to Add Co-Trustees (Not Including Self). If the grantor merely has the power to add co-trustees, the grantor generally should not be treated as holding the powers of the trustees, as long as he cannot appoint himself. Durst v. U.S., 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, and there was no estate inclusion). Nevertheless, there is concern that if the grantor can keep adding co-trustees indefinitely, the grantor could control the trustees' decision by just appointing trustees who would agree with his position. Even in that situation, there would still be the argument that the grantor has no real power at all, because anyone he appoints is subject to fiduciary standards and control of the courts, unless an express or implied agreement could be shown. See Estate of Vak v. Comm'r, 973 F.2d 1409 (8th Cir. 1992) (transfer constituted completed gift; court rejected IRS's argument that donor "had the power to replace trustees with individuals who would do his bidding"); Estate of Wall v. Comm'r, 101 T.C. 300, 312 (1993) ("a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take") (See section II.B.2.c.(1)(a) of this outline regarding the implied agreement principle.)

- g. Power to Remove and Replace Trustee—Sections 2036 and 2038. If the grantor could remove the trustee and appoint himself, it has long been clear that the grantor is treated as holding the powers of the trustee for purposes of Sections 2036 and 2038. See section II.B.5.a of this outline, above. There is a long history of disagreement as to the tax effect of the grantor's power to remove the trustee and appoint someone other than the grantor as successor trustee. Since 1995, there is now a very clear objective safe harbor, but a brief review of the history of this issue may help provide perspective (and help to analyze situations where the safe harbor is not met.)

In a 1977 revenue ruling, the IRS ruled on a situation in which the decedent held the power to appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process. The IRS ruled that Section 2036 did not apply because "the decedent's power to appoint a successor corporate trustee in the event of resignation or removal of the original trustee did not amount to a power to remove the original trustee that, in effect, would have endowed the decedent with the trustee's discretionary control over trust income." Rev. Rul. 77-182, 1977-1 C.B. 273.

The IRS followed that with the now infamous Revenue Ruling 79-353, 1979-2 C.B. 325, which takes the position that the right to remove a corporate trustee without cause and appoint a successor corporate trustee caused estate inclusion under Sections 2036 and 2038. The IRS posited that this removal and appointment power was an "extremely potent power," even though the decedent was forced to appoint a successor corporate trustee. After receiving considerable criticism of the ruling, the IRS relented somewhat in 1981, and agreed that Revenue Ruling 79-353 would apply only to transfers after the date of the 1979 ruling. Rev. Rul. 81-151, 1981-1 C.B. 458.

The first court case to address the IRS's position in Revenue Ruling 79-353 was Estate of Vak, which held that the grantor's unlimited power to remove the trustee and appoint a successor independent trustee (who was not a related or subordinate party under Section 672(c)) did not prevent the grantor from making a completed gift when the transfer to the trust was made. The case summarily rejected the IRS's position that "Mr. Vak had the power to replace the trustees with individuals who would do his bidding." Estate of Vak v. Comm'r, 973 F.2d 1409 (8th Cir. 1992).

The IRS next urged its position under Sections 2036 and 2038 regarding removal powers in Estate of Wall. That case presented facts very similar to the facts of Revenue Ruling 79-353. Estate of Wall v. Comm'r, 101 T.C. 300 (1993). The IRS's position was "that even a corporate trustee will be compelled to follow the bidding of a settlor who has the power to remove the trustee; otherwise the settlor will be able to find another corporate trustee which will act as the settlor wishes. In other words, says respondent, under these circumstances the settlor has the de facto power to exercise the powers vested in the trustee." 101 T.C. at 311. The Tax Court rejected this argument, relying primarily on the fiduciary duty of any trustee that might be appointed by the grantor:

"[U]nder established principles of the law governing trusts, a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the settlor, prior to appointment, as to how fiduciary powers should be exercised over the distribution of income and principal. The trustee has a duty to administer the trust in the sole interest of the beneficiary, to act impartially if there are multiple beneficiaries, and to exercise powers exclusively for the benefit of the beneficiaries.

...

In the absence of some compelling reason to do so, which respondent has not shown, we are not inclined to infer any kind of fraudulent side agreement between Mrs. Wall and First Wisconsin as to how the administration of these trusts would be manipulated by Mrs. Wall. Instead, since the language of the trust indentures provides maximum flexibility as to distributions of income and principal, the trustee would be expected to look to the circumstances of the beneficiaries to whom sole allegiance is owed, and not to Mrs. Wall, in order to determine the timing and amount of discretionary distributions." 101 T.C. at 312-313.

The IRS concluded by relying on the Supreme Court's analysis of Section 2036 in U.S. v. Byrum, 408 U.S. 125 (1972), to conclude that the grantor did not retain an ascertainable and enforceable power to affect the beneficial enjoyment of the trust property. 101 T.C. at 313.

Following its losses in Estate of Vak and Estate of Wall, the IRS changed its position in Revenue Ruling 95-58, 1995-2 C.B. 1. The ruling revokes Revenue Ruling 79-353 and Revenue Ruling 81-51. In addition, it modified Revenue Ruling 77-182 "to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent would not have retained a trustee's discretionary control over trust income." In effect, the ruling allows a safe harbor based on the facts of the Vak case. The safe harbor is that Sections 2036 and 2038 will not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was "not related or subordinate to the decedent" within the meaning of Section 672(c). (Interestingly, this position is consistent with the removal provisions in the income tax regulations for grantor trusts. Treas. Reg. § 1.674(d)-2.)

Thus, the grantor can retain an unlimited right to remove the trustee, and there is no requirement that a successor corporate trustee be appointed. However, the IRS does add the requirement that, to come within the safe harbor, the successor trustees must not be a "related or subordinate party."

In many situations, the grantor will want to have a removal power and have the power to appoint someone other than the grantor, but the grantor may want to keep the ability to name relatives or others who would not come within the safe harbor. The grantor will need to weigh the desire for the retained flexibility vs. the comfort of coming within the safe harbor of Revenue Ruling 95-58. If the grantor decides to keep the more expansive ability to appoint relatives as successor trustees, the grantor would rely on the broad language in Estate of Wall relying primarily on the fiduciary duty of any trustee who might be appointed.

- h. Power to Remove and Replace Trustee—Section 2042. Revenue Ruling 79-353, 1979-2 C.B. 325 held that retaining the ability to remove a trustee gave the grantor all of the powers of the trustee for purposes of Sections 2036 and 2038, but did not address Section 2042.

Technical Advice Memo 8922003 held, in reliance on Revenue Ruling 79-353, 1979-2 C.B. 325, that the ability of the insured to remove the trustee *without cause* and appoint someone other than the insured as successor trustee resulted in the insured holding incidents of ownership.

Revenue Ruling 95-58, 1995-2 C.B. 1, revoked Revenue Ruling 79-353 (which addressed Sections 2036 and 2038) and provided that those Sections would not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was "not related or subordinate to the decedent" within the meaning of Section 672(c).

The revocation of Revenue Ruling 79-353 seems to imply that the extension of its rationale to Section 2042 in TAM 8922003 is no longer valid. Furthermore, Letter Ruling 9832039 cited Revenue Ruling 95-58's revocation of Revenue Ruling 79-353 to support its conclusion that the power to remove a trustee *for cause* did not trigger Section 2042. (However, the citation to Revenue Ruling 95-58 was not necessary because the power to remove a trustee *for cause* was probably not an incident of ownership even prior to Revenue Ruling 95-58.) See Janson, Life Insurance Potpourri—Recent Developments and Private Split Dollar Plans, 34TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 401.5.C. (2000).

The IRS has not addressed the effect of a removal power *without cause* for purposes of Section 2042, but it would probably be treated the same as for Sections 2036 and 2038 under Revenue Ruling 95-58. See Ltr. Rul. 200314009 (if trustee ceased to serve or was removed, insured could appoint successor trustee who was not related or subordinate to insured; held that section 2042 did not apply; ruling did not clarify whether insured held a removal power, but the reasoning of the ruling seems to apply Rev. Rul

95-58 for §2042 purposes); Covey, Recent Developments in Transfer Taxes and Income Taxation of Trusts and Estates, 35TH ANNUAL UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 120 (2001) (suggesting that the IRS likely will not take a harsher position under Section 2042 than under Sections 2036 and 2038, observing that the IRS has taken same position in PLR 9746007 regarding the effect of removal powers on a beneficiary under Section 2041).

- i. Disability of Grantor. The disability of the grantor will have no impact on powers that may be held by the grantor with respect to any of the prior subsections regarding trustee appointment powers. See section II.B.3.d.(5) of this outline.
 - j. **Summary of Selection of Trustee Issues Regarding Trustee Removal and Appointment Powers**. If the trustee holds powers that would cause estate inclusion if the grantor held the powers directly, the following restrictions apply regarding appointment procedures to avoid estate inclusion by reason of the appointment powers. The grantor cannot have the power to appoint himself—even a power contingent upon the occurrence of future conditions outside his control. Also, the grantor cannot serve as a co-trustee or have a power to veto actions by the trustee. The grantor can, however, keep the power to appoint a successor or series of successor trustees in the future (apparently) or to add co-trustees. The grantor can keep the power to remove and replace the trustee (with someone other than the grantor) as long as the successor is someone who is not related or subordinate to the grantor. If the grantor wants to have the ability to remove and appoint a successor (other than himself) is who a related party, the parties would have to rely on the reasoning of Vak and Wall that any successor trustee would be subject to fiduciary duties, but that procedure would not be within the safe harbor that is clearly recognized by the IRS.
6. Special Trusts.
 - a. Minor's Trusts Under Section 2503(c)
 - b. Special Needs Trust
 - c. Qualified Domestic Trust
 - d. S Corporation
 - e. Charitable Remainder Trust appraisal of the trust assets each year.
 - f. Grantor Retained Annuity Trust (GRAT).
- C. Federal Income Tax Issues.
1. Foreign Trust Status and Effects.
 - a. Tax Concerns With Being Foreign Trust. Various tax complexities arise for foreign trusts. A few of them are described.
 - (1) Reporting Requirements. U.S. beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the IRS on Form 3520. (Additional required information is described in Notice 97-34.) In addition, a U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made. In addition, the foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust may be liable for a 5% penalty of the value of the trust assets that are treated as owned by that person. I.R.C. § 6677(b). If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S. grantor must report the transfer. I.R.C. § 679(a)(5).
 - (2) Foreign Grantor Trust. If a U.S. grantor establishes a foreign trust for the benefit of U.S. beneficiaries, it is treated as a grantor trust. I.R.C. § 679. Upon termination of grantor trust status (i.e., at the death of the grantor or if there are no longer any U.S. beneficiaries), Section 684 imposes a tax on the unrealized appreciation. However, if that occurs because of the death of the grantor, the step-up in basis under Section 1014 should avoid having any gain to which Section 684 would apply.
 - (3) Foreign Nongrantor Trust. If a foreign trust is not treated as a grantor trust (which, for example, could occur despite Section 679 if it is created in a testamentary transfer at

the death of the U.S. grantor, or it is created by a non-U.S. grantor, or if it is created during the lifetime of a U.S. grantor and does not have any U.S. beneficiaries) special income tax rules apply. It is subject to U.S. income tax only on certain types of income (primarily income effectively connected with a U.S. trade or business, I.R.C. § 871(b), U.S. source fixed or determinable annual or periodic income [such as interest, dividends, and rents], I.R.C. § 871(a)(1)(A), U.S. source gains, I.R.C. § 871(a)(1)(B & D), or income on the disposition of U.S. realty, I.R.C. §871(a)(1)(A)).

