Estate Planning
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From Howard M. Zaritsky
***47** GIFT TAX-FREE INCOME SHIFTING
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Recent increases in the estate tax applicable exclusion amount and the generation-skipping transfer ('GST') tax exemption, and the continuing possibility of estate tax repeal have caused some practitioners to focus more attention on the tax savings available through income shifting. A client who can shift taxable income from a high-bracket (35%) donor to a low-bracket donee (0%-15%) can realize significant income tax savings, despite the relatively low current income tax rates and the relatively narrow discrepancy between the top and bottom rate brackets. For example, a donor in the top income tax bracket who can shift the incidence of tax on $36,000 of income to three children whose other income merely offsets any available personal exemptions and standard deductions, can save over $8,000 per year in federal income taxes.

Two recent private letter rulings demonstrate a good method for using an irrevocable trust to shift taxable income from a high-bracket donor to low-bracket donees, without a taxable gift of the underlying principal. These trusts are based on well-established income and gift tax rules, and should be considered by estate planners for appropriate clients.

The rulings

In Ltr. Rul. 200502014, the grantor proposed to create a trust that authorized the trustee to distribute income and principal (including all or none) to and among a class of beneficiaries that included the grantor and the grantor's spouse, the grantor's descendants, the grantor's sibling, and the grantor's parent. The trustee was to make distributions as directed either by the unanimous decision of the distribution committee or by the joint decision of the grantor and one member of the committee. The initial distribution committee consisted of the grantor's sibling and parent, and the committee was always required to include two beneficiaries, other than the grantor or the grantor's spouse. The grantor also reserved a testamentary special power to appoint the trust principal, including any accumulated and undistributed income, to anyone other than the grantor, the grantor's estate, the grantor's creditors, or the creditors of the grantor's estate.

The facts in Ltr. Rul. 200612002 were quite similar. There, the grantor created a trust and directed that, during the grantor's lifetime, the trustee would distribute trust income and principal to and among a class that included the grantor, the grantor's sibling, the grantor's descendants, a named individual, and a named private charitable foundation. The distributions would be made in amounts and at times selected either by the unanimous vote of a 'power of appointment committee' or by the decision of the grantor and one member of the committee. The power of appointment committee initially consisted of the grantor's sibling and the named individual beneficiary, but it was, at all times, required to include at least two trust beneficiaries, other than the grantor or a spouse of the grantor. [FN1] The grantor retained a broad testamentary power to appoint the trust funds at the grantor's death, to anyone other than the grantor, the grantor's estate,

the grantor's creditors, or the creditors of the grantor's estate.

In both rulings, the IRS stated that the grantor's transfers to the trust were incomplete transfers for gift tax purposes, because the trustee could distribute trust funds back to the grantor and the grantor reserved a testamentary power to appoint any undistributed trust funds. [FN2] Thus, the grantor had not completely parted with dominion and control over the transferred assets. The IRS also concluded that any actual trust distributions to the beneficiaries would complete the grantor's transfer, to the extent of the distribution, and would constitute a taxable gift to the ***48** beneficiary of the amount distributed. [FN3]

In addition, the IRS found that none of the trustees held general powers of appointment over the trust fund, merely because they were also beneficiaries of the trust. The IRS noted that each trustee could distribute trust funds to himself or herself only with the consent of another beneficiary, whose interest was adverse to the trustee's exercise of the power in his or her own favor. Accordingly, distributions to a beneficiary were not gifts by a trustee to that beneficiary, for gift tax purposes. [FN4]

The IRS also stated that neither trust was a grantor trust. The trusts did permit distributions to the grantor, which normally creates a grantor trust under Section 677(a), but the IRS observed that this power could be exercised only with the consent of a party whose interest was adverse to its exercise in favor of the grantor, which prevents characterization of the trust as a grantor trust. [FN5]

Analysis and planning

Private letter rulings are, of course, not precedents upon which a taxpayer can rely, but these two rulings appear to construe the various tax rules correctly. Consequently, they demonstrate how to create an irrevocable trust that has the following tax attributes:

1 transfers to the trust are not completed taxable gifts for gift tax purposes; [FN6]

