

2011 REGIONAL FORUMS - TRUST AND ESTATE DEVELOPMENTS

Trust modification prevents drafting error from resulting in costly transfer tax

PLR 201132017

IRS has given its blessing to a court-approved modification to a trust containing a drafting error that could have triggered significant transfer tax to the surviving spouse. Specifically, IRS ruled that, as a result of the modification, the surviving spouse will not be considered (1) to possess a general power of appointment over the trust at his death, (2) to have released a power during his life, or (3) to have made a deemed gift of an interest in the trust under [Code Sec. 2501](#) .


Background. Under [Code Sec. 2041\(a\)\(2\)](#) , the gross estate includes property over which the decedent possessed at the time of death a general power of appointment created after Oct. 21, '42. For this purpose, a general power of appointment is a power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. ([Code Sec. 2041\(b\)](#))

The exercise or release of a general power of appointment created after Oct. 21, '42, is deemed a transfer of property by the individual possessing such power. ([Code Sec. 2514\(b\)](#))

[Code Sec. 2501\(a\)](#) imposes a gift tax for each calendar year on the transfer of property by gift during the year by an individual.

Facts. Husband and Wife (Trustors) created an inter vivos revocable trust (Trust). They were Trust's original trustees.

Trust provided that upon the death of the first Trustor to die, the trust assets were to be divided among the Marital Trust, the By-Pass Trust, and the Survivor's Trust.

 **RIA observation:** Married persons often use a marital trust in conjunction with a bypass trust to reduce estate tax to zero on the death of the first spouse to die. The marital trust qualifies for the marital deduction and the bypass trust uses the decedent's applicable exclusion amount. On the death of the surviving spouse, assets in the marital trust are included in the surviving spouse's estate but those in the bypass trust are not. For estates of decedents dying after 2010 and before 2013, a deceased spouse's unused exclusion amount can be transferred to the surviving spouse. This option may preclude the need to employ a bypass

trust but there are differences between the two approaches that should be considered. See [Weekly Alert ¶ 35 03/10/2011](#) for details.

Trust Article IV, Section 4.01 provided that on the death of the Surviving Spouse, the Trustee was to pay from the trust estate the Surviving Spouse's debts, expenses, and death taxes due by reason of the Surviving Spouse's death and charge them against property in the *By-Pass Trust*.

Wife died, survived by Husband and three children. Husband was appointed executor of Wife's estate and is the trustee of the Survivor's Trust, the By-Pass Trust, and the Marital Trust.

Attorney 1 drafted Trust. After Wife's death, Attorney 2 was consulted and discovered an error in Article IV, Section 4.01. The error was that the language charging the Surviving Spouse's debts, expenses, and death taxes against property in the By-Pass Trust should have referred to the Survivor's Trust.

In affidavits, Husband and Attorney 1 represented that it was the Husband and Wife's intent as Trustors to minimize estate taxes, including maximizing the use of the unified credit.

Accordingly, the By-Pass Trust should have been drafted to ensure that the assets in the By-Pass trust would not be included in the Surviving Spouse's gross estate and the Surviving Spouse would not have any property or other rights to the trust property that would cause the assets to be included in the Surviving Spouse's gross estate upon Surviving Spouse's death.

In order to correct the error in the Trust and to accurately reflect the intent of the Trustors, Husband, as the Trustee of Trust, filed a petition with a state court seeking authorization to modify Trust *nunc pro tunc* (retroactive to the trust's inception). Husband, as the surviving Trustee, stated that it was at all times his intent and desire that the assets of the By-Pass Trust be administered so as to avoid taxation at Surviving Spouse's death. He advanced various arguments that the reference to the By-Pass Trust was a scrivener's error. The state court agreed and modified the trust in the manner sought.

Favorable rulings. IRS observed that the documentation submitted by Husband strongly indicated that he and his wife did not intend to have any control over the assets held in the By-Pass Trust, and that the provision in Section 4.01 of Trust to charge Surviving Spouse's debts,

expenses and death taxes from the By-Pass Trust was the result of a scrivener's error. In reforming the By-Pass Trust, the state court found that the modification of Trust was an equitable reformation of Trust under common law and a state statute providing that when through fraud or mutual mistake of the parties, or a mistake of one party, a written contract does not truly express the intention of the parties, it may be revised on the application of the party aggrieved.

