The Beneficiary as Trustee:

Designing the Henhouse Around the Fox

by William E. Sigler

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Suppose that a client desires to leave property to a child, grandchild, niece, nephew or other relative. It is suggested that a trust be used to obtain transfer tax benefits and protection against claims of creditors. The client is willing to consider a trust, but only if it gives the beneficiary sufficient control over the transferred property. How can these conflicting goals be achieved?

The What and How

After discussions between the client and attorney, the following objectives are identified:

- the beneficiary should be able to control distributions during lifetime and upon death;
- the trust property should be protected from claims of the beneficiary's creditors and the beneficiary's spouse in the event of death or divorce;
- the beneficiary should be able to control the investment of the trust property;
- the trust property should not be included in the gross estate of either the grantor or the beneficiary; and
- the administrative and fiduciary obligations of the beneficiary should be minimized.

The trust that the attorney has in mind to accomplish the foregoing objectives has the following characteristics:

- an independent trustee would have the power to terminate the trust if the value of the trust property falls below a certain amount, deal with insurance on the life of the beneficiary, and distribute trust assets to the beneficiary for any purpose other than the beneficiary's health, education, maintenance and support;
- the beneficiary would have all other trustee powers, including the power to make distributions to the beneficiary and the beneficiary's descendants for their health, education, maintenance and support;
- the beneficiary would have the right to withdraw the greater of $5,000 or 5 percent of the value of the trust assets each year for any reason;
- the beneficiary would have broad lifetime testamentary limited powers of appointment over the trust property;
- the beneficiary would have the power to replace the independent trustee, as long as it is with someone who is not related or subordinate to the beneficiary; and
- broad discretion would be given to the beneficiary with respect to administrative and investment powers in order to minimize fiduciary duties and administrative obligations.

Beneficiary Flexibility

The trust property will be included in the grantor's gross estate for federal estate tax purposes if the grantor retains the power to change the beneficiary of the trust.[1] This should be no problem, because the objective is to give the beneficiary maximum control over the trust property without jeopardizing the tax or creditor protection benefits of the trust. One way to maximize the control of the beneficiary over the trust property is to give the beneficiary a limited power of appointment. The primary down side of this approach is that if the primary beneficiary appoints trust property to someone else, then arguably the beneficiary has made a gift of the beneficiary's equitable interest in the appointed property.[2]

An alternative is to include other possible beneficiaries as potential distributees of the trust property. For example, this may include the beneficiary's descendants. This approach has several benefits:

- the presence of other beneficiaries will reduce the possibility of the beneficiary's exercise of the limited power of appointment resulting in a taxable gift;
- the beneficiary's descendants can benefit from the trust even if the beneficiary is incapacitated and unable to exercise the limited power of appointment in their favor; and
- the fact that there is more than one beneficiary will provide additional protection against claims by the beneficiary's creditors or spouse.

On the other hand, by including additional beneficiaries another group of potential claimants is created to whom the beneficiary (as trustee) will owe fiduciary duties.

Distribution Flexibility

The beneficiary cannot have unlimited control over the trust property and still serve as trustee without negative consequences. Retaining broad distribution powers would constitute a general power of appointment.[3] The beneficiary's appointment of trust property to someone else, or ceasing to serve trustee, would result in gift tax.[4] If the beneficiary retains these broad distribution powers until death, then the trust property would be included in the beneficiary's gross estate for federal estate tax purposes.[5] Retaining broad distribution powers would also make the trust income taxable to the beneficiary.[6]

Avoiding these negative consequences requires that distributions be limited to an ascertainable standard, *i.e.*, health, education, maintenance and support.[7] However, a measure of additional flexibility may be afforded by stating in the trust agreement that the trustee "may," as opposed to "shall," make distributions pursuant to this health, education, maintenance and support standard.[8]

In addition, the trust agreement can permit the beneficiary to withdraw the greater of $5,000 or 5 percent of the value of the trust property each year. The failure to exercise the withdrawal right will not constitute a lapse of a general power appointment for gift tax purposes as long as the withdrawal right is limited to these amounts.[9]

If the trustee has a legal obligation to support a beneficiary, then the trust agreement should prohibit the trustee from making any distributions to satisfy or reduce that support obligation. The ability to make distributions to satisfy a support obligation constitutes a general power of appointment under Sections 2514 and 2041 of the Internal Revenue Code, resulting in adverse gift and estate tax consequences for the trustee.

Powers of appointment can be exercisable during lifetime (inter vivos) or at death (testamentary), and they can be general or limited. A general power of appointment is exercisable in favor of the beneficiary or the beneficiary's creditors or estate. A limited power of appointment is exercisable only in favor of other appointees.[10] If one of the goals is to minimize transfer taxes, then the beneficiary should only be granted a limited power of appointment, since general powers of appointment have adverse gift and estate tax consequences.

A broad limited power of appointment can cause the beneficiary's interest in the trust to resemble outright ownership without impairing the benefits of the trust. A broad limited power of appointment also allows the beneficiary to address changing circumstances involving potential appointees such as disability, financial need, creditor problems, substance abuse or the need for third-party management over inherited assets. Finally, giving the beneficiary a broad limited power of appointment can minimize the risk of disputes and litigation between the beneficiary (as trustee) and the secondary and remainder beneficiaries.

