## The Furnace of Confusion Smolders Deep Within Section 2036 (a) (2)

### I. Section 2036(a) (2) is an Oldie but Not a Goody

Much discussion has been had since *Estate of Strangi* ("*Strangi II*"),[1] on that mysterious section, 2036 (a) (2) of the Code, and its implications. But estate planners have been dealing with 2036 (a) (2) and trusteeship issues for a long time.

Section 2036 provides:

"(a) GENERAL RULE. ---The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer … under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death –…

ii. The right, either alone in conjunction with any person, **to designate** the persons who shall possess or enjoy the property or the income therefrom. (Emphasis added)."

As practitioners are all too painfully aware of these days, in *Strangi II,* Judge Mary Ann Cohen accepted both prongs of section 2036 to include decedent's pro rata value in the partnership (essentially all of the partnership), without discounts, in the decedent's gross estate.

She implicated the second prong -- 2036 (a)(2) -- by concluding that a partner that has any say with regard to the right to liquidate or distribute partnership assets, either as a controlling general partner, or as a limited partner acting in conjunction with the other limited and general partners, was tantamount to the "right to designate."[2] The decision has been the topic of much intellectual discussion over its correctness, as well as ruminations on how to proceed on partnership planning in light of the decision.

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[1] TCM 2003-145. The IRS appealed the decision of the Tax Court in *Gulig*, 89 AFTR 2d 2002-2977 (5th Cir. 2002) (Gulig was the independent executrix acting on behalf of the estate). There, in addition to the arguments it raised in *Strangi I*, the IRS sought to have the Circuit Court reverse the Tax Court's denial of leave to amend to add a claim that under § 2036 the estate should include the value of the limited partnership assets transferred from the decedent. Concluding that the Tax Court's denial was an abuse of discretion, the Fifth Circuit reversed and remanded for consideration of the § 2036 claim. It affirmed all other conclusions made by the Tax Court, but with the proviso that the Tax Court may revisit its valuation ruling after considering the § 2036 claim.

[2] *Id.* at 742-745. "The SFLP/Stranco arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed *infra*, therefore fall within the purview of section 2036 (a)(2)."

But practitioners have been dealing with the implications of section 2036 (a) (2) in the trust context for a long time. Despite the questionable application of 2036 (a) (2) to the partnership area, its application to irrevocable gifting trusts still presents major hurdles to practitioners in the planning area. It is time to revisit that section and its implications to donors acting as trustees of the various gifting type trusts, including GRATs, QPRTs, and *crumm*ey trusts.

The decision to make gifts in trust raises the question of who to name as trustee. The most conservative route and the one often advocated for gifts in trust is to name a third party as trustee, one other than the donor or the donor's spouse. Often, however, that choice for trustee is not palatable to the client. In many instances, the client wishes to be trustee over gifted assets in order to maintain decision making authority over the investment and distribution of those assets.

## II. Estate Tax Concerns with Donor acting as Trustee

Even when the donor retains **no** beneficial interest in a trust the donor created and funded, sections 2036(a)(2) and 2038 pose statutory obstacles to a donor acting as trustee. [3]

The right of a donor of property to act as trustee over transferred property may invoke these provisions. Under Section 2036(a)(2), certain trustee authority is arguably tantamount to a right to "designate" who will enjoy the trust property. Under Section 2038, those powers may equate to "altering" a beneficiary's interests. For example, treas. reg. §20.2036-1(b)(3) provides that the right to designate includes a reserved power to designate the persons "to receive the income from the transferred property, or to possess or enjoy non-income producing property." The regulation implies that certain powers as trustee equal that right.[4]

Further, there is a line of cases holding that a donor who, as trustee over gifted property, has discretionary authority to accumulate income or discretion to distribute principal to the beneficiary has a 2036(a)(2) and 2038 power. For example, in the U.S. Supreme Court Case of United States v. O'Malley[i], the donor as co-trustee had the power to accumulate income in a trust. The court held that "[t]his is a significant power . . . and of sufficient substance to be deemed the power to ‘designate.'"

Other cases stand for the same proposition.[ii] The reasoning of these cases is that the right as trustee to determine whether and when a beneficiary is to receive property is tantamount to "designating" the beneficiary who will receive the property.

[3] Section 2038 provides that if the enjoyment of the transferred property was subject to change through a right to "alter" or "amend" held by the decedent at death, the gifted property is included in the decedent's estate.

[4] Treas. Reg. §20.2038-1(a) is more express in the dangers of a grantor acting as trustee: "Section 2038 is applicable to a power reserved by the grantor of a trust 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."

As a result of these cases, as well as IRS rulings on the topic[iii], practitioners tend to advocate against a donor acting as a trustee of a trust holding gifted property. However, in those situations in which the donor insists on acting as trustee, the exceptions to the applications of Sections 2036(a)(2) and 2038 should be understood and a permissible format developed.

## III. Trusts Designed to avoid 2036(a)(2) and 2038 application

The regulations provide no explicit exceptions to the rule invoking Sections 2036(a)(2) and 2038 in the event the donor of property acts as trustee over that property. However, there is a line of cases creating an exception to the application of those sections if the grantor can act only pursuant to an ascertainable distribution standard in the trust document.

A leading case is Jennings v. Smith.[iv] In the trust in Jennings, income could be distributed as "reasonably necessary to enable the beneficiary in question to maintain himself and his family . . . in comfort and in accordance with the station in life to which he belongs." Principal could be invaded for extraordinary medical expenses, financial misfortune or to purchase a home. The court held that neither sections 2036(a)(2) nor 2038 were invoked, because the trustees did not have "unlimited discretion to act or withhold action under the power, since the trust instrument provided an external standard which a court of equity would apply to compel compliance by the trustees . . . ."[v] The court required only that the distribution power be "sufficiently definite to be capable of determination by a court of equity."[vi]

Other cases also stand for the proposition that sections 2036(a)(2) and 2038 can be avoided if the trustee must act pursuant to an ascertainable distribution standard.[vii] These cases all reason that an ascertainable standard is one that is enforceable under state law, thereby allowing a court to delineate the specific purposes for which funds are to be used. The unstated premise is that the trustee does not in essence have discretionary distribution power, only the right to carry out the terms of the trust pursuant to specific conditions. Accordingly, the donor-trustee has not retained any 2036(a)(2) or 2038 power to designate, alter or amend the enjoyment of the transferred property. These decisions place emphasis on the ability of a beneficiary to have a state court compel the distribution. Accordingly, in structuring these trusts, the following rules should be followed.

First, the trust document should provide that the trustee "shall" make the distributions pursuant to the specific standards. The use of the permissible language, "may," though implicitly allowed by the Jennings court, arguably removes a court's ability to compel distribution even pursuant to ascertainable standards.[viii]

Second, unascertainable standards should be avoided. Discretion to distribute funds for a beneficiary's "comfort," "welfare" or "happiness" are not ascertainable and a court can not construe the trustee's authority.[ix] The same result applies to distribution standards for a beneficiary's "benefit," "best interest," and "if the circumstances so require."[x]

Standards limited to "support, education or maintenance," "care, support and medical attention," "support in reasonable comfort," "education", or "in the event of sickness, accident, misfortune or other emergency," have been held to be ascertainable[xi] and are therefore exceptions to the application of 2036(a)(2) and 2038.

Third, unlike Section 2041, the ascertainable standard exception does not necessarily have to relate to health, support, maintenance or education. Accordingly, a standard requiring distribution of funds to develop a business or purchase a house, or at certain ages, or to buy a boat or take specific trips, or when a certain income is obtained, should be acceptable.

While it may be possible to include such provisions in certain gift trusts, not all gifts in trust will allow the use of ascertainable standards. Therefore, the type of gift and trust must be analyzed and coordinated with the use of an ascertainable standard.

## IV. Annual Exclusion and Unified Credit Gifts.

### a. Described

Annual exclusion ($12,000 per donee per year) and unified credit gifts ($1,000,000 per donor during lifetime) can be made outright or in a manner deferring actual ownership, like a trust or custodial arrangement.

### b. Retaining Custodianship In A Transfer Pursuant To A Custodial Arrangement

Gifts under the Uniform Transfers to Minors Act grant to the custodian broad discretionary distribution powers. For example, the Uniform Transfers to Minors Act provides that a custodian may use for a minor's benefit so much of the custodial property as the custodian "considers advisable for the use and benefit of the minor."[xii] These standards are not necessarily ascertainable, thereby creating 2036(a)(2) concerns. In Revenue Ruling 57-366, the Service held that the custodial property was included in the gross estate of the donor when the donor acted as custodian, a result followed by the courts.[xiii]

### c. Retaining Trusteeship in Annual Exclusion Trusts and 2503(c) Trusts.

Gifts in trust are generally gifts of future interests that do not quality for the annual exclusion. Two widely used exceptions are so-called Crummey trusts and section 2503 (c) trusts.