Consequently, IRS concluded that the state court order modifying the trust instrument *nunc pro tunc* based on a scrivener's error was consistent with applicable state law that would be applied by the highest court of that state. IRS found that section 4.01 of Trust, as modified by the court order, did not provide Surviving Spouse with a general power of appointment under [Code Sec. 2041\(b\)](#) over the assets of the By-Pass Trust. Therefore, IRS concluded that the value of the assets in the By-Pass Trust will not be included in Surviving Spouse's gross estate under [Code Sec. 2041\(a\)\(2\)](#) upon his death.

IRS also concluded that the modification will not (1) constitute the exercise or release of a general power of appointment by Surviving Spouse within the meaning of [Code Sec. 2514\(b\)](#) , or (2) be treated as a deemed transfer of an interest in Trust by Surviving Spouse for gift tax purposes under [Code Sec. 2501](#) .

References: For general powers of appointment, see [FTC 2d/FIN ¶ R-3000](#) ; [United States Tax Reporter Estate & Gift ¶ 25,144](#) ; TaxDesk ¶ 767,301 ; TG ¶ 41000

Trust's distribution of annuity contracts to beneficiaries won't be gratuitous transfer

PLR 201124008

IRS has privately ruled that flexible premium deferred annuity contracts purchased by a trust, of which each of the trust beneficiaries will be the named annuitant of a contract in proportion to his residuary share of the trust, will be considered owned by natural persons for [Code Sec. 72\(u\)](#) purposes. Additionally, the trust's distribution of the contracts to the beneficiaries won't

be treated as an assignment of an annuity contract without full and adequate consideration under [Code Sec. 72\(e\)\(4\)\(C\)](#) .

Background. An annuity is a contract providing for regular payments beginning on a fixed date and continuing for the life of one or more individuals or for a term of years. Generally, the contract is a life insurance, endowment, or annuity contract purchased from an insurance company, but an annuity may be issued by a party other than a commercial insurer. The special tax rules for annuities under [Code Sec. 72](#) generally permit the annuitant to recover the cost of the contract tax-free over the term of the annuity.

However, under [Code Sec. 72\(u\)](#) , an annuity contract won't be treated as an annuity contract if it is held by a person who isn't a "natural person." Instead, the income on the contract for any tax year of the policyholder will be treated as ordinary income received or accrued by the owner during that tax year. Corporations and trusts aren't natural persons according to the '86 TRA Committee Reports, but [Code Sec. 72\(u\)\(1\)](#) provides that the holding by a trust or other entity as an agent for a natural person will generally be disregarded.

An individual who holds an annuity contract transfers it for less than full and adequate consideration, is treated under [Code Sec. 72\(e\)\(4\)\(C\)\(i\)](#) as receiving a nonannuity payment equal to the excess of: (i) the cash surrender value of the contract at the time of transfer, over (ii) his investment in the contract.

Facts. Husband (H) established a grantor trust (Trust) and named as beneficiaries Wife (W) and their six descendants. H and W were co-trustees during H's life.

Upon H's death, W became the sole trustee, and the trust was divided into subtrusts A, B, and C. Subtrust A was allocated an amount based on the allowed estate tax exemption and marital deduction. Subtrust C was allocated an amount based on the estate tax exemption, provided the amount was not used for the payment of taxes, debts, or administration expenses of H's estate. Once all taxes, debts, and expenses have been paid, the assets of subtrust C are to be distributed to subtrust B, which contains all remaining trust property.

During the life of W, in her capacity as trustee and subject to an ascertainable standard, W may pay or use the property of subtrust B for the benefit of herself and others partly or wholly

dependent upon her. At her death, the property of subtrust B is to be divided and distributed among the descendant-beneficiaries in the proportions stated in Trust.

W, as trustee, intends to purchase flexible premium deferred annuity contracts naming each of the descendant-beneficiaries as the annuitant on one annuity contract, in proportion to each's residuary share of Trust. The material provisions of each contract will be substantially the same, except for the dates of annuitization. Trust will be the owner and beneficiary of the contracts during W's life. Trust anticipates that its other assets will be sufficient to fund its expenses and make nominal distributions to W, and that there should not be any need for Trust to take a distribution from the annuity contracts.

Upon Trust's final distribution, each beneficiary will be distributed the contract for which that beneficiary is the annuitant. This distribution is anticipated to occur before the contract's annuity starting date. Trust won't receive any consideration from any beneficiary in exchange for the contracts.

IRS rules favorably. In a taxpayer-friendly private letter ruling (PLR), IRS concluded that the annuity contracts are considered owned by natural persons for **Code Sec. 72(u)** purposes, and that the distribution of the contracts by Trust to the beneficiaries won't be treated as an assignment of an annuity contract for less than full and adequate consideration under **Code Sec. 72(e)(4)(C)** .

