Gift Without Gift Tax

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Overview. This article presents a narrow slice of a broad subject, pointing out a potentially useful estate and gift tax planning feature.

The most-discussed form of this technique involves making a gift through an irrevocable trust, and retaining one of several powers over the trust estate enumerated in the *Internal Revenue Code* (*IRC* or Code) grantor trust provisions,[1] so as to impose on the donor the legal duty to personally report and pay the taxes on income earned by the trust. Since the duty is a *legal obligation*, it is not a gift, thus not taxable as such. This leaves the donees enjoying the gifts *and* an accelerated growth rate attributable to the absence of income taxes, and to the extent of the taxes paid it further reduces the gross estate of the donor-power holder for federal estate tax purposes.

Here, we consider a twist on the orthodox model: a gift by a parent to children through a trust under which both the parent and a *grand*parent of the children hold a power that obligates them to pay the trust income taxes. This becomes especially important when the grandparent has already made gifts exhausting his or her applicable exclusion amount.

The Grantor Trust Rules. The grantor trust rules require that the trust income, principal, or both be ignored for *income* tax purposes where they apply. The income, gift and estate tax provisions of the Code operate independently, so separate analysis is required for determining the effect of varying facts and circumstances.

The rationale for the rules rests on the premise that where a grantor has retained or granted rights to the trust property through interests in or controls over the trust, the grantor (if retained) or the third party power holder (if granted) should be taxed as though he or she owns the income from those assets.

When the assets of a trust are deemed owned by its grantor under *IRC* Sections 671 through 677 or 679, it is called a grantor trust. It is called a beneficiary-controlled trust when its assets are deemed owned by someone *other* than the grantor under Section 678 of the Code.

Definitions. Following are the definitions related to the grantor trust discussion:

Grantor. The term is undefined in the Code, but self-evident. It is anyone who has contributed property to a trust, to the extent of that contribution. Thus, if husband and wife make a contribution of community property for the benefit of the children, each is a grantor as to one-half.[2]

Adverse Party. An adverse party is any person: (a) who has a beneficial interest in the

trust; (b) whose beneficial interest is "substantial"; and (c) whose interest would be adversely affected by the exercise or non-exercise of the power or interest held by the grantor or other third party holder in question.[3]

Beneficial Interest. This refers to any interest held in a beneficial capacity, whether vested or contingent. It does *not* include the interest of a trustee, since a trustee has no beneficial interest as such, holding only bare legal title to trust property for the benefit of others.

Substantial Interest. A "substantial interest" is one, the value of which "...in relation to the total value of the property subject to the power is not insignificant."[4] Stated another way, taking into account all the contingencies that could prevent the beneficiary from receiving the interest or power, the value of the interest is substantial. Generally, a vested interest is treated as substantial. A contingent may or may not be so treated.

Adverse Interest. This is a trust interest adversely affected by the exercise or non-exercise of a power held by someone else. The determination turns on the relationship between the interest and the power; *e.g.*, the holder of an *interest* adverse to that of the grantor is a *party* adverse to the grantor.

Non-Adverse Party. One holding a substantial interest who is not an adverse party.

Related or Subordinate Party. This relates most closely to the application of *IRC* Sections 674 and 675. It is any *non-adverse party* who is: (a) the spouse of the grantor (if co-habiting); (b) a member of the grantor's family (parents, siblings, issue); and (c) persons in certain business relationships to the grantor over whom the grantor may exercise control.[5] As to the last, Sections 674 and 675 require that a related subordinate party be "subservient to the wishes of the grantor" in order to be so classified. Subservience is rebuttably presumed from the relationship.

Spousal Attribution. A grantor is treated as holding any power or interest held by his or her spouse.[6]

Assumed Facts. The donor is the parent (Pop) of the donees (Kids) *and* trustee under the gift trust. The power holders are Pop and the grandparent of the Kids (Gramps). The Kids are minors. The trust provides separate shares for each Kid, and for the accumulation of income and direct payment of the Kid expenses (other than those representing the support obligation of Pop) until age 21, followed by a 90-day window in which the Kid attaining that age may withdraw his or her share of the trust. If not withdrawn, the trust continues for the benefit of the Kid or Kids until some specified age is attained.