It is possible to make annual exclusion gifts to and retain trusteeship over the gifted assets without 2036(b) or 2038 consequences in a Crummey trust. Crummey trusts are not statutory creatures but a result of the Ninth Circuit's decision in Crummey v. Comm'r,[xiv] and the Seventh Circuit in Kierckhefer v. Comm'r.[xv]

For gifts to a Crummey trust to qualify for the annual exclusion, it is required only that the beneficiary have a meaningful right to withdraw the property from the trust for a relatively short time period. No further rights to receive distributions of income or principal from the trust are required.[xvi] Therefore, limiting trustee discretion to an ascertainable standard is permissible in Crummey trusts.

Conversely, section 2503(c) trusts in effect require that distributions be allowed to be made pursuant to a broad unascertainable standard. Section 2503(c) provides that a transfer to a donee under age 21 in trust qualifies for the annual exclusion if certain requirements are followed. One criterion is that "the property and the income therefrom . . . may be expended by, or for the benefit of, the donee before his attaining the age of 21 years . . . ."[xvii] Treasury Regulation Section 25.2503-4(b)(2) interprets that requirement to allow trustee discretion to make distributions provided there are no "substantial restrictions" in the trust instrument on the exercise of that discretion. No definition is provided in the regulations for the term "substantial restrictions."

Recent case law and prior rulings have hinted that a substantial restriction may exist when the trustee's distribution power is limited by an ascertainable standard. For example, in Pettus v. Comm'r,[xviii] the Tax Court upheld prior rulings that trust distribution standards under a 2503(c) trust could be no more restrictive that those required of guardians under state law.[xix] See also The Illinois Nat'l Bank of Springfield v. U.S.[xx]

In light of National Bank of Springfield and Rev. Rul. 67-270, the prudent approach from a gift tax perspective is to draft discretionary language in section 2503(c) trusts in a broad manner, with a broad distribution standard. A broad distribution standard is by definition one which is not ascertainable. Accordingly, the donor of property will not be able to meet the judicial exception to sections 2036(a)(2) or 2038 and should not act as trustee.

### d. Retaining Trusteeship in Unified Credit Trusts

Gifts which are lifetime taxable gifts, invoking the unified credit, need not meet any requirement with regard to distribution standards. As a result, these gifts can be structured to fall within the ascertainable standard exception to 2036(a)(2). In this regard, distribution standards only for emergency medical needs, for education, or at certain defined ages or upon certain achievements, would be conservative routes to follow. This type of trust, as well as Crummey trusts, should be carefully drafted to avoid any right in the trustee to discharge his or her legal obligation of support. Under the regulations to Section 2041, a trustee who may discharge a legal obligation of support arguably has a general power of appointment.[xxi]

### e. Retaining Trusteeship in Insurance Trusts

A life insurance trust may be structured as a Crummey trust or a unified credit trust. Typically these trusts are set up in the Crummey manner. If the donor is the insured, the donor should not act as the trustee of the trust. Even though sections 2036(a)(2) may not apply, section 2042 could include the trust in the insured's gross estate.

That section includes in the insured gross estate any life insurance policy over which the insured has an incident of ownership at death. The insured may be considered to have an incident of ownership if a policy on the decedent's life is held in trust and the insured is the trustee.[xxii]

Conversely, if the insured's spouse is the trustee, section 2042 should be inapplicable unless the spouse is also an insured, such as would be the case with a joint life policy.

## V. Retaining Trusteeship in a QPRT and GRAT

The grantor may be the trustee of property transferred to a QPRT during the retained interest term. During that time, if the grantor dies, the property will be included in the grantor's gross estate under Section 2036(a)(1). Accordingly, during the retained interest term, the grantor acting as trustee adds no further estate tax disadvantage.

A different result occurs when the retained interest term expires and the property continues to be held in trust for the benefit of third parties. If the property is then held for the benefit of third parties pursuant to unascertainable standards, the grantor acting as trustee invokes 2036(a)(2) concerns.