2 the trust is a separate taxpayer for federal income tax purposes, and distributions of income to beneficiaries will be taxed to the beneficiaries, rather than to the grantor;

3 outright distributions from the trust to persons other than the grantor will be completed taxable gifts of present interests to the beneficiary in the year they are distributed; and

4 the trust assets will be included in the grantor's gross estate for federal estate and GST tax purposes. [FN7]

The IRS did not address the estate tax treatment of the trust, but the grantor's power to alter the ultimate distribution through the retained testamentary power of appointment--even though limited--is likely to constitute a retained power to alter beneficial enjoyment of the trust fund under Section 2038. Furthermore, in most states, the trustee's discretion to make distributions to the grantor would constitute a retained beneficial enjoyment of the trust, because the grantor's creditors could compel the trustee to exercise that power. Hence, the trust would be included in the grantor's gross estate under Section 2038 and, possibly, under Section 2036(a)(1). [FN8]

This arrangement thus permits a wealthy grantor who is in a high income tax bracket to transfer income-producing assets to an irrevocable trust, that can then make distributions to children and grandchildren in lower income tax brackets, shifting the incidence of the income tax to those beneficiaries. The IRS did not discuss whether those transfers would qualify for the gift tax

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annual exclusion, but as they are outright distributions, they certainly should constitute gifts of present interests for which the $12,000 gift tax and GST tax annual exclusions would be available.

Moreover, distributions made outright for the payment of tuition or medical expenses should arguably qualify for the unlimited annual exclusion, despite the fact that this exclusion is available only for direct transfers (amounts 'paid on behalf of an individual'). The transfers to the trusts in these two private rulings are completed only when the distribution is actually made to or on behalf of the beneficiary, and if made directly to the medical or educational services provider, they should logically qualify for the exclusion. [FN9] There appears to be no relevant case or ruling on this point, however.

Conclusion

The incomplete transfer trusts described in these private letter rulings may be a useful tool for shifting income to children and grandchildren of grantors who can afford to transfer income-producing principal to fund such trusts. Support for adult children and grandchildren who may be attending college may be a particularly appropriate use of these trusts, because the trustee can both make cash distributions to the beneficiary and directly pay educational expenses. These are not simple transactions, but for appropriate wealthy clients, they may be very useful.

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[FN1]. The trust instrument included extensive provisions to assure that the committee always included one or more persons, other than the grantor, who had a substantial interest adverse to the exercise of the committee's power to make distributions to the grantor. These provisions are a good drafting guide for practitioners.

[FN2]. Regs. 25.2511-2(b) , 25.2511-2(c) , and 25.2511-2(e) . Also see Estate of Sanford, 308 U.S. 39, 23 AFTR 756 (S.Ct., 1939).

[FN3]. Reg. 25.2511-2(f) .

[FN4]. Reg. 25.2514-3(b)(2) .

[FN5]. Section 677(a). The IRS also noted that there were no provisions of the trust that would cause the grantor to be deemed to own the trust under Section 673, 674, 676, or 677, and that no conditions appeared to cause administrative controls to be exercisable primarily for the benefit of the grantor under Section 675, but that this latter point was a question of fact, to be determined after the returns filed by the parties are examined by the IRS.

[FN6]. Section 2702 does not apply, because the transfer in trust is incomplete. Section 2702(a)(3)(A)(i) .

[FN7]. It is also noteworthy that the result of this ruling would be changed under Section 2511(c) , which is effective only after the repeal of the estate tax. This section states: 'Notwith-

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standing any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.' The transfers in this ruling would, therefore, be deemed completed gifts after repeal of the estate tax, because the trust is not a grantor trust.

[FN8]. Outwin, 76 TC 153 (1981); Rev. Rul. 76-103, 1976-1 CB 293; see also TAM 199917001.

[FN9]. Section 2503(e); Reg. 25.2503-6 ; and compare, Reg. 25.2503-6(c), Example 2 , where a transfer to a trust that would pay tuition expenses was itself a completed transfer, and therefore did not qualify for the unlimited exclusion.

33 Est. Plan. 47, 2006 WL 1360900 (W.G.&L.)

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