Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2421

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From: Steve Leimberg's Estate Planning Newsletter
Subject: Austin Bramwell & Sean Weissbart on GST Tax Planning with Dueling Transferors

"Perhaps the most important unresolved GST tax issue is whether a gift of a beneficial interest in a trust causes a change in the identity of the trust's transferor. Whether common estate tax planning techniques, such as GRATs, can also be used to minimize GST tax hinges on the answer to the question. Perhaps more importantly, the question goes to very viability of the GST tax. Depending on how the question is resolved, as discussed below, there could be massive opportunities for GST tax avoidance.

The authors have published in ACTEC Law Journal a controversial article which argues that the assignment of a beneficial interest has no effect on the identity of the transferor of the underlying trust property. Here, the authors present their ideas in shorter, question-and-answer format."

Austin Bramwell and **Sean Weissbart** provide **LISI** members with important commentary that analyzes the "dueling transferors" issue, which they refer to as one of the "great mysteries" of the GST tax.

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Before we get to their commentary, members should note that two **60 Second Planners** by **Bob Keebler** were recently added to the **LISI** homepage:

- In his first podcast, Bob reports on PLR 201622021, where the IRS granted a trustee an extension of time to file a final Form 706-QDT notifying and certifying to the IRS that the decedent's surviving spouse has become a United States citizen. The text of the ruling can be found at https://www.irs.gov/pub/irs-wd/201622021.pdf , and members may click this link to listen to the podcast

- In his second podcast, Bob reports on Ohio's becoming the first state to authorize the creation of ABLE accounts under the federal Achieving a Better Life Experience (ABLE) Act. Click this link to listen to the podcast.

Now, here is Austin and Sean's commentary:

EXECUTIVE SUMMARY:

Perhaps the most important unresolved GST tax issue is whether a gift of a beneficial interest in a trust causes a change in the identity of the trust's transferor. Whether common estate tax planning techniques, such as GRATs, can also be used to minimize GST tax hinges on the answer to the question. Perhaps more importantly, the question goes to very viability of the GST tax. Depending on how the question is resolved, as discussed below, there could be massive opportunities for GST tax avoidance.

The authors have published in ACTEC Law Journal a controversial article which argues that the assignment of a beneficial interest has no effect on the identity of the transferor of the underlying trust property. Here, the authors present their ideas in shorter, question-and-answer format.

FACTS:

One of the core defined terms in the GST tax is the "transferor" of property. Generally speaking, if property is transferred to persons who are two or more generations below the "transferor" – known as "skip persons" – then a GST tax may be imposed. By contrast, if property does not pass to skip persons, then the GST tax does not apply. To

determine whether a transfer of property is subject to GST tax, therefore, the "transferor" of that property must first be identified.

Surprisingly, however, it is not always obvious which individual should be considered the "transferor." In particular, if a beneficiary of a trust assigns his or her interest to another person, two individuals – the grantor of the trust and the beneficiary making the assignment – could both plausibly be identified as the transferor of the underlying trust property. Below, the authors pose and answer a series of questions in order to help describe and solve the problem of dueling transferors.

COMMENT:

1. What is the "dueling transferors" problem?

Very simply, it is the deeply puzzling question of who is the "transferor" for GST tax purposes if a beneficiary of a trust assigns his or her interest to another. **Richard B. Covey** of *Practical Drafting* calls it "probably the most significant unanswered question under Chapter 13." We call it "one of the great mysteries of the GST tax."

2. Can you give an example?

The dueling transferors problem is most commonly discussed in the context of grantor-retained annuity trusts or "GRATs." Suppose that the grandfather of the family ("G1") creates a GRAT in order to pass future appreciation free of gift and estate tax to his descendants. G1 wants to allocate GST exemption to the GRAT so that the remainder can also pass down free of GST tax. But his tax advisor tells him he can't do that. Thanks to the estate tax inclusion period or "ETIP" rule, the advisor explains, an allocation of GST exemption won't be effective until the end of the fixed term. Consequently, the advisor tells G1, he can't leverage GST exemption by allocating it to a GRAT.

But then the advisor comes up with a bright idea. Suppose G1 names his son, G2, as the remainder beneficiary. Shortly after the GRAT is created, G2 can then assign the remainder interest to G2's own children (G3s). The G3s are not skip persons with respect to G2, the advisor observes. Hence, he argues, no GST tax will be imposed when the GRAT terminates.

Is G1's tax advisor right? Maybe. But the problem is that G1, not G2, is the transferor of the GRAT property for GST tax purposes, at least when the GRAT is created. Consequently, when the GRAT terminates, there are two potential transferors of the remaining GRAT property. If G2 at some point *displaces* G1 as the transferor of the GRAT, then G1's advisor is correct that no GST occurs. But if G1 *remains* the transferor, then a taxable termination will occur when the fixed term ends.

In short, you can have two potential transferors when a beneficial interest in a trust is assigned to another. Which one prevails over the other makes all the difference.

3. I don't see what the problem is. If you make a gift of a beneficial interest, that makes you the transferor for GST tax purposes. In your GRAT example, that means that G2 is the transferor of the property that G2 assigns to the G3s, so there should be no GST tax when the GRAT terminates. What am I missing?

Well, a number of things. But let's start by noting that, if you are correct, then it becomes child's play to avoid GST tax. To see why, we need to stop focusing so narrowly on GRATs, and consider the wider implications.

Try this example instead:

> ***Example.*** Grandfather (G1) creates a trust under G1's will (the "Testamentary Trust") that permits income or principal to be paid over to daughter (G2a) during G2a's life in the discretion of the trustee. Upon G2a's death, the remainder of the Testamentary Trust is to be paid over to G1's son (G2b) or G2b's estate.
>
> G2b then makes a gift of his remainder interest in the Testamentary Trust to a long-term trust that G2b creates for G1's grandchildren and more remote descendants (G3s, G4s, etc.) (the "Dynasty Trust"). The assignment is effective under local law. G2b allocates GST exemption in an amount that is equal to the value of his gift.

Here, G2b makes a taxable gift to the Dynasty Trust of his remainder interest in the Testamentary Trust created by G1. The value of the interest, for gift tax purposes, is likely very small. After all, not only is the remainder of the

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Testamentary Trust not payable until G2a's death, but the remainder interest could be curtailed or eliminated if the trustee exercises its discretion to distribute the entire corpus to G2a. It is well-established that the value of an interest of that kind – known as a "restricted beneficial interest" – may be discounted to reflect the possibility that it could be defeated through the exercise of another's discretion. Consequently, G2b makes a gift of only minimal value.

Now, who is the transferor for GST tax purposes of the Testamentary Trust property once G2a dies and the property is paid over to the Dynasty Trust? Some would say that the transferor is G2b, since G2b makes a gift of the remainder interest in the Testamentary Trust. But if you believe that the transferor is G2b, then you are also saying that G2b's *de minimis* gift makes it possible to avoid GST tax at G2a's death, even though the property passes exclusively for the benefit of G1's grandchildren and more remote descendants. You are also saying the minimal amount of GST exemption that G2b allocates to his gift will protect the corpus of the Testamentary Trust (once paid over to the Dynasty Trust) from GST tax forever. In other words, you are committed to a massive leveraging opportunity.

In fact, the opportunity is so big that, through this simple device of assigning a restricted beneficial interest down generations, the GST tax becomes pretty much an illusory tax. At *de minimis* gift tax cost, the family in this example is supposedly able to cause the entire Testamentary Trust to pass down to grandchildren and more remote descendants at zero GST tax cost. If the tax were that easy to avoid, one wonders why Congress would have imposed it to begin with.

4. Okay, I can see your point outside the GRAT context. But does anyone actually argue for that position? I don't see the abuse in the case of GRATs.

Understandably, nobody comes out and says that the GST tax has this gaping loophole that makes the tax easy to avoid. But it's hard to escape that conclusion if you believe that a gift of a beneficial interest causes the donor to become the transferor for GST tax purposes of any distributions paid over to the donee. Put another way, there is no principled way, at least not that we can see, to confine the implications of the position to the GRAT context. Indeed, at least one article claims that that a gift of a restricted beneficial interest, even though the value of the gift may be minimal, does cause a change of transferors.

5. Okay, so what does the law say about the dueling transferors problem?

Very little, unfortunately, that's directly on point. The IRS, in at least one private letter ruling (PLR 200107015, which may not be cited as precedent) rejected the view that a gift of a remainder interest causes a complete change in the identity of the transferors of the underlying trust property. Sadly, although we don't have space to get into it here, the IRS had the right instincts but completely botched the analysis.

There is also an example in the GST tax regulations – Treas. Reg. § 26.2652-1 (a)(5) Example 4 – that addresses the consequences of a gift of a beneficial interest (specifically, an income interest for life). Interestingly enough, the example concludes that, despite that the income beneficiary made a gift of his interest, the original settlor still "remains the transferor with respect to the trust." That makes it sound as if a gift of a beneficial interest does not cause a change of transferors.

Unfortunately, the example is very poorly drafted and susceptible to so many interpretations as to make it almost worse than useless. To solve the dueling transferors problem, you need to get back to first principles.

6. So, what do you think the answer is?

In our view, the assignment of a beneficial interest in trust property has no effect on the identity of the transferor of the underlying trust property. We call our position the "no effect theory." In our Testamentary Trust example, the no effect theory would say that G1 remains the transferor of the Testamentary Trust property, even after it is paid over to the Dynasty Trust created by G2b. (G2b is, indisputably, the transferor of the remainder *interest* in the Testamentary Trust, but, in our view, that does not necessarily make G2b the transferor of the underlying Testamentary Trust corpus.) Consequently, a taxable termination would occur at G2a's death and a GST tax would need to be paid.

The contrary theory is that G2b's gift of the remainder interest causes G2b to displace G1 as the transferor of Testamentary Trust property. Hence, we call it the "displacement theory." The displacement theory, if correct, opens up opportunities for abuse that would not be available under the no effect theory.

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7. ***It sounds as if your conclusion is based on public policy. You might be right as a policy matter, but that doesn't make your position correct.***

It's true that there are compelling policy arguments against the displacement theory. The displacement theory really is too good to be true. But our argument against it isn't based on policy. The displacement theory, though it also happens to be contrary to the policies of the GST tax, is also technically flawed.

8. What's your argument?

The no effect theory follows from a very straightforward reading of the definition of "transferor." Under Treas. Reg. § 26.2652-1(a)(1), the transferor is the "individual with respect to whom property was most recently subject" to gift or estate tax. There are three distinct elements in that definition. To have a transferor, you need (i) an individual, (ii) a transfer by that individual that was subject to gift or estate tax, and (iii) property whose transfer was subject to tax. The third element is crucial and also, perhaps, the one that is most often overlooked.

When a beneficiary makes a gift of a beneficial interest in a trust, what is the "property" that is "subject to" the gift tax? The answer is contained in the question's premise: the "property" that is subject to gift tax is the beneficial interest. Thus, in the Testamentary Trust example above, G2b is the "transferor" of the remainder interest.

But what about the corpus of the Testamentary Trust (and accumulated income, if any) once it is paid over to the new owner of the remainder interest, namely, the Dynasty Trust created by G2b? The displacement theory would say that G2b is the transferor. In other words, the displacement theory says that the property of the Testamentary Trust – as distinct from the remainder *interest* in that property – was "subject to" to gift tax when G2b made his gift.

But that is literally untrue. G2b made a gift of a remainder interest in the Testamentary Trust, but he did not make a gift of the underlying Testamentary Trust corpus, which was never assigned at all but remained in the hands of the trustee when the gift was made. To be sure, when the Testamentary Trust terminates, the Dynasty Trust receives the fruits of G2b's gift, namely, all of the property of the Testamentary Trust at the time of termination. But a fundamental gift tax principle is that the fruits are distinct from the tree. That is, as Treas. Reg. § 25.2511-2(a) provides, the gift tax is a tax on the transfer of property and *not* a tax on the degree of enrichment of the donees. In other words, it is not the fruits of a gift of property that are subject to gift tax, but only the transfer of the property itself. In context of the example, G2b's gift of the remainder interest is "subject to" gift tax, but the Testamentary Trust corpus is not.

To put it as simply as we can: when a beneficiary of a trust makes a gift of his or her interest, the transfer of the interest is subject to gift tax, but any subsequent distributions received by the donee are not. Therefore, the donor of the interest is not the "transferor" of distributions. The no effect theory simply applies the definition of "transferor" as far as it goes. It refuses to pretend that an individual can be deemed to be the "transferor" of property *other than* that which the individual actually transferred by gift.

When you add to this simple interpretative point (i) the policy considerations, (ii) Treas. Reg. § 26.2652-1(a)(5) Example 4, and (iii) the weaknesses of the rival theories, we think you have a strong case in favor of the no effect theory. We also find indirect support in gift and estate tax case law. There is even a famous Supreme Court case, *Blair v. Comm'r*, 300 U.S. 5 (1987) that adopts the no effect theory in the income tax context.

9. What are the arguments in favor of the displacement theory?

In truth, we are not exactly sure. The theory tends to be simply asserted rather than defended, as if a defense of the theory were unnecessary.

One cautious defense of the displacement theory can be found at pages 154-59 of ABA's 2004 Report on Reform of Federal Wealth Transfer Taxes. (Links to the ABA's Report, and to our article, can be found below under "CITES.") The defense is based on the actuarial principles articulated in *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997), *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996), and *Estate of Magnin v. Comm'r*, 184 F.3d 1074 (9th Cir. 1999). But as we point out in our article, those cases, and the actuarial principles on which they rely, not only do not support but are actually at odds with the displacement theory.

In the end, we think that the displacement theory is based on two unarticulated but flawed intuitions. The first intuition is based on substance over form. Suppose I have an interest in a trust, which I want to pass down to my children. I have at least two ways of doing that. First, I could keep the beneficial interest, receive distributions from the trustee,

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and then immediately pay over whatever I receive from the trustee over to my children. In that case, I would clearly be the transferor for GST tax purposes of whatever amounts I pay over to my children.

Alternatively, I could (if permitted) assign the beneficial interest directly to my children. In that case, my children would get exactly what they would have received if I had instead kept the interest, and paid over distributions to my children. Substantively, the two ways of shifting wealth from me to my children are the same, in that my children are enriched, and my wealth is depleted, by the same amount in both cases. Therefore, the argument goes, the two sets of transactions should have the same tax results.

The problem with this intuition, however, is that taxpayers aren't allowed to disregard the form of their transactions. The substance-over-form doctrine is a one way street. That is, the IRS can invoke the doctrine against taxpayers, but taxpayers, as the Supreme Court held in *National Alfalfa v. Comm'r*, 417 U.S. 134 (1974), can't invoke it against the IRS. "The Treasury may take the taxpayer at his word," as Learned Hand put it. Thus, that an assignment of a beneficial interest is economically equivalent to just paying over distributions directly does not prove that the displacement theory is correct. It's a flawed premise.

The second intuition is that if you make a gift of a piece of property, then you are the transferor for GST tax purposes not only of the property itself, but also of the fruits of the property. For example, if you make a gift of stock, according to the intuition, you become the transferor (for GST tax purposes) not only of the stock but also of any appreciation and dividends. Likewise, the intuition holds, if you make a gift of a beneficial interest in a trust, then you become the transferor not only of the interest, but also of the fruits – namely, any subsequent distributions from the trust.

The problem with this intuition, as discussed, is that it as odds with the gift tax concepts on which the definition of "transferor" for GST tax purposes is based. Under the general definition of "transferor," you are the "transferor" of any property whose transfer was "subject to" gift tax. But the gift tax is not imposed on the subsequent enrichment of the donee. Rather, the gift tax is a tax on the transfer of property. Even if a transfer of property is subject to gift tax, therefore, the "fruits" of the property are not. In the GST tax area, that means that the donor of a beneficial interest in a trust is the transferor for GST tax purposes of the interest, but not necessarily the transferor of any subsequent distributions from the trust to the donee.

10. What should the IRS do about it?

We believe that the IRS should issue a revenue ruling embracing the no effect theory. We do not think new regulations are necessary. After all, the solution to the dueling transferors problem is already inherent in the definition of "transferor." By all means, the IRS should solicit comment before issuing the ruling. But the ruling by itself, we believe, will be sufficient to curb abuses.

11. What should practitioners do in the meantime?

There is a lot more to be said about this topic. That said, for practitioners, we have some simple advice: do not assume that an assignment of a beneficial interest causes a change of transferors of a trust. We think that assumption is almost certainly wrong.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITES:

"The Dueling Transferors Problem in Generation Skipping Transfer Taxation," 41 ACTEC L. J. 95 (Spring 2015); Report on Reform of Federal Wealth Transfer Taxes; *National Alfalfa v. Comm'r*, 417 U.S. 134 (1974); *Blair v. Comm'r*, 300 U.S. 5 (1987); *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997), *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996), *Estate of Magnin v. Comm'r*, 184 F.3d 1074 (9th Cir. 1999); Treas. Reg. § 26.2652-1(a)(1); Treas. Reg. § 26.2652-1(a)(5) Example 4; PLR 200107015.

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