U.S. beneficiaries of foreign nongrantor trusts are subject to several special rules. DNI of a foreign nongrantor trust is determined under special rules, a primary distinction of which is that capital gains are included in DNI. I.R.C. § 643(a). The ticking time bomb for foreign nongrantor trusts is that if all of the DNI is not distributed each year, accumulation distributions (again determined under very special rules in Section 665(b)) are subject to the imposition of a tax under the throwback rule, I.R.C. § 665(d). Furthermore, the tax under the throwback rule is increased by an interest charge. I.R.C. §§ 667(a)(3) & 668. The interest rate is the floating interest rate under Section 6621 that applies to underpayments of tax generally.

(4) Cannot Be S Corporation Shareholder. A foreign trust is not an eligible S corporation shareholder. I.R.C. § 1361(c)(2) (last sentence).

(5) Bottom Line—Substantial Complexity and Possible Increased Tax Costs. The extremely brief preceding summary of some of the tax effects of foreign trusts demonstrates that the tax rules become substantially more complex, with huge penalties for failure to file required information to the I.R.S., and with potentially increased taxes (with interest charges).

b. Selection of Trustee Can Cause Foreign Trust Treatment. A trust is a foreign trust unless both of the following tests are satisfied: (1) courts in the U.S. must be able to exercise primary supervision over the trust; and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. I.R.C. §§ 7701(a)(30)(E) & (31)(B). A foreign person is someone who is not (among other things) a U.S. citizen or resident, or a U.S. domestic corporation. If a foreign person has control over only one “substantial decision,” foreign trust status results. “Substantial decisions” are defined in the regulations to mean “all decisions other than ministerial decisions.” Treas. Reg. § 301.7701-7(d)(1)(ii).

Examples are included that are very expansive, including not only the power to determine the timing, amount and selection of beneficiaries, but other administrative actions such as making income/principal allocations, investment decisions, and compromising claims. The definition even includes the power to appoint a successor trustee (unless it is restricted so that it cannot change the trust’s residency) and the power to remove, add, or replace a trustee. Id.

c. Summary of Selection of Trustee Issues Regarding Foreign Trusts. **Do not appoint a foreign person (anyone other than a U.S. citizen or resident or a U.S. domestic corporation) as a trustee with the power to control any substantial decision— unless the planner (who really knows what he or she is doing with foreign trusts) purposefully wants the trust to be a foreign trust. (This generally means that any non-U.S. person or persons must be less than half of the trustees, and no decisions are left specifically to their control even though non-U.S. persons are a minority vote.)**

2. Grantor Trust Rules—Effects of Grantor Trust Status.

a. Grantor Report Income For Income Tax Purposes.

b. Gift Tax Effects of Grantor’s Payment of Income Taxes on Trust’s Income.

c. Income Tax Reimbursement Provision. In PLR 9444033, the IRS stated in dicta that the failure to reimburse the grantor for income taxes would be considered a gift by the grantor to the remaindermen. The IRS subsequently reissued the ruling without the dicta in PLR 9543049 and has yet to challenge taxpayers on this issue. Rulings have approved various types of reimbursement provisions. PLRs 9415012, 9416009, 9353004, and 9353007. The IRS’s position created a dichotomy, because including an income tax reimbursement provision would seem to create some risk that the trust would be included in the grantor’s estate under section 2036 (by providing for payment of legal obligations

of the grantor.) See Treas. Reg. § 20.2036-1(b)(2). Various IRS private rulings previously held that there would be no inclusion under Section 2036(a). See Ltr. Ruls. 200120021; 199922062; 199919039; 9710006; 9709001; 9413045. However, the IRS changed its position in Revenue Ruling 2004-64, 2004-27 IRB 7.

Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under section 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation. (Situation 2) (The statement that the "full value of the trust assets" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death.) In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004.

- d. S Corporation Shareholder.
 - e. Sales Between Trust and Grantor.
 - f. Exclusion of Gain From Sale of Personal Residence.
3. Grantor Trust—Trust Provisions that Cause Grantor Trust Status.
- a. Power of Disposition by Related or Subordinate Parties Not Governed by Reasonably Definite External Standard.
 - (1) Overview.
 - (2) Section 674(a) General Rule.
 - (3) Section 674(b)(5) Exception for Corpus.
 - (4) Section 674(b)(6) Exception for Income.
 - (5) Section 674(c), Independent Trustees.
 - (6) Section 674(c), "Subservient to the Wishes of the Grantor."
 - (7) Section 674(d), Reasonably Definite External Standard.
 - (8) **Summary of Trust Provisions to Trigger Grantor Trust Status Under Section 674.**
Navigating all of the exceptions based on a dispositive power of the trustee requires very careful planning. A non-adverse party must serve as trustee with a power of disposition over trust assets (Section 674(a)). The instrument must not have reasonably definite external standards for distributions (to avoid Section 674(d)), and more than half of the trustees must be related or subordinate parties (to avoid Section 674(c)). In addition, the trustee should have a spray power over corpus distributions and not have to charge any distributions of corpus against the beneficiary's proportionate share of corpus (to avoid Section 674(b)(5)). Also, the trust should permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries (to avoid Section 674(b)(6)). (Alternatively, to avoid Section 674(b)(6), if the grantor wishes to provide for "separate shares" for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and do not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment.)
 - (9) Does Not Have the Appearance of Just Being a "Grantor Trust" Provision.
 - (10) Giving Grantor's Spouse Power to Control Distributions Without a Reasonably Definite Standard.
 - b. Power of a Non Adverse Person to Distribute to or Accumulate Income for the Grantor or the Grantor's Spouse, §677(a)(1) or (2).
 - (1) Probably Results in Grantor Trust Treatment Only as to Income.

- (2) Grantor or Grantor's Spouse as Discretionary Beneficiary Plus Power of Appointment May Cause Grantor Trust Status As to Income and Corpus.
- (3) Grantor Trust Status May be Unintended.
- (4) Difficult to Relinquish Grantor Trust Status if Spouse is Discretionary Beneficiary
- (5) Grantor Status Would Be Terminated at Spouse's Death.
- c. Power of Non-Adverse Person to Use Income to Pay Life Insurance Premiums on Life of Grantor or Grantor's Spouse, §677(a)(3).
 - (1) Statutory Provision.
 - (2) Grantor Trust Treatment May Apply Only as to Actual Payment of Life Insurance Premiums.
 - (3) Not Useful to Assure Grantor Trust Status.
- d. Actual Borrowing of Trust Funds by Grantor or Grantor's Spouse Without Adequate Interest Or Security, §675(3).
 - (1) Actual Borrowing Required.
 - (2) Grantor Trust Status if Loan Outstanding Any Time During the Year.
 - (3) Unclear as To Portion of Trust Treated as Grantor Trust.
 - (4) Permits Toggling, But Close Supervision Required.
- e. Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets By Substituting Assets of Equivalent Value, §675(4)(C).
 - (1) Nonfiduciary Capacity Determination.
 - (2) Trustee Should Not Hold Power
 - (3) Retention of Power by Grantor.
 - (4) Substitution Power Held By Third Party.
 - (5) Substitution Power Held by Grantor's Spouse.
 - (6) Power of Substitution Held by Insured Not an Incident of Ownership.
- f. Power of Non-Adverse Trustee to Make Loans to the Grantor and/or Grantor's Spouse Without Adequate Security, §675(2).
 - (1) Mere Existence of Power Sufficient.
 - (2) Grantor Treated as Owner of Entire Trust.
 - (3) Power to Borrow Without Adequate Security is Sufficient.
 - (4) Non Adverse Party Other Than Grantor Should Hold the Power.
- g. Power of Non-Adverse Party to Add Beneficiaries, §674(b), §674(c), 674(d).
 - (1) Statutory Provisions.
 - (2) Who Should Hold the Power.
 - (a) Grantor.
 - (b) Grantor's Spouse.
 - (c) Beneficiary.
 - (d) Trustee.
 - (3) Classes of Beneficiaries That May Be Added.
 - (a) Charities.
 - (b) Specified Classes of Individuals.
 - (4) Special Power of Appointment.
 - (5) Checks and Balances.
- h. Foreign Grantor.
- i. **Summary of Selection of Trustee Issues With Respect to Grantor Trust Rules.** **The trust will be a grantor trust if the trust may make distributions to the grantor or grantor's spouse (probably only as to trust income) or if premium payments may be made on life insurance on the life of the grantor or grantor's spouse (probably only as to the amount of premiums actually paid during the year.)**

If the planner wants to avoid grantor trust status, use one of the following exceptions. (1) Use an independent trustee (no more than half of whom are related or subordinate parties) and give them the authority to distribute assets among a designated class of beneficiaries. (2) Use a trustee other than the grantor or grantor's spouse, whose distribution powers are limited by a reasonably definite external standard. (3) With no limitation on who is the trustee—as to corpus use a reasonably definite distribution standard (or have separate shares for the

beneficiaries), and as to income, either have (i) a vested trust for a single beneficiary, (ii) provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, or (iii) provide that on termination the assets may be appointed to appointees (other than the grantor or grantor's estate) if the trust is reasonably expected to terminate during the current beneficiary's lifetime. (4) Use an adverse party as trustee. Even if one of those exceptions is satisfied, also make sure the trust is not a foreign trust and that none of the proscribed administrative powers in Section 675 are present.

If the planner wants to trigger grantor trust status, use one (or more to be safe) of the following. (1) Select trustees and dispositive powers to flunk all of the exceptions in Section 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions. (2) Give a non-adverse party the power to add beneficiaries. (3) Give a non-adverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan. (4) Give the grantor a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case.)

4. Grantor Trust—Toggle Provisions.

- a. Desirability of Flexibility. A grantor may be concerned with being liable for what could potentially be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to “turn off” the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to “toggle” grantor trust status could be achieved. For an excellent discussion of these issues, see Van Hoften, Planning With Intentionally Defective Grantor Trusts, ALI-ABA Video Law Review 207 (March 26, 1997).
- b. General Guidelines to Maximize Flexibility.
 - (1) Use Different Persons to Trigger Power Verses Right to Relinquish or Reacquire Power. If the grantor has the right to relinquish a power that causes grantor trust status but has the right to reacquire that power, the relinquishment would not be given effect. The regulations provide specifically that if the grantor has a power broad enough to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under Section 675, he will be treated as the owner of the portion from the trust's inception. Treas. Reg. §1.675-1(a). Therefore, at a minimum, if the grantor has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power (to toggle back “on” the grantor trust status.) Furthermore, the grantor's retention of the right to toggle grantor trust status might arguably constitute a Section 2036(a)(2) estate inclusion power or arguably result in an incomplete gift.
 - (2) Adverse or Non-Adverse Party Could Hold Power to Relinquish and Reinstat The Grantor Trust Power.
 - (3) Spouse Holding Power to Relinquish or Reacquire Grantor Trust Powers
 - (4) Using Different Persons May Provide Helpful Checks and Balances
 - (5) Relinquishment Should Address Whether it Binds Successors
- c. Examples of Toggle Arrangements.
 - (1) Removal and Replacement Power of Trustees Where Power to Make Discretionary Distributions by Trustee Who is Not “Related or Subordinate” is Used to Cause Grantor Trust Status
 - (2) Third Party Having Authority to Cancel and Reinstat Substitution Power.
 - (3) Power to Loan to Grantor Without Adequate Security
 - (4) Power to Add Beneficiaries.

