Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2420

Date: 31-May-16
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Dick Oshins & the PLR 200949012 "Myth" - Now You See It, Now You Don't**

"The Beneficiary Defective Inheritor's Trust ('BDIT') is a very powerful estate tax planning strategy. It is designed to follow the philosophy - 'control it; don't own it.' Because the BDIT provides controls and beneficial enjoyment similar to outright ownership, plus shelter from potential claimants, the IRS transfer tax system and certain income taxes, many planners view the BDIT as the quintessential estate planning technique.

A BDIT is a trust created by a person other than the client. It is the creator/donor's dynasty trust for transfer tax and creditor protection purposes. All gifts to the trust will be subject to the beneficiary's lapsing Crummey power of withdrawal and the trust is not a grantor trust as to the donor. As a result, the beneficiary will be the deemed owner for income tax purposes under IRC § 678.

The income tax consequences mentioned in the previous paragraph reflect the constant position of the IRS, although some pundits have said otherwise. The premise of these commentators is that because the gift will fully lapse, there must be a second power ('HEMS') that doesn't lapse in order to secure and maintain beneficiary owned status. They cite PLR 200949012 (the '2009' PLR) as support for that proposition.

The 'facts' in the PLR mention that the beneficiary will have a HEMS power that will not lapse. Significantly, however, neither the IRS's 'legal analysis' nor the 'ruling conclusions' ever address the HEMS power. Query – How can the 2009 PLR be cited as authority for a position that it never discusses?"

Dick Oshins provides **LISI** members with his analysis of PLR 200949012.

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Here is his commentary:

EXECUTIVE SUMMARY:

A Beneficiary Defective Inheritor's Trust ("BDIT") is a very powerful estate tax planning strategy. It is designed to follow the philosophy - "control it; don't own it."[i] Because the BDIT provides controls and beneficial enjoyment similar to outright ownership, plus shelter from potential claimants, the IRS transfer tax system and certain income taxes, many planners view the BDIT as the quintessential estate planning technique.[ii]

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200949012 (the "2009" PLR) as support for that proposition. The "facts" in the PLR mention that the beneficiary will have a HEMS power that will not lapse. Significantly, however, neither the IRS's "legal analysis" nor the "ruling conclusions" ever address the HEMS power.

> *Query – How can the 2009 PLR be cited as authority for a position that it never discusses?*

This newsletter is designed to show that the position of the contrarians is flawed. Their evaluation is based upon a false narrative and it is impossible to conclude that the 2009 PLR says what they espouse. Indeed, the correct analysis is that the 2009 ruling is consistent with the prior rulings and the two subsequent rulings on the exact issue. It is also consistent with Congressional intent which was designed to prevent the shifting of income where the grantor or someone else had retained or was given too much power, control or entitlements. Moreover, this fundamental proposition is clearly stated administratively in Treas. Reg. Sec 1.671-2 (b) which states that the "…principle underlying (the grantor trust provisions) …is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than the trust which receives the income or the beneficiary to whom the income may be distributed." (Emphasis supplied).

In addition to not being meaningful on the income tax issue, the use of the HEMS power alters the character of the trust for asset protection purposes. The HEMS access changes the creditor protection analysis from a favorable Discretionary Trust status where an independent trustee possesses the distribution power to a potentially risky Support Trust. A fully Discretionary Trust with an independent trustee has been referred to as is the most protective trust design structure available, because the beneficiary does not have any enforceable rights against the trust.[iv] On the other hand, Support Trusts have been incurring increasingly diminishing protection as creditor protection laws in many states have been evolving.

COMMENT:

What Is a BDIT?

Transfer Tax and Creditor's Rights: Typically, a third-party such as a parent or grandparent, will set up the trust for the client so that the third-party will be the trust creator for transfer tax and creditor purposes. Often the gift is made as an accommodation to enable the client to do his or her own estate planning. The client will never make a gratuitous transfer to the trust. Any transactions between the trust and the client will be handled as permissible loans or sales for adequate and full consideration – i.e., equal value.

Simply because legal title remains in the name of the trust, the assets will be sheltered from claimants of the beneficiaries, including the IRS transfer tax collectors, even though the client has substantial control and beneficial enjoyment, provided that the trust is located in the proper jurisdiction.

Income Tax: All gift transfers will be subject to a "*Crummey*" power of withdrawal which will lapse within the "5 or 5" protection of IRC §§ 2514 and 2041(b)(2). The donor will not have any rights which will cause grantor trust status to a settlor of a trust. As a result, the trust will be taxed to the beneficiary.

Why the "HEMS/Dual Power" Theory Is Unsupportable – Intriguing Questions:

1. The conclusion of the HEMS proponents is based on a false narrative. How does an inconsequential fact that is never ruled on by the IRS support a conclusion that it is impactful?

2. How can a PLR be cited as authority for a position that it never discusses?

3. Why was the very issue that the taxpayer wanted to be resolved not discussed in the ruling analysis?

4. Was the "partial" lapse theory addressed in the ruling application?

5. Was a ruling on the "partial" lapse issue requested from the IRS and inadvertently left out of the published ruling?

6. If the IRS was requested to rule on a matter and they did not rule on it, why would the taxpayer's representative accept the ruling?

7. Why would the PLRs issued subsequent to the 2009 PLR be favorable to the taxpayers, but not address the theoretical partial release issue if there was a change in IRS policy?

What Does IRC § 678 Provide?

Prevailing View: The IRS's position has been that as long as all gratuitous transfers to the trust are subject to a withdrawal power by the powerholder, during the period the withdrawal power is outstanding it is a beneficiary-taxed trust under Subsection (a)(1) and to the extent that it lapses, the powerholder will be taxed as the owner of the trust income under Subsection (a)(2), *unless* the exception of IRC § 678(b) is applicable and the trust is taxed to the donor. The aggregation of (a)(1) and (a)(2) will result in 100% beneficiary grantor trust status.

The Theoretical Disparity: A contrary viewpoint has been expressed by some commentators based on the 2009 PLR. They conclude that their reading of the statute and the 2009 PLR requires that there must be a second power, a HEMS withdrawal right, that will not lapse.

The 2009 PLR

The Ruling facts, legal discussion and IRS conclusion as to the questions that the IRS was asked to rule on is quite basic.

Facts: The grantor made a gift to an irrevocable trust subject to a hanging power of withdrawal. The beneficiary was the Investment Trustee, there was a Distribution Trustee who had the discretionary power to distribute income or corpus, and there was an Administrative Trustee. In addition, the Beneficiary had a HEMS power that will not lapse and a broad testamentary power of appointment.

Legal Discussion and IRS's Ruling on Issues Requested by the Taxpayer: In the legal analysis, the IRS discussed IRC §§ 671, 673-679 in a manner similar to both prior and subsequent PLRs simply paraphrasing the statutes. The Service then concluded that the Beneficiary would be treated as the owner for income tax purposes.

There is no evidence that the HEMS provision was essential to a positive ruling for the taxpayer, nor that it was even an issue that the IRS was asked to rule on. *(see questions 4-6 above).* It was simply one of many extraneous elements of the trust design. The HEMS design feature is immaterial to the IRS Ruling conclusions and would not have produced a different result under IRS policy if it was not given to the powerholder. It is quite compelling that neither the "legal analysis" nor the "ruling conclusions" discuss the HEMS power that would not lapse. The 2009 ruling was consistent with both prior Rulings and subsequent Rulings.

- *Comment:* *Because the IRS issued the favorable ruling that (i) was consistent with their ruling policy both before and after the 2009 PLR; and (ii) it never addressed the theoretical issue espoused by the partial lapse proponents, the 2009 ruling supports the "Prevailing View" set forth above, that a trust funded solely with gift transfers subject to powers of withdrawal will confer beneficiary taxed status without regard to whether they are presently withdrawable, have lapsed or have partially lapsed. To extrapolate that the IRS dual powers are compulsory after the PLRs subsequent to the 2009 PLR are silent on the issue, is even more questionable.*

Illusory Analysis

Proponents of the partial lapse thesis argue that IRC § 678 requires more than gifts subject to powers of withdrawal where the donor is not the grantor for income tax purposes. They believe that in order to secure continuing grantor trust status, it is crucial for the beneficiary to have two powers – (i) a *Crummey* power of withdrawal; and (ii) a second power (HEMS) that will not lapse. Although never mentioned in the Ruling, the second power allegedly is essential to follow the statutory language verbatim. Their position is that dual powers are necessitated because the power of withdrawal will fully lapse and a partial lapse is required. They do not explain their aggregation theory of how a full lapse of one power ("withdrawal") and no lapse of the other ("HEMS") results in a "partial" lapse.[v] The more logical analysis is that the "partial" lapse theory is both not plausible and was not met even if the concept did apply. Rather, there is a full lapse of the ability to withdraw and no lapse of the HEMS power. The HEMS power stands alone and is not affected.

In addition to the analysis of two powers with one lapsing and the other surviving and thus theoretically resulting in a "partial" lapse, the dual power analysis is flawed in another manner. It is based on the false premise that the irrelevant ancillary HEMS power that will not lapse is meaningful to the conclusion of the Ruling. Because the IRS *never* addressed any possible implications of HEMS or "partial" lapse in either its legal analysis or its conclusions of law, it is difficult to justify citing it as authority that it had relevance for income tax purposes. Rather, the mere existence of a non-integral factor that was not the subject of IRS scrutiny and non-essential to the legal analysis should be rightfully ignored. In addition to the 2009 PLR, there isn't a discussion in any other Rulings that involves the HEMS non-lapsing power thesis.

> *Note: Readers are invited to read the 2009 PLR and come to their conclusion as to (i) whether the IRS ruled that a HEMS power that will not lapse was an essential component to comply with IRC § 678; or (ii) the HEMS power was an irrelevant factor that the IRS did not address because they were not requested to review it and there was no reason to do so. (See link to PLR 200949012, IRC § 678 as well as PLR 201039010 and PLR 201216034 that followed the 2009 ruling which did not support the narrative that a second power which "will not lapse" is essential for beneficiary grantor trust status).*

In order to prevail, the pundits would have to also overcome the express language of Treas. Reg. Sec. 1.671-2(e)(6) (Example 4) which states: "B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1)." There is no mention of HEMS or a partial lapse.

The IRS Has Applied a Sensible, Workable Interpretation of IRC § 678 in Its Ruling Policy

The IRS has treated gratuitous transfers to trusts subject to a power of withdrawal as a beneficiary taxed trust unless the donor was the deemed owner. The Service has not deviated from that pragmatic position irrespective of whether the power was outstanding, partially lapsed or fully lapsed. Proponents of the partial lapse/HEMS theory argue that the IRS changed its position in 2009 and requires that there cannot be a full lapse citing the 2009 PLR as authority.

If the Service's position had changed, how do the partial lapse advocates justify the fact that the taxpayer prevailed in the subsequent PLRs? Similar to the legal analysis and the Ruling issued in 2009, the IRS ruled that the post-2009 trusts were beneficiary owned trusts and did not discuss or even mention HEMS or partial release. To conclude that the position of the IRS is consistent with the dual power analysis after the IRS was silent on the issue in 2009 (except mentioning it as a non-consequential fact) is quite dubious. Being silent on the partial release in the two PLRs issued subsequently makes the 2009 supporters' dual power conclusion even more troublesome:

- PLR 201039010 – The 2010 PLR was favorable to the taxpayer. It did not discuss HEMS or partial release. If the dual powers were essential, it certainly would have been mentioned and taxpayer's request denied.

  <u>Note:</u> *I had several PLR requests in front of the Service. After the partial release premise went viral, I spoke with IRS Chief Counsel's office to discuss the issue and was told that the theory was incorrect and that the 2010 ruling was the best one to follow. It is consistent with the government's position and issued after the 2009 PLR.*

- PLR 201216034 – The taxpayer received a favorable ruling in 2012 three years after the 2009 PLR. In the 2012 Ruling, the trust was funded with a *Crummey* gift. No mention was made of a HEMS power or partial release.

  <u>Note:</u> *The beneficiary was given a "swap-out" power in a non-fiduciary capacity. The IRS ruled that the beneficiary would be taxed both before and after the lapse. The 2012 PLR is flawed in that the "swap-out" power will result in the trustor/donor being the owner of the trust income.*[vi] *If a conflict exists between the donor and the powerholder being treated as the deemed owner, the donor will be the one subjected to grantor trust treatment.*

  Notwithstanding the inadvertent error, the 2012 PLR is significant in that it re-confirms both the IRS position and my position that a "partial" release is not a required element of beneficiary ownership status. However, because of the fatal flaw, the 2012 PLR should not be followed with respect to the "swap-out" power.

The Law of Unintended Consequences

The concept of “first do no harm” is a fundamental principal usually viewed in terms of physicians not making matters worse for their patients. That philosophy is equally applicable to estate planning advisors and their clients.

The visceral reaction is that if giving a HEMS withdrawal power is innocuous, why wouldn’t a careful planner simply advise proceeding with BDITs that provide a HEMS power and achieving the safety that the proponents of the partial lapse technique advocate? A HEMS entitlement standard is not disconcerting from a tax standpoint; however, there is potential exposure from an asset protection prospective.

The HEMS power in the 2009 PLR creates a “Support Trust” for creditor’s rights purposes and can expose the trust assets to statutory or judicially created creditors, depending upon state law. The laws on spendthrift trust planning have been evolving unfavorably for beneficiaries. Not that many years ago, spendthrift planning simply involved putting a spendthrift clause in the trust instrument. Planners are operating in a very different environment where theories of creditor trust access are rapidly increasing.[vii] An area in the asset protection laws that has become blurred is the accessibility of trust assets to creditors, including divorcing spouses where the trust design is as a HEMS trust. Putting an unnecessary HEMS provision which cannot lapse according to the document to satisfy a non-sustainable position is difficult to justify. Thus, practitioners in states that do not provide relief from Support Trust exposure, should at a minimum seek to change the trust’s situs or decant the trust if possible.

> <u>*Planning note:*</u> *Although we conclude that a second power is inconsequential, there appears to be a preferable alternative to a HEMS Support Trust which complies with the word “partial” but compresses the potential creditor exposure. The simple solution is to use a formula where gifts lapse except for a minimal amount (e.g., $1) that will continue to hang until the death of the powerholder. That should satisfy the “partial” lapse concern of the literalists and avoid potential creditor exposure except for the $1 that remains withdrawable. That option is certainly safer than a Support Trust in an unfriendly jurisdiction. In addition, it is indisputable that the formula approach is a “partial” lapse. On the other hand, the contrived dual power process with the withdrawal right fully lapsing, and a very different right not being affected, is problematic.*

Conclusion

We conclude that the 2009 PLR is not impactful at all. It appears that the taxpayer in the 2009 PLR received a favorable ruling except to the extent of the very issue that concerned him or her. Because a secondary power is not essential, and the taxpayer otherwise complied with the ruling posture of the IRS, he or she is rightfully treated as the deemed owner of the trust income.

In light of the evolving exceptions to spendthrift planning rules it is recommended that beneficiaries should not unnecessarily be given many rights, powers and entitlements that appear innocuous, but have the potential to cause harm.

> <u>*Note:*</u> *Many advisors are comfortable using HEMS. Although that is not my design preference, HEMS is certainly popular and permissible, subject to the caveats previously mentioned. The "key" is that it should not be used for the wrong reason.*

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

Dick Oshins

CITE AS:

LISI Estate Planning Newsletter #2420 (May 31, 2016) at http://www.leimbergservices.com

CITATIONS:

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[i] Quote attributable to John D. Rockefeller.

[ii] **Prof. Jerome M. Hesch**, **Prof. David J. Herzig** and **Eileen Trautman**, Putting it All Together: Deciding Upon the Appropriate Wealth-Shifting Technique, Their Advantages and Disadvantages, Their Potential Risks, and How They Should be Structured to Minimize These Risks, NYU 70th Inst. On Taxation (2011); **Jerome M. Hesch** and **David A. Handler**, Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth, NYU 68th Inst. on Federal Taxation (2009); **Richard A. Oshins** and **Steven G. Siegel**; The Anatomy of the Perfect Modern Trust – Parts 1 & 2; Estate Planning (Jan and Feb 2016); **Richard A. Oshins, Lawrence Brody, Jerome M. Hesch** & **Susan Rounds**, A Gift From Above: Estate Planning On a Higher Plane, Trusts & Estates (Nov 2011); **Richard A. Oshins**, **Larry Brody** and **Katarinna McBride**, "The BDIT: A Powerful Wealth Planning Strategy When Properly Designed And Implemented," LISI (June 22, 2011).

[iii] The IRS has placed this issue on their non-ruling list.

[iv] **Fredrick R. Keydel**, "Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control, 23rd Annual U. of Miami Inst. on Est. Planning (1989); Ch. 4 at Se. 408.

[v] In order for a "lapse" to be effective, the powerholder must be passive. On the other hand, a HEMS power could only be terminated pursuant to an affirmative action taken by the beneficiary. The former lapses and the other is released or disclaimed. The differential supports a non-aggregation approach.

[vi] IRC §§ 674(c); 678(b).

[vii] For example see the following support trust cases in the marital context – Delaware: *Garretson v. Garretson*, 306 A.2d 737 (Del.1973); Florida: *Bacardi v. White*, 463 So. 2d 218 (1985); Massachusetts: *Pfannenstiehl v. Pfannenstiehl*, 37 N.E. 2d 15 (Mass. App. Ct. 2015). See also **Steven J. Oshins**, 39th Annual Heckerling Institute on Estate Planning, "Asset

Protection other than Self-Settled Trusts: Beneficiary Controlled Trusts, FLPs, LLCs, Retirement Plans and other Creditor Protection Strategies," (2005).