In that situation, one strategy is for the grantor to resign as trustee (or for the grantor's tenure as trustee to end pursuant to the terms of the document) at the end of the retained interest term. Termination of the grantor's position as trustee should not cause the three year rule under Section 2035 to apply. Section 2035 provides that in the 2036 and 2038 context, there is a three year rule when there has been a transfer of property or a relinquishment that removes a 2036 or 2038 taint. One question, then, is whether there has been a "transfer of property" or "relinquishment" when the trustee resigns. Although there is arguably no transfer with a mere resignation as trustee, that action appears to be tantamount to a relinquishment. Accordingly, to avoid any affirmative act of "relinquishing," the terms of the document should provide that the trustee's tenure ends at the end of the retained interest period.

Although the GRAT presents a slightly different analysis, even in a GRAT the grantor acting as trustee is permissible during the retained interest term. When the grantor dies during the retained interest term, it is uncertain whether the full amount or only a portion of the trust will be included in the grantor's estate under section 2036(a)(1).[xxiii] Partial inclusion is more likely if the grantor dies toward the end of the grantor's retained interest term. In that instance, if the application of 2036(a)(2) would require full inclusion, that would be a problem.

But as trustee of a GRAT, the grantor is directed to distribute a fixed amount each year. Although the trustee has investment and other administrative powers, the trustee of a GRAT ordinarily has no discretionary distribution authority during the retained interest term. This limited distribution authority, because there is no discretion, should be sufficient to avoid sections 2036(a)(2) or 2038.

## VI. Conclusion

Beware 2036 (a)(2); the recent partnership cases have alerted the practitioner that this section of the Code is far from having its terms probated.

In creating trusts to hold lifetime gifts, the most prudent and versatile route is to name a third party, other than the donor or the donor's spouse, as the trustee. Circumstances arise in which the donor requests to act as trustee and will not make gifts pursuant to certain lifetime strategies unless able to act in that capacity. In those situations, certain trusts, with carefully drafted ascertainable distribution standards, may allow the donor to act as trustee while avoiding the applications of Sections 2036(a)(2) under current law.

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i. 383 U.S. 627 (1966).

ii. See also Estate of O'Connor v. Comm'r, 54 T.C. 969 (1970); Estate of Alexander, 81 T.C. 757 (1983); Old Colony Trust Co. v. U.S., 423 F.2d 601 (1st Cir. 1970); and Estate of Yawkey v. Comm'r, 12 T. C. 1164 (1949).

iii. Rev. Rul. 70-513; Rev. Rul. 73-143; Rev. Rul. 57-366.

iv. 161 F.2d 74 (2d. Cir. 1947).

v. Id. at 77, citing Estate of Budlong v. Comm'r, 7 T.C. 756 (1946)

vi. Id. at 77.

vii. See also Estate of Budd v. Comm'r, 49 T.C. 468 (1968); [Estate of Wilson v. Comm'r, 187 F.2d 145 (3d Cir. 1951),] Estate of Wier v. Comm'r, 17 T.C. 409 (1951), Estate of Pardee v. Comm'r, 49 T. C. 140 (1967).

viii. See Bogert, The Law of Trusts, at ¶89.

ix. See, e.g., Treas. Reg. § 20. 2041-1(c)(2).

x. Leopold v. U.S., 510 F.2d 617 (9th Cir. 1975), Estate of Yawkey v. Comm'r, 12 T.C. 1164 (1949), Hurd v. Comm'r, 160 F.2d 610 (1st Cir. 1947).

xi. Estate of Budd v. Comm'r, infra; See also Estate of Wier v. Comm'r, 17 T.C. 409 (1951); and Treas. Reg. §20.2041-1(c)(2).

xii. See ¶14 of UTMA of Uniform Laws Annotated (2d Edition).

xiii. See, e.g., Surrey, FEDERAL WEALTH TRANSFER TAXATION (2nd Ed. 1982) at 371.

xiv. 397 F.2d 82 (9th Cir. 1968).

xv. 189 F.2d 118 (7th Cir. 1951).

xvi. See Cristofani v. Comm'r, 97 T.C. 74 (1991).

xvii. I.R.C. § 2503(c)(1).

xviii. 54 T.C. 112 (1970)

xix. See also Rev. Rul. 67-270 and Ross v. U.S., 348 F.2d 577 (5th Cir. 1965).

xx. 756 F. Supp. 1117 (C.D. Ill. 1991).

xxi. Treas. Reg. §20.2041-1(c)(1).

xxii. See, e.g., Rose v. U.S., 511 F.2d 259 (1978); cf. Hunter v. U.S., 624 F.2d 833 (8th Cir. 1980).

xxiii. See Rev. Rule 76-273.