III. **BENEFICIARY TAX ISSUES**

A. Gift Tax Issues.

1. Exercise of General Power of Appointment.
2. Exercise Limited Power of Appointment.

- a. Mandatory Income Interest.
 - b. Discretionary Beneficial Interest.
 - c. **Summary.** If the instrument grants an inter vivos limited power of appointment to a trust beneficiary, the planner must recognize that the beneficiary will face this gift issue if he or she ever decides to appoint some or all of the trust assets during his lifetime. The gift tax issue could be avoided by giving the inter vivos power of appointment to someone other than the beneficiary. For example, the power of appointment might be granted to the beneficiary's spouse.
3. Gift By Beneficiary If Fail to Exercise Rights.
 4. Gift if Beneficiary/Trustee Makes Distribution to Another Under Discretionary Standard. A regulation indicates that a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a "reasonably fixed or ascertainable standard" (and the regulation goes on to give examples of standards that would qualify). Treas. Reg. § 25.2511-1(g)(2). The implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift would result.

For example, assume that Tom is trustee of a trust, and can make distributions to himself for "health, support and maintenance." In addition, he can make distributions to his siblings for their "health, support, maintenance, or happiness." Under the regulations, distributions from Tom to his siblings appear to be a gift. The regulation applies to any trustee that has "a beneficial interest in trust property." (Indeed, that language would suggest that the same gift result might occur if the trustee is not a current potential beneficiary but only has a contingent remainder interest.) Another unresolved issue is whether a power to make distributions in the discretion of the trustee, but not exceeding amounts needed for health, education, support and maintenance would be treated as a "reasonably fixed or ascertainable standard" for purposes of this regulation. There have been no cases or rulings interpreting that regulation in this context. However, commentators have advised planners of the potential issue. E.g., Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 503.2 (1986). That commentator suggests including a "savings clause" provision in instruments providing "that no trustee shall have any discretionary power, other than a power described in Regulations Section 25.2511-1(g)(2), to pay to other than himself any trust property in which he personally has a beneficial interest." Id. at. ¶ 506, p. 5-70 (1986).

Planners often focus on limiting the trustee's ability to make distributions to himself to only ascertainable standards, so that the trustee does not hold a general power of appointment. However, this regulation, if it is upheld, means that planners also need to limit the ability of trustees to make distributions for other beneficiaries to an ascertainable standard also if the trustee has any beneficial interest in the trust.

5. Gift if Beneficiary/Trustee Makes Distribution to Another Where Trustee's Determination "Is Conclusive".
6. Gift if Beneficiary/Trustee Fails To Makes a Distribution to Himself.
7. **Summary of Application of Selection of Trustee to Gift Tax Issues.** Once a beneficiary becomes trustee or otherwise acquires a power that constitute a general power of appointment, there is a permanent taint that is difficult to shed. If the beneficiary realizes that there is a problem while he is still alive, getting rid of the problematic power generally will cause the beneficiary to make a completed gift for gift tax purposes (unless he still has the power to shift benefits among other beneficiaries.)

In granting ascertainable distribution rights to beneficiaries, (including a trustee who is a beneficiary) realize that the IRS might conceivably argue for a gift if the beneficiary does not enforce his legal rights. If a trustee has any beneficial interest in the trust, the regulations say that the trustee makes a gift if he makes a distribution to other beneficiaries under a discretionary power to make distributions that is not limited by an ascertainable standard. To be safe, provide that any trustee who also has a beneficial interest in the trust is limited to a HEMS standard in making distributions to other

beneficiaries as well as to himself and do not provide that the trustee's determination in that regard is "conclusive" (or other words to that same effect).

B. Estate Tax Issues—Dispositive Powers.

1. Section 2041—General Rules.

a. General Rule.

- b. General Power of Appointment. An individual has a "general power of appointment" if he has the power to determine who (including himself) may become the owner of the property.

Under Section 2041, a decedent has a general power of appointment if he has a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; unless the power satisfies one of several important exceptions, discussed in the following subsections c-f below.

Sometimes the planner specifically wants to create a general power of appointment in a beneficiary (for example, to cause the trust assets to be included in the beneficiary's estate for estate tax purposes rather than being subject to the generation-skipping transfer tax.) Even though the general power of appointment is needed for some tax purpose, the settlor may wish to limit, as much as possible, the beneficiary's ability to divert the assets away from the settlor's family. The IRS has acknowledged that merely allowing exercise in favor of the creditors of the beneficiary's estate is sufficient to create a general power of appointment. E.g., Ltr. Rul. 8836023.

- c. Ascertainable Standard Exception. If the power to consume, invade or appropriate property for the decedent is limited by an ascertainable standard relating to his health, education, support, or maintenance, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(A). This exception is addressed in detail in section III.B.4. of this outline below.
- d. Joint Power—Exercisable With Grantor. If the power is exercisable only in conjunction with the creator of the power, it is not a general power of appointment. I.R.C. § 2041(b)(1)(B). (The policy behind this exception is that the creator of the power will likely have to include the property in his estate under Sections 2036 or 2038 if the grantor holds this power jointly with the power holder. See section II.B.3.d.(2-4) of this outline.)
- e. Joint Power—Exercisable With Person With Adverse Interest. If the power is exercisable only in conjunction with a person who has a "substantial interest" in the property which is adverse to the exercise of the power in favor of the decedent, the power is not a general power of appointment. I.R.C. § 2041(b)(1)(C)(ii).
- f. Joint Power-Exercisable With Person Who is Potential Appointee.
- g. Other Joint Powers.
- h. Contingent General Powers of Appointment. If the existence of the power is by its terms contingent upon an event that did not occur before the decedent's death, it is not a power "which the decedent has at the time of his death"—which is a requirement for estate inclusion under Section 2041. "For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred." Treas. Reg. § 20.2041-3(b). If, however, the occurrence of the contingency was within the decedent's control prior to his death, he is deemed to have possessed the power even though he did not actually trigger the condition. Estate of Kurz v. Comm'r, 68 F.3d 1027, 1030 (7th Cir. 1995) (decedent had power to withdraw 5% of family trust only if she first withdrew all of the marital trust; "the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment"). Kurz relied, in part, on the first sentence of regulation § 20.2041-3(b), which provides that the power is considered to exist on the date of death even though the exercise of the power is subject to the precedent giving of notice.

Under this same principle, the IRS has taken the position that the mere fact that a testamentary trust was not funded and the decedent had not accepted office as trustee, under which he would have the power to make distributions for his "reasonable comfort" or "best interests," did not preclude the decedent from being deemed to have a general power of appointment at his death. Tech. Adv. Memo. 9125002. The IRS reasoned that under local

law, an interest in property established by a will takes effect at the time of death unless the will provides otherwise. See Estate of Bagley v. United States, 443 F.2d 1266 (5th Cir. 1971) (husband and wife were killed in automobile accident; husband's will said wife would be deemed to survive in a common accident and gave wife a general power of appointment over property to qualify for marital deduction; wife's estate argued it did not have a general power of appointment because will had not been probated at time of her death; held, that power of appointment existed in the theoretical instant in which wife survived husband); Treas. Reg. § 20.2041-1(e) ("power of appointment created by will is, in general, considered as created on the date of the testator's death").

The effect of these rules regarding contingencies is that once conditions have occurred such that a beneficiary is qualified to accept office as trustee (with overly broad distribution powers), the beneficiary has a general power of appointment. The beneficiary cannot avoid the general power of appointment taint by merely declining to accept office as trustee. However, a power holder may "disclaim" a power, and not be considered as having released the power, if the requirements of Section 2518 are met. Treas. Reg. § 20.2041-3(d)(6)(i), referencing Reg. § 25.2518-2(c)(3); see Ltr. Rul. 9521032. An attempt to disclaim a general power of appointment by limiting it to a limited power to appoint to others, or by limiting it to an ascertainable standard may not be recognized. Ltr. Rul. 8149009; Goudy v. United States, 86-2 USTC ¶ 13,690 (D. Ore. 1986), *revd. in unpub. opinion* (9th Cir. 1988); Treas. Reg. § 20.2041-3(d)(6). Under Section 2518, the power holder generally must disclaim the power within nine months after the transfer creating the power. Treas. Reg. § 25.2518-2(c)(3).

- i. Effect of Incompetency of Power Holder.
 - j. Reciprocal Powers. The IRS applied an analogy of the reciprocal trust doctrine to general powers of appointment in private letter rulings 9235025 and 9450159.
2. Independent Trustee With Complete Discretion.
- a. General Rule—No General Power of Appointment.
 - b. Power to Bring Judicial Action to Compel Trustee to Make Distributions.
 - c. Giving Trustee Extremely Broad Discretion.
3. Beneficiary as Co-Trustee. Naming the beneficiary as a co-trustee (with someone who does not have a substantial adverse interest) does not help at all in avoiding Section 2041 if the co-trustees have the authority to make distributions to the beneficiary that are not subject to an ascertainable standard. See section III.B.1.g. of this outline.
- Naming a co-trustee to serve with the beneficiary, however, can be very helpful if the trust instrument restricts the beneficiary/co-trustee from participating in any decision to make distributions to himself beyond an ascertainable HEMS standard. As long as the beneficiary has no right to succeed to the powers held by that co-trustee, the broad distribution powers of the co-trustee will not be imputed to the beneficiary.
- Indeed, it is wise to use a "savings clause" that automatically restricts the beneficiary from taking any actions that might possible be construed as a personal benefit, unless those actions are limited by a HEMS standard, and to provide that any such actions would be taken only by the co-trustee. If no co-trustee is acting, the beneficiary/trustee could take steps to have the next successor trustee appointed as a co-trustee for the sole purpose of making that decision. See Section IV of this outline.
4. Beneficiary as Trustee—Distributions to Self as Beneficiary. The practical difficulty of applying Section 2041 in practice comes in the very common situation where the settlor wishes to name a beneficiary as trustee and give the beneficiary the authority to make distributions to himself.
- a. Ascertainable Standard Exception. As discussed above, there is an exception in the statutory language of Section 2041 for "a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent." I.R.C. § 2041(b)(1)(A). (This is unlike Sections 2036 and 2038, which contain no ascertainable standard exception in the statute. But that has not deterred the courts in fashioning an ascertainable standard exception for those sections also.)

- b. Regulations. The regulations give a variety of detailed examples of language that constitutes an ascertainable standard:

“A power is limited by such a standard if the extent of the holder’s duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words ‘support’ and ‘maintenance’ are synonymous and their meaning is not limited to the bare necessities of life. . . . Examples of powers which are limited by the requisite standard are powers which are limited by the requisite standard are powers exercisable for the holder’s ‘support,’ ‘support in reasonable comfort,’ ‘maintenance in health and reasonable comfort,’ ‘support in his accustomed manner of living,’ ‘education, including college and professional education’ ‘health,’ and ‘medical , dental, hospital and nursing expenses and expenses of invalidism.” Treas. Reg. § 20.2041-1(c)(2).

The regulation also gives the following examples of standards that do not constitute an ascertainable standard:

“A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard.” Id.