The Power Granted to Gramps. As a general proposition, anyone *other than* Pop (here, Gramps) is deemed to be the owner of some portion of the trust if:

_ he has a power, exercisable alone, to withdraw principal or income for himself; or

_ he has previously released or modified -- or partially released or modified -- such a withdrawal power, and thereafter retains such control as would make him the deemed owner under the grantor trust rules of *IRC* Sections 671-677. It is the *first* of those two powers we grant to Gramps in our illustration.

Note that Gramps need not be a beneficiary of the trust in order to be given the withdrawal power.

There are certain exceptions to the general rule. If *both* Gramps and Pop are deemed to be the owners (because of some other power retained by Pop) of some portion of the trust estate, the position of Gramps yields to that of Pop as to that overlapping portion. This avoids double-taxation of the trust income.

The Power Reserved by Pop. *IRC* Section 677 is a provision dealing with powers reserved by Pop. Specifically, he is deemed to own all or any portion of a trust, the income from which, without an adverse party s consent:

_ is or may be distributed to him, his spouse, or both;

_ is or may be accumulated for later distribution to him, his spouse, or both;

_ is or may be applied to pay premiums on policies of insurance on his life, that of his spouse, or both; or

_ is used to discharge Pop s legal support obligation to the Kids.

This section provides that Pop owns any portion of a trust ... whose income is or may be expended in any of the four ways enumerated without the consent of an adverse party. The language suggests that the grantor would own a fractional cross-section of the entire trust, including both income and principal, whenever the trust income may be applied in any of the four ways; *i.e.*, if one-fourth of the trust income could be paid to his spouse, Pop is deemed to own one-fourth of each item of trust income, deduction and credit allocable to both income and principal interests. The U.S. Treasury Regulations, however, reject this approach in favor of a more limited interpretation.

Under Regulation 1.677(a)-1(g), the Internal Revenue Service (IRS) declined to focus on the word whose and instead deemed the grantor to own only those items of income, deduction and credit allocable specifically to the portion of the trust from which the grantor (or spouse) may benefit. So, if the trustee may distribute to Pop only items allocable to the trust s ordinary income, he owns only the income portion of the trust, and if the trustee may distribute to him only items of gain allocable to trust principal, he owns only that portion of the trust principal.

The Effect of the *De Minimis* Rule. In our example, the withdrawal power is never exercised. Its non-exercise is called a lapse of the power. Neither Section 678 nor 677 addresses what happens on lapse, although other sections of the Code treat a lapse as an exercise of the power for gift and estate tax purposes. So, in order to avoid the risk of having some substantial part of the trust included in Gramps or Pop s estate at death, we limit their withdrawal powers to the *de minimis* amount ($5,000 or 5%).

IRC Sections 2041(b)(2) and 2514(c) provide that this will prevent inclusion of any part of the trust estate in the gross estate of either Pop or Gramps on death. (Technically, the restricted power to withdraw is not treated as a general power of appointment.)[7]
A trustee *power* to distribute to or for the support of someone Pop is obligated to support (here, the Kids) does not, in and of itself, make Pop the owner for income tax purposes. To the extent *actually* distributed for that purpose, however, Pop is taxed on it. This brings in the abatement noted above, as to overlapping tax obligations between Pop and Gramps. This aspect of Section 677 may cause the withdrawal power of Pop to exceed the *de minimis* amount, presenting a risk — however small — of inclusion in his estate of some small part of the trust estate at his death.

The foregoing does not apply if the power is timely renounced or disclaimed. So, if either Pop or Gramps runs out of money, there is an exit option.

