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NONFIDUCIARY RIGHT TO SUBSTITUTE ASSETS DOES NOT CAUSE ESTATE TAX INCLUSION

By Howard M. Zaritsky and Stephan R. Leimberg

The irrevocable grantor trust (sometimes known as an “intentionally defective grantor trust” or “IDGT”) has become a common tool of sophisticated estate planning. A sale of assets to an irrevocable grantor trust can provide a very effective tool for freezing the estate tax value of the transferred asset and moving most or all future appreciation in value to the beneficiaries of the trust, without imposition of estate, gift, or generation-skipping transfer taxes.

One of the most difficult questions in planning with such a trust is selecting the appropriate way to cause the trust to become a grantor trust for income tax purposes but not cause estate tax inclusion. Obviously, a power to revoke or reserved power to control beneficial enjoyment cannot be used because the trust assets and all future appreciation would remain part of the grantor’s gross estate. I.R.C. §§ 2036(a), 2038(a). What practitioners have long sought is a reserved power that does not materially change the dispositions contemplated by the trust instrument but that will still cause the grantor to be deemed to own the trust assets for income tax purposes. *Rev. Rul. 85-13, 1985-1 C.B. 184.*

The grantor trust power favored by many practitioners is the power described in section 675(4)(C), which treats a grantor as the owner of any portion of a trust in respect of which:

A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: * * * (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

The power to reacquire assets in exchange for assets of equivalent value seems likely not to affect the beneficial enjoyment of the trust assets and interests, because it cannot shift benefits from one beneficiary to another, or reduce the value of the trust's net assets.

The use of this power, however, has been somewhat restricted by fear among many practitioners that the IRS might view the power as a retained right to revest the property in the grantor or to enjoy or control the benefits of the trust assets. Such a treatment would cause the trust assets to be included in the grantor's gross estate under section 2036(a) or 2038(a). They might also cause the transfers to the trust to be incomplete gifts for gift tax purposes. See

Treas. Reg. § 25.2511-1(c), 25.2511-1(g).

These fears were increased when, in 2006, the IRS added to its 2007-2008 Guidance Priority Plan (Aug. 13, 2007) a project described as: "Guidance under section 2036 regarding the tax consequences of a retained power to substitute assets in a trust." Practitioners should be pleasantly surprised to see how the IRS addressed this issue in *Revenue Ruling 2008-22*, 2008-16 I.R.B. 796 (April 21, 2008). This ruling is immensely important to sophisticated estate planning, and it deserves close scrutiny by estate planning practitioners.

Facts of the Ruling

A U.S. citizen funded an irrevocable inter vivos trust for the benefit of his descendants and named another person as the trustee. The trust instrument specifically prohibited the grantor from serving as trustee and granted the grantor the power, exercisable at any time, to acquire any property held by the trust by substituting other property of equivalent value. The substitution power was exercisable by the grantor in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity.

The trust did, however, require that, to exercise the substitution power, the grantor must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. Local

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