- c. Slight Difference in Language Can Be Critical. A very slight difference in language may produce a different result. For example, in Estate of Vissering v. Comm’r, the trustee authorized distributions “required for the continued comfort” of the beneficiary, as well as other standards. 990 F.2d 578 (10th Cir. 1994), *rev’g*, 96 T.C. 749 (1991). The Tenth Circuit acknowledged that the use of the word “comfort,” without further qualifying language, creates a general power of appointment. However, the trust language puts a limit on this word, saying it permits distributions only as “required”, not as “determined” or “desired.” Furthermore, the court observed that the invasion must be for the beneficiary’s “continued” comfort, implying amounts reasonably necessary to maintain the accustomed standard of living. The Court concluded that such words did not constitute a general power of appointment.

When the stated standards differ from the safe harbor standards described in the regulation, it is often impossible to rationalize results that have been reached in varying cases. For example, in Whelan v. U.S., the court held that an invasion power “for the **reasonable support, care and comfort** of such beneficiary” constituted an ascertainable standard. 81-1 USTC ¶ 13,393 (S.D. Cal. 1981). Seven years earlier, the very same court held that a standard permitting invasion of corpus for “**reasonable care, comfort and support**” was not an ascertainable standard. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974).

Another example of the impossibility of rationally categorizing the cases based on the language in the instrument is Brantingham v. U.S., 631 F.2d 542 (7th Cir. 1980). The decedent’s will contained a provision stating that “my wife shall have and is hereby given the **uncontrolled right**, power and authority to use and devote such of the corpus thereof from time to time as in their judgment is necessary for her maintenance, **comfort and happiness**.” Those words are typically held not to constitute an ascertainable standard. However, the court analyzed Massachusetts law, and concluded that this language constituted an ascertainable standard. The IRS has indicated that it will not follow the Brantingham case. Rev. Rul. 82-63, 1982-1 C.B. 135.

The Vissering case and the combination of the Whelan and Tucker cases illustrate the extreme danger in modifying, even slightly, the standards given as safe harbor language in the regulations. The Brantingham case illustrates that using some of the magic “bad” words may nevertheless be sanctioned by a court, but one certainly cannot rely on such a result.

- d. Two-Fold Analysis Approach; Combination of Clauses and Total Context of Standards Control, Not Presence of Single Words. The courts have reviewed trust instruments in their entirety rather than just focusing on “magic” words that are or are not present. One commentator has suggested applying a two level analysis. First, are the powers of invasion of trust assets limited to ascertainable standards related to the beneficiaries’ health, education, support or maintenance, thus bringing the trust assets within the safe harbor language of Section 2041(b)(1)(A)? Second, are the standards expanded (or restricted)

- elsewhere in the trust documents? See Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990).
- e. Summary of Standards that Typically Are Not Ascertainable. While there is no uniform consistency in the cases, courts have typically found certain words not to be ascertainable: “For example, the federal courts have repeatedly concluded that the presence of any of the condemned, operative words—‘welfare and ‘happiness’—prevents a standard from being ascertainable. Other synonymous words and phrases *not* limited to an ascertainable standard include: ‘well-being,’ ‘benefit,’ ‘use and benefit of,’ ‘enjoyment,’ ‘pleasure,’ ‘as she may require,’ ‘as she may see fit,’ ‘business purpose,’ and ‘any purpose whatsoever.’” Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 244 (1981).
- f. Example Cases and Rulings Finding Ascertainable Standard Exists. A detailed compilation of cases that have addressed the ascertainable standard exception under Section 2041 are contained in several differing articles. See Randall & Schmidt, The Comforts of the Ascertainable Standard Exception, 59 TAXES 242, 247-49 (1981) (chart compilation of cases and rulings); Corbett, Judicially Determined Standards Formulated Under §§2036, 2038, and 2041, 15 Tax Mangt. Estates, Gifts & Tr. J. 198, 201 (Nov. 8, 1990) (chart summarizing cases under Sections 2036 and 2038 and separate chart summarizing cases under Section 2041). The following is a sampling of some of the cases and rulings that have found that an ascertainable standard exists. Tucker v. U.S., 74-2 USTC ¶ 13,026 (S.D. Cal. 1974) (“reasonable care, comfort, and support”); Estate of Vissering v. Comm’r, 990 F.2d 578 (10th Cir. 1994) (“required for the continued comfort”); Martin v. U.S., 780 F.2d 1147, 1150 (4th Cir. 1986) (“[i]n the event of the illness of Theo N. Martin or other emergency”; court said clear that IRS argument “was a loser”, and if argument was not “frivolous” before, it became so after Sowell decision of Tenth Circuit was issued); Finlay v. U.S., 752 F.2d 246 (6th Cir. 1985) (“right to encroach if she desires”); De Oliveira, Jr. v. U.S., 767 F.2d 1344 (9th Cir. 1985) (“for the benefit of”); Sowell v. Comm’r, 708 F.2d 1564 (10th Cir. 1983) (“in case of emergency or illness”); Pittsfield Nat’l Bank v. U.S., 181 F. Supp. 851 (D.C. Mass 1960) (“as he may from time to time request, he to be the sole judge of his needs”); Estate of Anderson v. U.S., 96-1 USTC ¶ 60,223 (D. Neb. 1995) (“reasonably necessary for ... comfort, support and maintenance”) Hunter v. U.S., 597 F. Supp. 1293 (W.D. Pa. 1984) (“should any emergency arise”); Estate of Strauss v. Comm’r, 69 TCM 2825 (1995) (“care and comfort, considering his standard of living as of the date of ... death”); Estate of Duvall v. Comm’r, 66 T.C.M. 164 (1993) (“to do as she pleases”); Whelan v. U.S., 81-1 USTC ¶ 13,393 (S.D. Cal. 1981) (“reasonable support, care and comfort”); Rev. Rul. 78-398 (“maintenance and medical care”); Ltr. Rul. 9203047 (“maintenance, support and comfort, in order to defray expenses incurred by reason of sickness, accidents, and disability”).
- The IRS has been surprisingly lenient in a number of private letter rulings in interpreting standards to come within the ascertainable standard requirement. E.g., Ltr. Ruls. 200028008 (construing reference to “other emergency” following an ascertainable standard as limited to the type of emergency covered by that standard); 200013012 (“actual living expenses only”); 9728023 (“comfortable” modified “support and maintenance”); 9713008 (treats “care” equivalent to “support”); 9516051 (such distributions as the trustee deemed requisite or desirable under the circumstances if the trust income were insufficient to met the beneficiary’s reasonable needs); 9203047 (reference to “comfort” is qualified by other language limiting payment to medical costs); 9012053 (“to relieve emergencies affecting” beneficiaries; power to invade for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of Martin v. U.S. decision).
- g. Example Cases and Rulings Finding That Ascertainable Standard Does Not Exist. Miller v. U.S. 387 F.2d 866 (3rd Cir. 1968) (“proper maintenance, support, medical care, hospitalization, or other expenses incidental to her comfort and well-being”); Strite v. McGinnes, 330 F.2d 234 (3rd Cir. 1964) (“reasonable needs and proper expenses or the benefit or comfort” of beneficiaries); Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985) (one paragraph of the will authorized distributions “for her own proper maintenance;” that paragraph was nullified by more expansive powers in the next paragraph to use the assets “for whatever purpose she desires”); First Virginia Bank v. U.S., 490 F.2d

532 (4th Cir. 1974) (“right to dispose, sell, trade, or use (the stock) during her lifetime for her comfort and care as she may see fit”); Doyle v. U.S., 358 F. Supp. 300 (E.D. Pa. 1973) (“comfort, maintenance and support”); Estate of Jones v. Comm’r, 56 T.C. 35 (1971) (“in cases of emergency, or in situations affecting her care, maintenance, health, welfare and well-being;” court says that words “comfort” and “well-being” and “comfort, welfare or happiness” are not ascertainable); Lehman v. U.S., 448 F.2d 1318 (5th Cir. 1971) (holder of life estate could “consume, invade, or appropriate” the corpus for her “support, maintenance, comfort and welfare.”); Hyde v. U.S., 950 F. Supp. 418 (D. NH 1996) (“as in her sole discretion shall be necessary and desirable”; court rejected taxpayer’s argument that the power was limited to emergencies); Estate of Schlotterer v. U.S., 421 F. Supp. 85 (W.D. Pa. 1976) (“comfort and pleasure”; court focused on “pleasure” saying it is synonymous with gratification, enjoyment and pursuit of happiness); Forsee v. U.S., 2001-1 USTC ¶ 60,393 (D. Kan. 1999) (“happiness, health, support and maintenance”); Renfro v. U.S., 78-1 USTC ¶ 13,241 (E.D. Tx. 1978) (holder of life estate could “sell, mortgage or otherwise dispose of such property at such times and on such terms as to her may seem proper”); Franz v. U.S., 77-1 USTC ¶ 13,182 (E.D. Ky. 1977) (“care, maintenance and welfare”, stating “one cannot escape the import of the word ‘welfare’ as being ‘very broad’ and indicating ‘the extent of the discretion given to the trustee’”); Stafford v. U.S., 236 F. Supp. 132 (E.D. Wis. 1964) (“use and enjoy the principal ... for his care, comfort, and enjoyment”); Estate of Little v. Comm’r, 87 T.C. 599 (1986) (“proper support, maintenance, welfare, health and general happiness in the manner to which he [was] accustomed at the time of the death of [his wife];” court reasoned that standard did not relate just to HEMS, giving example of travel as an unrelated item to HEMS that might have been permissible under the standard in the agreement); Estate of Penner, 67 T.C. 864 (1977) (“business purpose”); Estate of Lanigan v. Comm’r, 45 T.C. 247 (1965) (“use and benefit”); Estate of Beyer v. Comm’r, T.C. Memo 1974-24 (“sole discretion ... for any purpose whatsoever”); Rev. Rul. 82-63, 1982-1 C.B. 135 (“maintenance, comfort, and happiness”); Rev. Rul. 77-194, 1077-1 C.B. 283 (“proper comfort and welfare”); Rev. Rul. 77-60, 1077-1 C.B. 282 (“as desired to continue an accustomed standard of living”); Rev. Rul. 76-547 (“health, care, maintenance, and enjoyment”); Ltr. Rul. 9344004 (“comfort,” “happiness,” and “welfare”); Ltr. Rul. 9318002 (“comfort,” “happiness,” and “welfare”; ruling subsequently revoked without explanation by Letter Ruling 9510001); Tech. Adv. Memo. 9344004 (“health, maintenance, support, comfort, and welfare at the standard of living to which he had become accustomed”, applying Texas law); Ltr. Rul. 9125002 (“reasonable comfort, best interest, and welfare”); Ltr. Rul. 9113026 (“care, support, maintenance, and welfare”); Ltr. Rul. 9030032 (“if that spouse’s income from other sources is not sufficient for the surviving spouse’s ‘support and comfort in the manner in which she was accustomed’”, reasoning that “support in reasonable comfort” is an ascertainable standard while “comfort” standing alone is not); Tech. Adv. Memo. 8606002 (provision for distributions for ascertainable standard, coupled with power to distribute for “emergency needs”); Tech. Adv. Memo. 8304009 (“any great emergencies which may arise in the lives and affairs ... such as extra needed medical services or hospitalization”); Ltr. Rul. 7841006 (“emergency”); Ltr. Rul. 7812060 (“as may be necessary for the well-being of my son”).