The Trust Provision. Remembering that legal drafting is an art, not a science (entitling each practitioner to his or her professional opinion), here is one provision that should serve these purposes:

> [Gramps] and [Pop] may each withdraw annually a sum equal to one-half the distributable net income and one-half the capital gains of the Trust Estate. This demand power takes precedence over any other power or discretion granted Trustee or any other person *except for* the 90-day general power of appointment of a beneficiary attaining 21 years of age.
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> The foregoing notwithstanding, neither [Gramps] nor [Pop] may withdraw annually more than the greater of $5,000 or 5% of the aggregate value, of the assets from which the exercise of the powers were or could have been satisfied, at the time of exercise or lapse.
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> This right of withdrawal shall be exercised only by written instrument filed with Trustee in the month of December and shall be non-cumulative, so that if power holder fails to withdraw in December of any calendar year the full amount to which he is entitled under the foregoing provisions, such right to withdraw the unwithdrawn amount shall lapse at the end of that calendar year.

This provision makes Gramps and Pop power holders taxable on both ordinary income and capital gains of the trust until (as to each) a Kid reaches the 90-day window at age 21. Since the Kid has a greater power at that point, he or she gets to pay the tax on 90/365ths of that year s income. Thereafter, if the trust continues, Gramps and Pop again get the remaining tax bill.

The History and Background. IRS takes the position — citing no supporting authority — that the power holder will be taxed following lapse.[8] Some tax practitioners, however, hold a contrary view; they feel that non-exercise of the withdrawal power does *not* impose a tax obligation on the power holder. The rationale is based on the notion that, unlike gift and estate tax law, *income* tax law does not equate lapse with release.

Indeed, non-exercise of the Sections 677 and 678 powers is not addressed in those sections. The side you choose depends on the desired result. In our example, we *want* Gramps and Pop to pay the trust

income taxes because doing so aids in moving cash from their estates to those of the Kids without a toll charge in the form of a gift tax or generation-skipping transfer tax.

The argument for non-taxation to the power holder on lapse follows these lines:

_ The grantor trust rules were intended to supersede court decisions based on general issues of dominion and control.[9] Accordingly, an attempt to treat the power holder as owner must be based on the statute itself.

_ Section 678(a) requires the withdrawal power *or* a release or a modification. By analogy to Sections 2041 (estate tax) and 2514 (gift tax), a *lapse* is not a release or modification for income tax purposes; *i.e.*, in the estate and gift tax provisions, the *non*-exercise of such a power is denoted a lapse and treated the same as an exercise, whereas Sections 677 and 678 do not address the consequences of a lapse.

The use of intentionally defective grantor trusts (used to shift the income tax burden to the grantor) is in growing use by estate planners, but there seems to be no appetite by IRS for litigating these questions. Therefore, the taxpayer may take whichever side serves the purpose (so long as it reported consistently from year to year) and should find the position well-supported in the law. Taxpayers are commonly concerned about such ambiguities, but this one has been around for half a century and is unlikely to go away any time soon.

The Numbers. How do the numbers work out? Let us suppose that there are four Kids, and the one-time gift is a sum equal to the annual gift tax exclusion amount with the Pop s spouse joining in that gift ($20,000 each for a total of $80,000). The trust earns 4% ordinary income and 6% capital gains annually, a total of 10% Gramps and Pop pick up income taxes at the rate of 20% for capital gain tax and 38% (at the margin) for ordinary income of the trust:

_ The $80,000 initial contribution grows at the 10% compounded annual rate over 20 years to $538,200.

_ Pop removes $80,000 from his gross estate (ultimately $538,200 if he survives for 20 years), avoiding an estate tax on the order of $295,000, and does so without a gift tax.

_ Gramps and Pop (again assuming survival for 20 years) *each* remove $62,280 from their respective gross estates by paying the taxes ($27,480 for capital gains and $34,800 for ordinary income), avoiding an estate tax on the order of $34,000 *each* and without a gift tax or generation-skipping transfer tax.

All in all, not a bad result.

Endnotes

1 IRC ⁄⁄671-679.

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3 *IRC* ⁄672(a); Reg 1.672(a)-1.

4 Reg 1.672(a)-1(a).

5 *IRC* ⁄672(c).

6 *IRC* ⁄672(e).

7 See also *Private Letter Ruling* 9034004.

8 *Private Letter Rulings* 9745010 and 8142061.

9 Reg 1.671-1(c), which provides in part, Except as provided in [Sections 671-679], income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust.