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Scrutinize Carefully Trusts That Were Irrevocable on September 25, 1985

-by Neil E. Harl

The Generation Skipping Transfer Tax does not apply to generation-skipping transfers under a trust that was irrevocable on September 25, 1985. That rule is clear and any trust existing on September 25, 1985 is considered to be an irrevocable trust unless otherwise provided. However, there are several exceptions that can snare irrevocable trusts in existence on September 25, 1985 and subject transfers to GSTT. A few of the major problem areas are discussed below.

Retained power under I.R.C. § 2038

The first major exception to the general rule of no GSTT liability for trusts that were irrevocable on September 25, 1985 is that a trust is not considered an irrevocable trust to the extent that, on September 25, 1985, the settlor of the trust had a power with respect to the trust that would have caused the value of the trust to be included in the settlor’s gross estate for federal estate tax purposes by reason of I.R.C. § 2038 if the settlor had died on September 25, 1985. Section 2038 reaches those transfers after June 22, 1936, “. . . (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent’s death.”

A trust is considered, under the regulations, subject to such a power on September 25, 1985, “. . . even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before September 25, 1985, notice had been given or the power had been exercised.”

An example in the regulations illustrates the application of this provision – On September 25, 1985, T, the settlor of a trust that was created before September 25, 1985, held a testamentary power to add new beneficiaries to the trust. T held no other powers over any portion of the trust. The testamentary power held by T would have caused the trust to be included in T’s gross estate under section 2038 if T had died on September 25, 1985. Therefore, the trust is not an irrevocable trust for purposes of this section.

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The exercise of a limited power of appointment over a trust that was irrevocable on September 25, 1985, does not cause property subject to the power to lose the exemption from the GST tax if the power could not be exercised to postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in the property for the longer of (1) 90 years, as provided in the Uniform Rule Against Perpetuities or (2) 21 years after the death of any life in being when the irrevocable trust was created. The exercise of a limited power of appointment over a trust that by the surviving spouse being included in the surviving spouse’s portion of the trust allocable to any property transferred to the trust power of appointment by the surviving spouse results only in the trust to a lower generation than holding interests.

Additions to trusts that were irrevocable on September 25, 1985

If additional property is transferred to an irrevocable trust after September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to GSTT. If property remains in a trust that was irrevocable on September 25, 1985, after the release, exercise or lapse of a power of appointment that is a taxable transfer for gift or estate tax purposes, the value of the property has been treated as an addition to the trust in a 1996 Second Circuit Court of Appeals decision. However, the opposite conclusion was reached by the Eighth Circuit Court of Appeals in 1999. In that case, a spouse’s disclaimer of a general power of appointment in a marital trust did not result in a constructive addition to an otherwise GSTT-exempt trust.

The regulations state that the release, exercise or lapse of a power of appointment (other than a general power as defined in I.R.C. § 2041(b)) is not treated as an addition to the trust “...if the power is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property, for a period measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation.” The amended regulations state that the transfer of property pursuant to the exercise, release or lapse of a general power of appointment is not a transfer by the trust but is a transfer by the holder of the power that becomes effective on such exercise, release or lapse.

The regulations also state that if a trust is relieved of any liability properly payable out of assets of the trust, the person or entity actually satisfying the liability is considered to have made a constructive addition to the trust in an amount equal to the liability.

Rulings on other problem areas

The Internal Revenue Service has ruled in numerous situations that a trust’s “grandfathered” status was not disturbed including partitioning of a trust into two or more trusts so long as the quality, value and timing of the beneficial interests did not change; the merger of trusts with substantially identical terms; a settlement agreement among beneficiaries; distribution of trust assets to newly created trusts and numerous other areas.

A modification of a pre-September 25, 1985, trust results in loss of exempt status if there is a shifting of the beneficial interest to a lower generation than holding interests. For a trust which was irrevocable on September 25, 1985, the exercise of a special power of appointment by the surviving spouse results only in the portion of the trust allocable to any property transferred to the trust by the surviving spouse being included in the surviving spouse’s gross estate.

In conclusion

As long as the generation skipping transfer tax is in effect, and it appears now that may be for an indefinite period, special care should be given to managing pre-September 25, 1985 trusts in an effort to preserve the exempt status wherever loss of that status would pose a significant cost in the form of liability for generation-skipping transfer tax.

FOOTNOTES

10. E. Norman Peterson Marital Trust v. Comm’r, 102 T.C. 790 (1994), aff’d, 78 F.3d 795 (2d Cir. 1996) (transfer of assets from marital trust on death of grantor’s spouse not excepted from GSTT even though irrevocable on September 25, 1985; transfers made from property constructively added to marital trust after that date by lapse of general power of appointment).
12. Id. See Bachler v. United States, 281 F.3d 1078 (9th Cir. 2002) (general testamentary power of appointment exempt from GSTT; irrevocable in May of 1976).
20. See Ltr. Rul. 200728033, March 26, 2007 (reformation of trust as to meaning of “lawful issue” did not affect exempt status).