- h. Rulings Related to Standard of Living.
- i. Rulings Related to “Emergency” Standard.
- j. Possibility of Reformation.
- k. Effect of Providing that Trustee Must/May Consider Outside Resources.
- l. Small Trust Termination Provision.
- m. State Laws Limiting Discretionary Distributions for Self to an Ascertainable Standard.
- 5. Beneficiary as Trustee—Effect of Authority to Satisfy Trustee’s Support Obligations; The *Upjohn* Issue.
 - a. Regulations—Power to Discharge Decedent’s Obligation is Power Exercisable in Favor of Decedent. The regulations provide that a power to satisfy the decedent’s obligation is treated as a power exercisable in favor of the decedent:
 - “A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent ... is considered a power of appointment exercisable in favor of the

decedent or his creditors.” Treas. Reg. § 20.2041-1(c)(1). See also Treas. Reg. § 25-2514-1(c)(1).

Therefore, if a trustee has the power to make a distribution that satisfies any of his obligations, the trustee is deemed by the regulations to have a power to distribute to himself. Thus, **although the trustee is not a beneficiary at all** under the trust, power of appointment problems for the trustee can still arise if any person that the trustee owes legal obligations to is a beneficiary.

- b. The Illogical Disconnect. A trustee may have the power to distribute property to himself for his support and he does not have a general power of appointment. But the trustee may not possess the very same power to make distributions to his minor children for their support. The reason is that the power to satisfy the trustee’s obligations is treated as a power to distribute to the trustee. Therefore, that power is a general power of appointment, unless it meets the ascertainable standard exception. The ascertainable standard exception, however, requires that the power be related to the power holder’s “... support.” Because the power is related to the child’s support and not the support of the trustee, it is not limited by an ascertainable standard. The IRS concurs with this analysis. See Rev. Rul. 79-154, 1979-1 C.B. 301; Ltr. Ruls. 8924011, 8921022
- c. Upjohn. This issue has become known by the name of a case that does not address this precise Section 2041 issue at all. Upjohn v. U.S., 72-2 USTC ¶12,888 (W.D. Mich. 1972). That case involved a Section 2503(c) trust which provided that the trustee should not make any distributions that would satisfy the settlor’s legal obligation of support. The issue was whether that constituted a “substantial restriction” on the right to make distributions to the beneficiary, so that it did not qualify under Section 2503(c), in which event gifts to the trust would not qualify for the annual exclusion. The court rejected the IRS’s argument, that this restriction constituted a substantial restriction, on the theory that it was no restriction at all to say that the trustee should not make a distribution to satisfy a need of the minor that someone else would provide anyway (i.e., the parent, because of the support obligation). In this regard, the provision really enlarged the rights of the minor child under the instrument, because it assured that the trust funds would be used to provide additional benefits that were not already provided for by the support obligation.

The Section 2041 problem exists if the surviving spouse serves as trustee of a Section 2503(c) trust. Unless the taxpayer can convince the court to rule like Upjohn that a limitation on making distributions in satisfaction of the trustee’s legal obligations is not a substantial restriction, the spouse cannot serve as trustee of a Section 2503(c) trust. Either the trust would restrict the trustee from making distributions to satisfy his legal obligation of support (in which event it is not a valid Section 2503(c) trust if a court cannot be persuaded to follow Upjohn), or else the spouse would have a general power of appointment. Hence, clauses to solve this problem have come to be known as “Upjohn clauses.”

Interestingly, no case has addressed what seems to be the real issue. If a trustee makes a distribution to a minor, and the parent uses that to provide what should be the parent’s legal obligation, has the parent violated his duty to his children, in effect converting the child’s assets for his own use? Does the parent still owe the amount of such support payment to the child? If so, a distribution from a trust to a minor does not satisfy the parent’s legal obligation of support. See section II.B.2.c.(3) of this outline. Stated differently, a distribution that satisfies the power holder’s legal obligation is in reality a distribution to the power holder. If the instrument says that no distribution may be made to the power holder other than for the power holder’s health, education, support or maintenance, the distribution would not be authorized (because it is not for the power holder’s “... support”—but for the payment of a claim against the power holder.) See Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 (1986).

- d. The Fix. To cure any possible argument, planners insert what has become known as the Upjohn clause: A clause prohibiting the trustee from making any distribution that would have the effect of discharging that trustee’s legal obligations. For an excellent discussion of the tax effects if a trust does not absolutely prohibit satisfying legal obligations of the donor or of a trustee, see Pennell & Fleming, Avoiding the Discharge of Obligation

Theory, PROBATE & PROPERTY 49 (Sept./Oct. 1998). One ruling approved a clause requiring that if the trustee (a surviving spouse) had the obligation to support any other trust beneficiary, the trustee was required to appoint a special trustee of her choosing at that time to make distributions for that beneficiary. Ltr. Rul. 9036048. See Section III.D.5. of this outline.

6. Special Issues With Settlor's Spouse as Trustee
 - a. Restrict Power to Distribute to Self to Ascertainable Standard.
 - b. Restrict Incidents of Ownership.
 - c. Restrict Power to Distribute to Minor Children or Otherwise in Satisfaction of Spouse's Legal Obligations.
 - d. Spouse and Children as Discretionary Beneficiaries—Use Ascertainable Standard for Distributions to Children Also.
 - e. Use Tax Savings Clause.
 - f. Fiduciary Obligations.
 - g. Income Tax.
 - h. QTIP Trusts.
 - i. Clayton Trusts.
 - j. Section 2503(c) Trusts.
7. **Summary of Selection of Trustee Issues Regarding Dispositive Powers Held by a Beneficiary.** The beneficiary should not have the power as trustee to make distributions to himself that are not limited by an ascertainable standard relating to his HEMS. If the beneficiary is a co-trustee (or holds a veto power), the beneficiary will be deemed to hold distributive powers of the trustee unless he is a co-trustee with the grantor (but then there would adverse tax consequences to the grantor) or an adverse party. If the beneficiary has a contingent power to become trustee in the future upon the occurrence of events outside his control, the beneficiary will not be deemed to hold the powers of the trustee until the triggering event actually occurs. Once the events have occurred entitling the beneficiary to become trustee, he will be deemed to hold any problematic powers (even before he accepts as trustee) unless he formally disclaimed the right to be trustee (generally within nine months of when the original transfer in trust was made.)

Reciprocal powers (in reciprocal trusts) may be uncrossed.

If there is a third party trustee: A third party trustee can have complete discretion over distributions. However, if there are mandated distributions, the beneficiary will be deemed to have a general power of appointment over any undistributed but “accrued” amounts (but this does not apply if the trustee just has the discretion, even within a standard, to make distributions.) A third party trustee may be used as a co-trustee with a beneficiary, and the instrument could direct that any problematic powers (to make distributions beyond a HEMS standard to the beneficiary or to any other beneficiary or to make distributions that satisfy the beneficiary's obligation of support) would be held solely by the third party trustee. Even if there is a third party trustee, to be safe, the instrument should prohibit any distributions in satisfaction of legal obligations of the trustee.

If the beneficiary is trustee: Use an ascertainable standard. Do not get fancy and stray from the pure HEMS standard. Even slight word deviations could potentially have disastrous effects—or at least give rise to a lawsuit. Adding “in the accustomed standard of living” is satisfactory as long as those words modify the stated standard. (In addition, as discussed in Section III.A.4., the instrument should not allow the beneficiary-trustee to make distributions to another beneficiary unless the distribution is within an ascertainable standard as to that other beneficiary.)

C. Estate Tax—Management/Administrative Powers.

1. The Issue. Overly broad administrative powers might potentially create (1) estate tax inclusion problems under Section 2041 if the powers enable the power holder to favor himself, and (2) gift tax concerns under Section 2514 if the power holder could exercise the power to favor himself, but instead exercises the power in a manner that favors others.

2. Regulations. The regulations to Sections 2041 and 2514 indicate that “mere ... management {and} investment” powers will not cause the holder of the power to have a general power of appointment:

“The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.” Treas. Reg. § 20.2041-1(b)(1); 25.2514-1(b)(1).

3. Lack of Cases; Analogy to Section 2036-2038 Cases. There have been very few cases addressing the effects of administrative and management powers under Section 2041. Estate of Rolin v. Comm’r, 68 T.C. 919 (1977), *aff’d*, 588 F.2d 368 (2nd Cir. 1978) (investment power not general power of appointment because required to be exercised in fiduciary capacity). However, the cases regarding the effects of administrative and management powers under Sections 2036 and 2038 should provide guidance by analogy. The underlying principles would seem to be the same.

The lack of very many cases under Section 2041 regarding administrative powers, however, does raise potential concerns. Some planners may want to draft around potential arguments by the IRS in sensitive situations.

4. Potentially Troublesome Powers.
5. Income and Principal Allocations.
6. Valuations; Non Pro Rata Distributions.
7. Tax Elections.
8. Power to Adjust Under Section 104.
9. Incidents of Ownership Over Life Insurance.
10. Beneficiary Consent to Trustee’s Administrative Actions.
11. Beneficiary Power to Veto Stock Sales.
12. Power to Borrow, Pledge Trust Property, Dispose of Property and Contract With Trust.
13. **Summary of Selection of Trustee Issues Regarding Administrative Powers**. **Make explicitly clear that all of the trustee powers are held in a fiduciary capacity. If any beneficiary has a mandatory income interest, require that income/principal allocations be made in a reasonable manner, and to be conservative, say that such allocations should be made by a co-trustee who is not a beneficiary or remainderman. If the trustee will be able to make a Section 104 discretionary power to allocate corpus to income, there must be a non-beneficiary trustee (or co-trustee) exercising that power. The beneficiary should not hold any incidents of ownership over life insurance on the beneficiary’s life. For the paranoid (in particularly sensitive situations), see Section III.C.4. for a listing of potentially troublesome administrative powers.**

D. Trustee Removal and Appointment Powers.

1. Overview; Analogy to Grantor Powers. Many of the appointment/removal issues that affect grantors also affect beneficiaries. There is a detailed discussion of this issue regarding removal and appointment powers retained by grantors in section II.B.5. of this outline, and much (but not all) of that discussion is relevant for trustee appointment powers held by beneficiaries.
2. If Beneficiary-Trustee Declines to Accept Office as Trustee. If a beneficiary is named as trustee, and if the beneficiary would have a general power of appointment because of dispositive powers of the trustee, the beneficiary will have a general power of appointment if he is the trustee, and as discussed in section III.A.1.a. of this outline, once the general power of appointment taint is cast, it is very difficult to ever get rid of that taint without gift or estate tax consequences. What if the beneficiary declines to serve as trustee before accepting office as trustee? That procedure apparently will not prevent the creation of a general power of appointment. However, the power holder may formally disclaim the power and not be treated as having released the general power of appointment, if the requirements of Section 2518 are satisfied. See section III.B.1.h. of this outline. The IRS ruled privately in Technical Advice Memorandum 9125002 that the mere fact that the named beneficiary-trustee died before the trust was funded and before accepting office as trustee did not prevent the beneficiary from having a general power of appointment.