With regard to the **Code Sec. 72(u)** ruling, IRS examined the legislative history and determined that provision was largely intended to target employers' use of annuity contracts to fund significant amounts of deferred compensation for employees on a tax-favored basis. In contrast, the annuity contracts at issue are owned by a trust under which all of the beneficial interests are owned by natural persons in a non-employment context. Accordingly, IRS determined that the contracts were properly treated as being owned by a natural person for **Code Sec. 72(u)(1)** .

Looking to the **Code Sec. 72(e)(4)(C)** issue, IRS found that the legislative history of this provision indicates that this rule is intended to prohibit taxpayers from avoiding **Code Sec. 72(s)** 's required distribution rules by continuing tax deferral beyond the life of an individual taxpayer. Here, since the transfer of the contracts from Trust to the beneficiaries doesn't have


the effect of avoiding [Code Sec. 72\(s\)](#) 's required distribution rules, the distribution of the contracts won't be treated as an assignment for less than full consideration.

References: For the requirement that annuity benefits be available only to natural persons, see [FTC 2d/FIN ¶ J-5005](#) ; [United States Tax Reporter ¶ 724.25](#) ; TaxDesk ¶ 146,506 ; TG ¶ 12656 . For transfers of annuity contracts without adequate consideration, see [FTC 2d/FIN ¶ J-5061](#) ; [United States Tax Reporter ¶ 724.13](#) ; TaxDesk ¶ 146,531 .

“Bundled fiduciary fees” are fully deductible until final regs are issued

Notice 2011-37, 2011-20 IRB

In a Notice, IRS has issued interim guidance on the treatment of investment advisory and other costs subject to the 2% floor under [Code Sec. 67\(a\)](#) . Specifically, for tax years beginning before the date that final regs under Reg. § 1.67-4 are published, nongrantor trusts and estates do not have to “unbundle” a fiduciary fee into parts consisting of costs that are fully deductible and costs that are subject to the 2% floor.

 **RIA observation:** Initially, IRS had provided this relief only for tax years beginning before Jan. 1, 2008. In late 2008, IRS extended the relief to apply to tax years beginning before Jan. 1, 2009. In 2010, IRS granted yet another extension of this relief for tax years beginning before Jan. 1, 2010. The extension now provided—pegged as it is to the issuance of final regs—is undoubtedly the final extension of this relief.

Background. Miscellaneous itemized deductions are allowed only to the extent they exceed 2% of adjusted gross income (AGI). ([Code Sec. 67\(a\)](#)) For purposes of this floor, the AGI of an estate or trust is computed the same way as for an individual, subject to certain exceptions. ([Code Sec. 67\(e\)](#)) Under one exception, costs paid or incurred in connection with the administration of an estate or trust that wouldn't have been incurred if the property weren't held in the estate or trust are allowed as deductions in arriving at AGI. ([Code Sec. 67\(e\)\(1\)](#))

In January of 2008, resolving a conflict in the circuits courts, the Supreme Court held that investment advisory fees paid by a trust are deductible only to the extent that they exceed 2% of the trust's AGI. The Supreme Court reasoned that in determining whether a particular type of

cost incurred by a trust “would not have been incurred” if the property were held by an individual, [Code Sec. 67\(e\)\(1\)](#) excepts from the 2% floor only those costs that would be uncommon (or unusual, or unlikely) for an individual to incur. The Court found that the trustee, who had the burden of establishing entitlement to the deduction, failed to demonstrate that it was uncommon or unusual for individuals to hire an investment adviser. (Knight v. Comm (S Ct 1/16/2008), [101 AFTR 2d 2008-544](#) , see [Weekly Alert ¶ 13 01/24/2008](#))

In late July of 2007, IRS had issued proposed regs providing that investment advice costs incurred by an estate or non-grantor trust would be subject to the 2%-of-AGI floor for miscellaneous itemized deductions under [Code Sec. 67\(a\)](#) (see [Weekly Alert ¶ 9 08/02/2007](#)). Under the proposed regs, an estate or non-grantor trust that pays a single fee that includes both costs that are unique to estates and trusts, and costs that are not, would have to use a reasonable method to allocate the single fee between the two types of costs. ([Prop Reg § 1.67-4\(c\)](#)) Thus, the 2% floor couldn't be circumvented by combining investment advisory fees and trustees' fees into a single fee.



RIA observation: The proposed regs—under which costs incurred by a trust would have to be unique to a trust in order to be excepted from the 2% floor—are more restrictive than the Supreme Court's decision in *Knight*, under which costs incurred by a trust are excepted from the 2% floor if the costs would not commonly or customarily be incurred by individuals.

IRS is planning to issue final regs consistent with the Supreme Court's holding in *Knight*. Those regs will also address the issue raised when a nongrantor trust or estate pays a “bundled fiduciary fee” for costs incurred in-house by the fiduciary, some of which are subject to the 2% floor and some of which are fully deductible without regard to the 2% floor. Because the final regs, which will only apply prospectively, were not issued before the due date for filing 2007 income tax returns (determined without regard to extensions), IRS provided interim guidance in [Notice 2008-32, 2008-11 IRB 593](#) , for tax years beginning before Jan. 1, 2008 (see [Weekly Alert ¶ 13 03/06/2008](#)). It provided that taxpayers would not be required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor for any tax year beginning before Jan. 1, 2008. [Notice 2008-116, 2008-52 IRB 1372](#) , extended the interim guidance provided in [Notice 2008-32](#) to any tax years beginning before Jan. 1, 2009. [Notice 2010-32,](#)

[2010-16 IRB 594](#) , further extended the interim guidance to tax years beginning before Jan. 1, 2010 (see [Weekly Alert ¶ 12 04/08/2010](#)).

Relieve extended again. In [Notice 2011-37](#) , IRS says that taxpayers are not required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor under [Code Sec. 67](#) for any tax year beginning before the date that final regs are published. Instead, for each such tax year, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the 2% floor. But, payments by the fiduciary to third parties for expenses subject to the 2% floor are readily identifiable and must be treated separately from the otherwise bundled fiduciary fee.

References: For how the 2% floor applies to trusts, see [FTC 2d/FIN ¶ C-2202](#) ; [United States Tax Reporter ¶ 674](#) ; [TaxDesk ¶ 653,001](#) ; [TG ¶ 2664](#) .

Trust can't claim charitable deduction for full value of appreciated property though purchased with trust gross income

Chief Counsel Advice 201042023

In Chief Counsel Advice (CCA), IRS has held that a trust can claim a charitable deduction for only the adjusted basis of donated property, and not for its higher fair market value, even though the property was purchase out of its prior year's gross income and could be traced to that income.

Background. Under [Code Sec. 642\(c\)\(1\)](#) , an income tax charitable deduction is allowed to a trust only for contributions made out of gross income. A contribution made out of income accumulated in earlier years is deductible, but only if no deduction was allowed to the trust for any previous year for the amount currently contributed.

Facts: The agreement under which a trust was organized provided that the trustee could distribute to charity such amounts of the trust's gross income as the trustee determined appropriate. The trust contended that all of the properties contributed to charity during the current year were purchased with prior years' gross income and could be traced to that gross

income. The charitable contribution deduction claimed by the trust was based on the donation of three properties to three different charities. The trust based its deduction on the fair market value of the properties at the time they were donated to the charities, rather than on the lower amount that the trust had actually paid for them.

IRS's conclusion. The CCA concluded that the trust could claim a charitable deduction only in the amount of the properties' adjusted bases, and not based on their higher fair market values at the time of donation. In so holding, IRS said that to conclude otherwise would give the trust a double tax advantage: (1) avoidance of tax on the potential gain, and (2) the ability to deduct not only the basis, but also the gain, from gross income. IRS also pointed to a statement in *Frank Trust of 1931 v. Com.*, (CA3 1944) [32 AFTR 1478](#) , to the effect that appreciation in value, unrealized by sale or other disposition, is not gross income for charitable deduction purposes. However, IRS noted that the present fact situation differs from *Frank Trust* in that the contributions to charity made here were of property purchased in a previous year from gross income, while in *Frank Trust* the contributions were of securities received in a tax-free exchange for other securities that had been part of the trust's original corpus. Thus, after concluding that the trust couldn't claim a deduction for the full value of appreciated property purchased out of trust gross income, IRS felt forced to add that it could find no prior cases or other authorities in which IRS had so limited such a deduction.

References: For requirement that charitable contributions by trust be made from gross income, see [FTC 2d/FIN ¶ C-2307](#) ; [United States Tax Reporter ¶ 6424.02](#) ; TaxDesk ¶ 653,023 ; TG ¶ 2678 .

Credits: This material has been taken from RIA Federal Taxes Weekly Alerts