3. Power to Appoint Self as Trustee.
4. Power to Appoint Self as Trustee Under Limited Conditions That Have Not Yet Occurred.
5. Power to Appoint Co-Trustee to Exercise Tax Sensitive Powers. Trusts often include a savings clause, to provide that the beneficiary-trustee cannot exercise various dispositive powers that would cause tax problems, but to provide that the beneficiary-trustee can appoint a co-trustee to exercise that discretion. The IRS has approved a similar arrangement in private letter ruling 9036048.
6. Power to Appoint Successor Trustee Other Than Self.
7. Power to Veto Appointment of Independent Trustee.
8. Power to Remove and Appoint Successor Other than Self. If a trustee holds powers that would be treated as a general power of appointment if held by a beneficiary, will a beneficiary's power to remove and replace the trustee with someone other than himself cause the beneficiary to have a general power of appointment?
 - a. Power to Remove For Cause. If a beneficiary has the power to remove a trustee for cause and replace the trustee, the beneficiary does not have a general power of appointment. A power to remove a trustee only for cause is a power that is subject to a contingency that is beyond the control of the power holder. Therefore, such a power can be given to a beneficiary without concern that it will result in the trustee's powers being imputed to the beneficiary. See Treas. Reg. § 20.2041-3(b), discussed in section III.B.1.h. of this outline.
 - b. Power to Remove Without Cause. In Rev. Rul. 95-58, 1995-2 C.B. 191, the IRS ruled that Sections 2036 and 2038 are not triggered if a grantor holds a removal and appointment power as long as the grantor must appoint someone other than the grantor who is not related or subordinate to the grantor under Section 672(c). The IRS, in private rulings, has extended the same principle to Section 2041 with respect to powers of removal held by beneficiaries. E.g., Ltr. Ruls. 200213013, 200031019, 9735025, 9735023 & 9746007. The IRS granted a ruling in 2000 that is more liberal than Rev. 95-58, in that a beneficiary could remove and appoint a successor (including individuals who are beneficiaries). Ltr. Rul. 200024007. The ruling relied on a restriction in the trust agreement that prohibited any trustee from participating in any decision to pay or apply trust assets to himself or his issue, and provided that any such decision would be made by the other then acting trustees. In effect, the beneficiary could appoint anyone else, who could make distributions back to the beneficiary. One wonders if the IRS realized the impact of its ruling. Reliance on the ruling at the planning stage would seem unwarranted.
 - c. Power to Remove and Replace Trustee—Section 2042. The principles of Rev. Rul. 95-58 would appear to extend to the power of an insured to remove and replace a trustee who holds incidents of ownership over a policy on the insured's life. See a detailed discussion of this issue in section II.B.5.h. of this outline.
9. **Summary of Selection of Trustee Issues Regarding Removal and Appointment Powers.**

The beneficiary will have the powers of the trustee if the conditions have occurred giving the beneficiary the power to accept office as trustee or to appoint himself as co-trustee (unless the beneficiary formally disclaimed the right to become trustee within the required time.) If the conditions allowing appointment of the beneficiary as trustee have not yet occurred, he does not yet hold a general power of appointment.

A beneficiary-trustee can have the power to appoint a co-trustee who would exercise tax sensitive powers. (To be very cautious, the instrument could stipulate that any such co-trustee would have to be an "independent trustee"—with some definition of that term. However, that should not be required—unless there is an extreme case of a beneficiary having an explicit prearrangement with whomever he appoints directing how the co-trustee's powers will be exercised, and even there, the taxpayer could make arguments that the fiduciary responsibility of the appointed co-trustee should override any such informal "agreements.")

If a beneficiary has the right to remove the trustee and appoint himself, that beneficiary will be deemed to hold the powers of the trustee. If a beneficiary has the power to remove and appoint someone else—the IRS appears to recognize a safe

harbor if the beneficiary must appoint someone who is not a related or subordinate party. If the power is retained to appoint a replacement who is a related or subordinate party, the taxpayer would argue, based on the Vak and Wall cases (see Section II.B.5.g. of this outline) that the fiduciary responsibility of any such successor would preclude the beneficiary from being deemed to hold any powers such appointee would have as trustee.

E. Income Tax Issues.

1. Section 678—Income Taxed to Beneficiary As Owner Under Grantor Trust Rule.

- a. Issue. If a beneficiary of a trust serves as the sole trustee and has the authority to make distributions to himself, there is the possibility (perhaps remote if the distribution power is limited by an ascertainable standard) that the income of the trust will be taxed to the beneficiary under a grantor trust rule, regardless of whether distributions are actually made to that beneficiary. Whether there is an ascertainable standard exception is not clear. If the beneficiary serves as co-trustee and does not make discretionary distribution decisions by himself, Section 678 clearly does not apply.
- b. Statute. Section 678(a)(1) provides that an individual shall be treated as the owner of any portion of a trust with respect to which the individual has a power, exercisable solely by himself, to vest the corpus or income from the trust in himself. See Ltr. Rul. 8211057 (trustee-beneficiary with mandatory income/discretionary principal interest with \$100,000 annual distribution cap taxable on income to that extent).
- c. Ascertainable Standard Exception Is Uncertain. There is no ascertainable standard in the statutory language of Section 678. Many planners, however, take the position that the trustee will not be taxed on trust income under Section 678 if the trustee's discretion is subject to an ascertainable standard. The theory is that the statutory language requires that the trustee be able to vest the corpus or income in himself "solely by himself," and the trustee is not making a determination "solely by himself" if he is making a distribution decision based on whether ascertainable standards are satisfied. The legislative history states that Section 678 would treat a person as an owner of the trust "if he has an *unrestricted power* to take the trust principal or income." S. Rep. No.1622, 83d Cong., 2d Sess. 87 (1954) (emphasis added).

The reference to an unrestricted power is consistent with case law under a predecessor provision to Section 678. See Funk v. Comm'r, 185 F.2d 127 (3d Cir. 1950) (trustee's power to distribute income to herself for her "needs" did not cause trust income to be taxed to trustee as owner); Smith v. U.S., 108 F. Supp 772 (S.D. Tex 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953) (power to distribute income for support, maintenance, comfort and enjoyment; trustee not taxed on trust income as owner).

In addition, there is one reported case that has addressed this issue after the adoption of Section 678, and it adopts an ascertainable exception approach. U.S. v. DeBonchamps, 278 F.2d 127, 130 (9th Cir. 1960) (held that grantor trust rules applied to determine tax effects of holder of life estate; life tenant did not have unrestricted power under state law to distribute corpus to self, but only for "needs, maintenance and comfort"; held that undistributed capital gains not taxed to life tenant).

Private rulings from the IRS have been inconsistent. Compare Ltr. Rul. 8211057 (trustee-beneficiary with discretionary principal interest for "support, welfare and maintenance" taxable on income under Section 678) with Ltr. Rul. 9227037 (trustee-beneficiary with discretionary principal interest for "health, support and maintenance" held not taxable under Section 678). See also Ltr. Rul. 8939012 (trustee-beneficiary not taxable as owner of trust under Section 678; however exact distribution standard not clearly set forth in ruling).

- d. Effect if Beneficiary-Sole Trustee Appoints Co-Trustee. If a beneficiary initially serves as sole trustee and appoints a co-trustee, the beneficiary who was initially the sole trustee will still likely be taxed on the trust income under Section 678(a)(2).
- e. Distributions to Satisfy Trustee's Support Obligation. The authority of a sole trustee to make distributions that would satisfy such person's legal obligation of support will be taxed as income to the person only to the extent that such distributions are actually made. I.R.C. § 678(c). See Ltr. Rul. 8939012 (sole trustee not taxable under Section

678 where beneficiaries were trustee's adult children and descendants to whom he owed no legal obligation of support). (If any such support distributions are actually made, the power holder is taxed under Sections 661-662—based on an allocation of DNI—rather than being treated as the owner of a portion of the trust. I.R.C. § 678(c).)

- f. Effect of Disclaimer. Section 678 does not apply if the power holder renounces or disclaims the power within a reasonable time after the holder first became aware of its existence. I.R.C. § 678(d). See section III.B.1.h. of this outline for a discussion of the Section 2041 effects of a disclaimer.
2. State Income Tax Issues. State income tax considerations are important in the selection of trustee analysis, because a determination of what state has jurisdiction to impose its state income tax on the trust will, in some states, depend on the residency of the trustee or where the administration of the trust occurs. The one thing that is consistent across the board regarding the state income taxation of trusts is inconsistency. There is a complex labyrinth of separate rules throughout the 50 states and the District of Columbia. (Texas planners generally have been spoiled by practicing in a state that does not tax trusts, and Texas planners typically have little experience in the complex world of state income taxation of trusts.) See generally ACTEC Study 6, State Taxation on Income of Trusts With Multi-State Contacts (2001); Michaels & Twomey, How, Why, and When to Transfer the Situs of a Trust, 31 Est. Pl. 28 (Jan. 2004); Warnick & Pareja, Selecting a Trust Situs in the 21st Century, 16 PROB. & PROP. 53, 57-58 (March/April 2002); Gutierrez, The State Income Taxation of Multi-Jurisdictional Trusts – The New Playing Field, 36TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL , ch 13 (2002); Coleman, State Fiduciary Income Tax Issues & Jurisdictional Bases for State Taxation of Trust as a “Resident Trust”, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES vol. 1, at 91-118 (Nov. 2003).
 - a. Brief Overview of State Taxation Approach. Grantor trusts are typically taxed to the grantor in his state of domicile. For non-grantor trusts, most states allow a deduction for distributions, and the distributed amounts are taxed to beneficiaries in their states of domicile. The undistributed income of trusts is taxed under the complex scheme of varying rules.

Almost all states will impose their taxes on undistributed income of trusts that is from real estate or businesses located in the state. (That can be a difficult determination for businesses which produce income in a variety of states.) Therefore, no matter whether a trust is a “resident trust” or a “nonresident trust,” undistributed trust income from real estate and businesses in the state will be taxed by that state.

The remaining income is generally taxed based on where the trust is deemed to be a resident—and a wide pattern of residency rules have developed over the years in determining whether a trust is a resident trust or nonresident trust as to a particular state.

After going through the steps described above, if two different states impose income tax on the same trust, most states allow some form of credit to the extent that other states impose an income tax on the same trust income (but the form of the credit varies dramatically).
 - b. Resident vs. Nonresident Trusts. Most of the states typically follow one of several patterns to determine whether a trust is a resident trust for that state. Ten states do not specifically define a resident trust. Some states look at various factors in determining whether a trust is a resident trust.
 - (1) Residency of Grantor. Almost half of the states treat testamentary trusts of resident-decedents of that state as resident trusts. (Therefore, if a decedent dies in one of those states, any testamentary trusts created by that decedent are forever after taxed by that state.) The same states also tax inter vivos trusts created by a resident grantor. Courts in various states have reached varying results as to the constitutionality of these statutes. See e.g., Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (recognized constitutionality of use tax on foreign mail order company for goods purchased within the state; relied on by courts in Connecticut and the District of Columbia to uphold constitutionality of grantor-resident statutes); Swift v. Director of Revenue, 727 S.W.2d 880 (Mo. Sup. Ct. 1987) (domicile of testator alone was not sufficient basis to tax testamentary trusts; subsequent decision of same court held

that testamentary trust owning Missouri real estate [also having a Missouri charity as a remote beneficiary and a Missouri bank as successor trustee] could be taxed in Missouri). Laws taxing inter vivos trusts based on residency of the grantor have particularly come under constitutional attack. E.g., Mercantile-Safe Deposit & Trust Company v. Murphy, 19 A.D. 765, 242 N.Y.S.2d 26 (1963), aff'd, 15 N.Y.2d 579, 203 N.E. 490, 255 N.Y.S.2d 96 (New York could not constitutionally tax undistributed income of inter vivos trust created by New York resident where the trustee and place of administration were both out of state).

Although New York has a grantor-resident statute for taxing trusts, following the Mercantile-Safe Deposit Id. case, the New York Tax Commissioner issued regulations making clear that New York will not tax a trust that has no New York trustees, no New York assets, and no New York source income. N.Y. Comp. Codes R. & Regs. Tit. 20 § 105.23(c). Accordingly, the selection of trustee for a trust created by a New York resident is a critical factor for determining if the New York income tax will apply to undistributed income from the trust. For example, if a New Jersey bank is named as trustee and trust assets are located in New Jersey, the undistributed trust income would not be taxed in New York or New Jersey.

For residents of these states who are creating trusts, state income taxation is still an important issue in the selection of trustee process. If the instrument appoints a trustee from a state that taxes based on administration or trustee residency, issues of dual taxation and multi-state credits arise.

- (2) Administration in the State. Approximately seven states impose tax on the basis of administration in the state. Accordingly, appointing a trustee who would be conducting a significant part of the administration in one of those states would subject the trust to income taxation in that state.
- (3) Residency of Trustee. Approximately eight states impose tax on the basis of the domicile of the trustee. (If there are co-trustees located in multiple states, the income may be pro-rated. For example, this is the approach in California. Cal. Rev. & Tax Code § 17743.) Obviously, this is a very important fact to consider before appointing a trustee who is a resident of one of these states.
- (4) Residency of Beneficiary. Only a handful of states impose tax on this basis. An example is California. For example, if no trustee is a resident of California, the trust is taxed on California source income and that portion of non-source income that is to be distributed to resident noncontingent beneficiaries. Cal. Rev. & Tax Code § 17744.) Various other states have a similar provision. E.g., Del. Code Ann. Tit. 30, § 1636; Ga. Code Ann. § 48-7-22(a)(1)(C); Mass. Gen. Laws Ann. Ch. 62, § 10.

IV. SAVINGS CLAUSES TO AVOID ADVERSE TAX EFFECTS FOR GRANTORS, BENEFICIARIES AND TRUSTEES

- A. Significance of Savings Clauses Regarding Tax Effects For Grantors, Beneficiaries and Trustees. To avoid inadvertent adverse tax effects, consider using a “savings clause” to limit automatically any retained powers of the grantor, or of the beneficiary. While a primary dispositive provision may come within accepted ascertainable standard language, other provisions of the will may inadvertently change the result. For example in Independence Bank Waukesha (N.A.) v. U.S., 761 F.2d 442, 443 (7th Cir. 1985), one paragraph of the will authorized distributions “for her own proper maintenance,” which would have been an ascertainable standard. However, it was nullified by more expansive powers in the next paragraph to use the assets “for whatever purpose she desires.” 761 F.2d at 442, 443, and 444. An excellent discussion of the various provisions that could be included in savings clauses to avoid adverse tax consequences with respect to powers that trustees may have is in Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 506 at p. 5-70 (1986).
- B. IRS Recognizes Savings Clauses For Section 2041 Purposes.
- C. Miscellaneous Examples of Savings Clauses and Other Clauses Important to Achieve Tax Effects of Irrevocable Trusts.
 1. Irrevocability.
 2. Fiduciary Powers Only.
 3. Settlor Prohibited From Serving as Trustee.

4. Prohibit Distributions Satisfying Support Obligations of Settlor Or Beneficiary.
5. Limitations on Beneficiary-Trustee as to Distributions, Termination, Estimated Taxes, and Life Insurance.

Beneficiary Serving As Trustee and Independent Trustee. If an individual serving as Trustee of any trust created under this Agreement is a beneficiary of such trust, such individual shall be authorized to make distributions to himself or herself pursuant to the terms of such trust, but such individual shall not possess or exercise any powers with respect to, nor authorize or participate in any decision as to: (i) any discretionary distribution or any loan to or for the benefit of himself or herself or any other beneficiary, except to the extent that such distributions are limited to amounts necessary for the person's health, maintenance, support and education; (ii) any discretionary distribution to any other beneficiary, if such distribution would discharge any of his or her legal obligations; (iii) the termination of such trust because of its small size, if such termination would result in a distribution to himself or herself or if the distribution would discharge any of his or her legal obligations; (iv) the treatment of any estimated income tax payment as a payment by such individual except to the extent that the payment is limited to an amount necessary for his or her health, maintenance, support and education; or (v) any action to be taken regarding an insurance policy held in such trust insuring the life of such individual unless such action is expressly authorized by other provisions of this Agreement. These decisions shall be made solely by the other then serving Trustee or Trustees of such trust ("Independent Trustee"). If such individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving for such trust, the currently acting Trustee may appoint the individual or entity next designated to act as Trustee as an Independent Co-Trustee of such trust; otherwise, upon written request of the currently acting Trustee, an Independent Co-Trustee of the trust shall be appointed by the Trustee Appointer. However, if an Independent Co-Trustee is appointed under these circumstances, the sole power and responsibility of the Independent Co-Trustee shall be to make decisions reserved to the Independent Co-Trustee.

Insurance On Life Of Beneficiary Serving As Trustee. This Section shall apply whenever any trust created under this Agreement owns any interest in an insurance policy on the life of an individual serving as sole Trustee of such trust. Such Trustee must: (i) designate the Trustee of such trust as the beneficiary of the policy to the extent of such trust's interest in the policy; (ii) continue to pay the premiums on such policy without using policy loans; and (iii) allow any policy dividends to reduce premiums. Upon termination of such trust, such Trustee must distribute the policy to the beneficiaries of such trust. Such Trustee shall not possess or exercise any other powers with respect to, or authorize or participate in any other decision as to, such policy. All other actions with respect to the policy shall be made solely by the other then serving Trustee or Trustees of the trust ("Insurance Trustee"). If such an individual serving as Trustee desires to engage in any such prohibited action but no Independent Trustee is then serving, then the currently acting Trustee may appoint the individual or entity next designated to act as Insurance Co-Trustee; but if no successor Trustee is designated, upon written request of the currently acting Trustee, an Insurance Trustee shall be appointed by the Trustee Appointer. If an Insurance Trustee is appointed, the only authority of the Insurance Trustee shall be to exercise the exclusive authority to make discretionary decisions as to the policy, including decisions to surrender or cancel the policy, borrow against the policy, and distribute the policy during the term of such trust. The intent of Settlor is that no Trustee will have any "incidents of ownership" over an insurance policy on the Trustee's life within the meaning of Section 2042 of the Code.

Observations regarding the Beneficiary Serving As Trustee and Independent Trustee clause:

Clause (i) restricts distributions to the trustee except for HEMS to avoid inadvertent violations of Section 2041 generally and restricts any distributions to any other beneficiary of the trust except for HEMS to avoid Regulation § 25.2511-1(g)(2), as discussed in section III.A.4 of this outline.

Clause (ii) restricts making any distributions that satisfies the trustee's legal obligations to avoid the Upjohn issue, as discussed in Section III.B.5 of this outline.

Clauses (iii) (small trust terminations) and (iv) (estimated tax payments) are included to avoid Section 2041—in case those powers might be held to constitute Section 2041 powers.

Clause (v) is included to avoid having incidents of ownership in a policy on the trustee's life, as discussed in section II.B.4.k.(2) of this outline.

Observations regarding the Insurance On Life Of Beneficiary Serving As Trustee clause: This clause is also intended to avoid having incidents of ownership in a policy on the trustee's life. It mandates certain actions with respect to the policy (such as naming the trust as the beneficiary and paying premiums), so that the trustee could take extremely routine actions with respect to the policy without having to appoint another co-trustee to take those actions. With respect to discretionary decisions, a co-trustee must be appointed to take those actions.

6. Jerry Horn's "Short-Form" Savings Clause.

- (1) *No particular Trustee shall possess, or participate in the exercise of, any power given the Trustee by this instrument or by law to make any determination with respect to*
- (a) *any payment or application which would discharge any legal obligation of such particular Trustee personally, or*
- (b) *any payment to, or expenditure for the benefit of, such particular Trustee personally (neither the preceding portion of this paragraph (1) nor any otherwise-applicable rule of law shall limit such particular Trustee's possession or participation in the exercise of any power (or severable portion thereof) granted in this instrument to such Trustee to consume, invade or appropriate property for the benefit of such Trustee personally which is limited by an ascertainable standard relating to the health, education, support or maintenance of such Trustee personally.)*

Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶ 502.2 at p. 5-14 (1986).

7. Broad Comprehensive Catch-All Savings Clauses for Settlor and Beneficiary to Avoid Estate Inclusion and Grantor Trust Treatment.

V. CREDITOR ISSUES

A. Self-Settled Trusts. Self-settled trusts for the benefit of the settlor generally may be reached by the settlor's creditors. For example, under the Texas spendthrift statute for self-settled trusts, the settlor's creditors may reach "his interest in the trust estate." TEX. PROP. CODE 112.035(d); Matter of Shurley, 115 F.3d 337 (5th Cir. 1997). A few jurisdictions have changed their statutes to allow creditor protection for the settlor if certain requirements are met. Under those statutes, the settlor must merely be a discretionary beneficiary of the trust, and the trustee must be someone other than the settlor. In addition, to come within the protection of those statutes, there must be a **resident trustee from that state**.

B. Spendthrift Protection for Trust Beneficiaries.

1. Discretionary Trust. The strongest protection can be obtained by giving the trustee total discretion in making distributions to the beneficiary. Courts have held that spendthrift trusts which require distributions to be made for the support of the beneficiary may be reached by creditors for support-related debts, but creditors generally cannot seize assets of a spendthrift trust that allows the trustee to distribute property based solely on the trustee's discretion. See Hildebrand, Asset Protection For Estate Planners, STATE BAR OF TEX. ADV. EST. PL & PROB COURSE (1995).

Despite the traditional spendthrift protection that has been afforded to beneficiaries under a discretionary trust with an independent trustee, some commentators believe that there may be a trend in the law limiting the spendthrift protection to beneficiaries of even discretionary trusts:

"The best way to protect a beneficial interest is to give an independent trustee the ability to make discretionary distributions to the beneficiary. The Second Restatement takes the position that a beneficial interest cannot be attached by a creditor if the beneficial interest is discretionary [citing Restatement (Second) of Trusts § 155(1) (1959)]. ...

The draft of the Third Restatement takes a dramatically different position with respect to the creditor protection available to a beneficiary of a discretionary trust. The Third Restatement provides that regardless of how the discretionary trust is worded, if the settlor's purpose is to provide for the beneficiary's needs, and if it is acceptable social policy that the beneficiary not be left without support, then the trustee would be subject to a general standard of reasonableness in determining whether a distribution should be made to a beneficiary [citing Restatement (Third) of Trusts § 60 Comment a (Tentative Draft No. 2, 1999)]. A beneficiary's need for support usually includes the needs of those who might be dependent on the beneficiary [*Id.*]. Thus, children, spouses and ex-spouses would be able to compel the trustee to make distributions to them in such an amount as would be considered equitable under the circumstances [*Id.*].

It is evident that a loss of creditor protection would occur in a discretionary trust if a dynasty jurisdiction adopts the new position of the Third Restatement. It is also important to note the Uniform Trust Code, as passed by the National Conference of Commissioners on Uniform State Laws on August 3, 2000, takes the same position as the Third Restatement regarding discretionary trusts. In fact, the Uniform Trust Code adopts nearly every position taken in the Third Restatement with respect to the manner in which trust assets can be protected from claims brought by a creditor against the beneficiary of a trust [citing Uniform Trust Code §§ 502-503 (2000), and observing that section 505(b) of the Uniform Trust Code differs from the position taken in the Third Restatement with respect to the creditor effects of withdrawal rights of beneficiaries].” Greer, The Alaska Dynasty Trust, 18 ALASKA L. REV. 253, 263-264 (2001).

2. Sprinkling Trust May Afford More Protection.
3. Allow Trustee to Change Beneficiary or “Hold-Back” Distributions to Maximize Protection.
4. Beneficiary as Trustee.
 - a. Same Person as Sole Trustee and Sole Beneficiary.
 - b. A Beneficiary is Also Trustee. “Black-letter” trust law would suggest that the beneficiary-trustee’s creditors cannot reach the trust assets where the trustee is not the sole beneficiary. “If A holds upon a spendthrift trust for A and B, A’s interest, being an interest under the trust and not a legal interest merely, cannot be assigned by him or reached by his creditors.” 2A Scott & Fratcher, The Law of Trusts § 99.3. The Restatement 2d of the Law of Trusts clearly takes the position that a beneficiary’s creditors cannot reach trusts with an ascertainable standard for “education and support” of the beneficiary. Restatement of the Law of Trusts, 2d §154. (However, that section does not specifically deal with a support trust of which the beneficiary is the trustee.)
 - Some states have adopted the position, by statute or by case law, that creditors of beneficiary-trustees cannot reach trust assets that are subject to an ascertainable standard. See., e.g., N.C. Gen. Stat. §36A-115(b)(1); Athorne v. Athorne, 128 A.2d 910 (N.H. 1957). One commentator, citing those authorities, has concluded that “[t]he present law of most states, whether statutory or judicially created, does not allow a creditor of a beneficiary who is also a trustee to force a distribution which would then be attachable by the creditor.” Oshins & Riser, Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection, TRUSTS & ESTATES (Oct. 2001).
 - Despite the existing “black-letter law,” there is little in the way of strong authority saying that a trust beneficiary may also serve as trustee, and still be assured absolutely of relying on strong spendthrift protection. The Restatement (Third) of the Law of Trusts, takes the position in §60, Comment g that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument. The Restatement gives the following illustrations:
 - “9. S’s will leaves his residuary estate to his daughter D, as trustee, “to pay income or principal to or for the benefit of anyone or more of D, her children, and their issue in such amounts, if any, as the trustee deems appropriate and desirable for the particular beneficiary’s support, education, and care, taking account of the beneficiary’s other resources if and to whatever extent the trustee deems appropriate.” D’s creditors may reach the maximum amount of trust funds that she

may, without abuse of her discretion, distribute to herself for the authorized purposes (see generally § 50), without reduction for other resources available to her for those purposes, but subject to a possible reservation the court may make for D's actual support needs.

10. The facts are the same as in Illustration 9, except that T serves as co-trustee with D, and they together hold the discretionary power to determine trust distributions. The special rule of this Comment does not apply. The creditors may still attach D's interest, absent a spendthrift restraint, but under the general rule of this Section." Restatement (Third) of the Law of Trusts, §60, Comment g (2003).

Some of the cases that are sometimes cited as support for the position in the Restatement (Third) of Trusts have actually been decided based on the principle that a beneficiary's creditors can reach assets of a trust that the beneficiary has complete control to withdraw. Despite the existence of distribution standards, courts in those cases have determined, under local law, that the beneficiary had the unfettered right to withdraw assets from the trust. For example, in Estate of Marcia Flood, N.Y. Law Journal (March 11, 1998). the decedent's husband was co-trustee with decedent's two children of a By-Pass Trust and Residuary Trusts created under Marcia Flood's will. The will directed the trustees to make payments to the husband from the By-Pass Trust of "so much of the principal of such trust as he shall request for his support and maintenance and the education of our children." The will also directed the trustees to make payments from the Residuary Trust to the husband of all the net income "together with so much or all of the principal as my husband may deem necessary for his health, support and welfare." The court determined that under state law, a beneficiary's right to invade corpus as he deems necessary for support and maintenance is absolute if the extent of the invasion is to be determined solely in the beneficiary's own judgment. Also, a gift for support and maintenance at the beneficiary's request or for health, support and welfare as the beneficiary deems necessary likewise confers on the beneficiary the right to demand distribution of the entire corpus. The court concluded:

"The spouse is entitled to distribution of the principal on demand and the creditors can reach his interest [Restatement of Trusts [Second], sec 161, illustration [2)]. The will confers upon the spouse a general power of appointment which subjects the property to the claims of creditors." Id.

In Florida, the courts have established that a creditor can reach the debtor's interest in a spendthrift trust (even where the trust is created by a third party) if the debtor-beneficiary can exercise dominion over the trust property. See In re May, 83 B.R. 812, 814 (Bankr. M.D. Fla. 1988) ("A trust fails, under Florida law, where the beneficiary exercises absolute dominion over trust property. ... Similarly, where the beneficiary has the right to require the trustee to convey trust property to him or her, the beneficiary has dominion and control over the trust res and the trust will fail as a spendthrift trust.").

A recent bankruptcy case in Illinois allowed creditors to reach a spendthrift trust because the beneficiary had control to obtain the trust assets. In re George McCoy, 274 B.R. 751 (N.D. Ill. 2002). In that case, the surviving husband was the trustee and primary beneficiary of a testamentary trust created under his wife's will. The trust authorized the trustee, in its discretion, to pay so much of the assets as the trustee determines "to be required or desirable for his health, maintenance and support. The trustee need not consider the interests of any other beneficiary in making distributions to my spouse." The court cited the Restatement (Second) of Trusts, for the proposition that "if the beneficiary can call for the principal or can take it as needed, the restraint on alienation is invalid." The court reasoned that the use of the term "desirable" and the fact that the trustee did not have to consider the interests of other beneficiaries meant that the husband-trustee did not have "a sufficient restraint to prevent the beneficiary to receive the corpus." The court interpreted the settlor's intent as giving the surviving spouse complete dominion and control. (Interestingly, the court said it would have recognized spendthrift protection if the trust had omitted the word "desirable" in the standard for distribution.)

Another recent arose under Arizona law. In re Pugh, 274 B.R. 883 (2002). In that case, a mother created two separate trusts, one for the benefit of each of her son and daughter. Each child was named as sole trustee of his or her trust, but before any distributions could be made, the child had to appoint a co-trustee, and could not participate in any distribution decisions. The son appointed the daughter as the co-trustee of his trust, but the evidence showed that the trust bank account was exclusively controlled by the son (who became the debtor in the bankruptcy case.) The court determined that the daughter did not, in fact, act as trustee. The Arizona spendthrift statute provides that a spendthrift trust is invalid if the sole beneficiary is also the trustee, and the court allowed the son's creditors to reach the trust assets.

Some commentators maintain that the beneficiary definitely should not serve as trustee if asset protection is important.

"Practitioners should generally avoid making the individual subject of asset protection planning a trustee of a trust, regardless of whether the individual created the trust or whether the trust was created for such individual by another party. Notwithstanding the fact that the trustee must govern himself or herself in accordance with fiduciary obligations, this situation raises the appearance of impropriety and may hinder the ability of a court to impartially consider the facts." Nelson, Asset Protection & Estate Planning Why Not Have Both? POWER OF ASSET PROTECTION ANNUAL WEALTH PROTECTION. CONF. (2002).

"It is still advisable to provide for the appointment of an independent trustee in an effort to foreclose any suggestion by the trustee/beneficiary's creditors that the law should be otherwise or that the trust is, in fact, somehow a 'sham'". Rothschild, Protecting the Estate from In-laws and Other Predators, 35TH ANNUAL UNIV OF MIAMI PHILIP E. HECKERLING INST. ON EST PL. ¶ 1707.4 (2001).

Mr. Rothschild suggests that a bank or trust company should be used as trustee in particularly sensitive situations: "Even where the trust is not self-settled, where maximum asset protection is needed, a bank or trust company can be named as trustee in lieu of an individual." Id.

A strategy suggested by various commentators would be to name two trustees—the primary beneficiary as the investment trustee, and another person (perhaps a friend of the beneficiary) as a distribution trustee. The primary beneficiary might even be given the power to remove and replace the distribution trustee. Oshins & Riser, Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection, TRUSTS & ESTATES (Oct. 2001). Mr. Greer indicates that "[t]he right to remove and replace the independent trustee could continue to be given to the beneficiary, provided the beneficial interest is not wholly discretionary but is limited to an ascertainable standard. However, it is preferable for both tax and creditor protection purposes to give the beneficiary the power to remove the independent trustee only 'for reasonable cause,' as defined in the trust document." Greer, The Alaska Dynasty Trust, 18 ALASKA L. REV. 253, 274 (2001).

C. Summary of Selection of Trustee Issues With Respect to Creditors Rights.

APPENDIX A

Twenty Things You Have to Know About Selecting Trustees and the Powers of Trustees Steve R. Akers Bessemer Trust

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PROBING NON-TAX ISSUES

1. Probe the appropriate selection of trustee for non-tax factors in our role as counselor.

DONOR ISSUES

GIFT TAX

2. Plan whether or not the transfer to the trust should be a completed gift.

ESTATE TAX

3. If the goal is to keep the asset out of the donor's estate, do not allow the donor to be a beneficiary, unless the trust is in a "self-settled trust" jurisdiction.
4. Be careful with having the donor serve as trustee if the donor has powers over distributions.
5. If the trustee's powers over distributions are not limited by a fixed determinable standard, prohibit any possibility of the donor becoming trustee or co-trustee.
6. The donor can serve as trustee if there is a determinable external standard on distributions.
7. The donor can have administrative powers as trustee as long as the powers are subject to court control and fiduciary duties.
8. Do not give the donor-trustee either of two prohibited powers.
9. The donor can have broad trustee appointment and removal powers.

INCOME TAX

10. Avoid having foreign persons as ½ or more of the trustees.
11. Avoid or trigger the grantor trust rules, as desired.

BENEFICIARY ISSUES

GIFT TAX

12. If the beneficiary is trustee, use an ascertainable standard on distributions to OTHER beneficiaries.

ESTATE TAX

13. Limit the beneficiary from serving as trustee if distributions to the beneficiary are not limited by an ascertainable standard.
14. The beneficiary can be given the authority as trustee to make distributions to himself or herself if there is an ascertainable standard on distributions.
15. Restrict the trustee from making distributions that would satisfy the trustee's legal support obligations.
16. The beneficiary may have broad powers to appoint and remove trustees (like the donor).

INCOME TAX

17. Having a beneficiary as sole trustee MAY result in grantor trust treatment as to the beneficiary.
18. Determine if the appointment of a trustee in another state will avoid or cause state income taxation on undistributed trust income and gains.

MISCELLANEOUS ISSUES

19. Use a Savings Clause
20. Be wary of having a beneficiary as trustee with the authority to make distributions if there are any creditor concerns for the beneficiary.