An important limitation on the beneficiary's control over the trust property that should be included in the trust agreement is a spendthrift clause. A spendthrift clause provides that a beneficiary's interest in the trust property may not be voluntarily or involuntarily transferred to another person before it is paid to the beneficiary by the trustee. A spendthrift clause helps to protect the trust property from claims of the beneficiary's creditors. It also prevents the beneficiary from assigning any of the trust property to the beneficiary's creditors, which could result in the trust property being included in the beneficiary's gross estate for federal estate tax consequences. If there is a significant concern about potential creditors' claims, then additional protection can be obtained by not making the beneficiary the sole trustee, making distributions to the beneficiary discretionary, and including other potential current beneficiaries.

Trustee Flexibility

There are several approaches to naming trustees. A client who desires to give the beneficiary maximum control will appoint the beneficiary as sole trustee with the power to appoint and remove successor trustees. In this case, certain of the trustee's powers must be restricted in order to achieve the tax and creditor protection objectives. The trust can name a third-party trustee with authority to exercise powers that cannot be granted to the beneficiary because the beneficiary is also serving as trustee.

If the independent trustee has the power to make distributions to the beneficiary for reasons other than health, education, maintenance and support, then the beneficiary's power to remove and replace the independent trustee will be equivalent to a general power of appointment.[11] This problem can be solved by prohibiting the beneficiary from replacing the independent trustee with anyone who is "related or subordinate" to the beneficiary within the meaning of Section 672(c) of the Internal Revenue Code.[12]

The trust agreement should include a broad exculpation clause with respect to the beneficiary (as trustee) and any individuals appointed as successor trustee by the beneficiary. This reduces the chance of the beneficiary being subject to claims by remainder beneficiaries and other interested parties. A higher standard of care can be retained if desired for the independent trustee.

A beneficiary may waive all or a portion of the compensation to which the beneficiary is entitled as trustee. If the waiver is made timely,[13] the amount of compensation waived should not be includable in the beneficiary's gross income and the foregone fees should not be treated as a gift to the trust.[14] If the beneficiary does not waive his or her trustee fees until long after the services have been performed, the IRS may seek to impute the waived compensation as taxable income to the beneficiary and as a gift by the beneficiary to the trust.[15] There must be a "fixed or definite intention to serve on a gratuitous basis" in order for the trustee to avoid incurring income or gift tax liability.[16]

Controlling Who Is Taxed on Trust Income

A grantor trust is a trust whose assets, for income tax purposes, are deemed to be owned by the grantor or another party and whose items of income, deduction and credit are attributable to the grantor or other person rather than to the trust as a separate taxpayer.[17] The trust can be structured as a grantor trust with respect to either the grantor or the beneficiary. Grantor trust status is beneficial because transactions between the grantor and the trust are essentially transactions between the grantor and himself or herself, and those transactions do not have any income tax consequences. In addition, the grantor's payment of tax on the trust's income represents a discharge of the grantor's own liability and not a discharge of the trust's liability. Therefore, there is no gift tax result as long as the trust agreement does not require the trustee to reimburse the grantor for those payments.[18]

The trust can be made a grantor trust with respect to the grantor by giving the grantor the power to reacquire the trust assets by substituting assets of equivalent value. To ensure that the trust assets are not includable in the grantor's estate for federal estate tax purposes, the trustee must have a fiduciary duty to ensure that the assets substituted are actually of equivalent value.[19] This power should result in the grantor being taxed on trust income[20] without causing the trust property to be included in the grantor's estate.[21] If the trust has substantially appreciated assets, the grantor may substitute those assets for cash or high-basis assets, and if the grantor still owns those assets at death, they will receive a new income tax basis equal to their fair market value.[22]

If the grantor or the grantor's spouse has the right to borrow trust property without adequate security or adequate interest, the trust will be a grantor trust with respect to the grantor.[23] In contrast, the ability of a trustee, other than the grantor, to lend to the grantor or the grantor's spouse without adequate security or adequate interest under the general lending power contained in the trust agreement will not result in grantor status.[24]

The ability under the trust agreement to give a non-adverse third party the power to add one or more beneficiaries to the trust is another method to obtain grantor status without causing the trust assets to be included in the grantor's estate for federal estate tax purposes.[25] If the grantor desires to limit the power to add beneficiaries, the trust agreement may provide that:

- the power to add beneficiaries may be exercisable only during the grantor's lifetime;
- the class of potential additional beneficiaries will be limited to a defined set of individuals or entities (such as charities); and
- the power to add beneficiaries and the power to make distributions to those beneficiaries will be bifurcated, with the independent trustee being given the power to make distributions to any beneficiary added by the non-adverse powerholder.

If the objective is to make the trust a grantor trust with respect to the beneficiary instead of the grantor, then the trust agreement should give the beneficiary a withdrawal right over the initial contribution to the trust and that contribution should not exceed $5,000. By limiting the withdrawal right to that amount, the failure to exercise the withdrawal right will not constitute a lapse of a general power of appointment for gift tax purposes under Section 2514 of the Internal Revenue Code. If the trust is intended to be a grantor trust with respect to the beneficiary, then care must be taken to ensure that the trust does not contain provisions that would cause the trust income to be taxed to the grantor.[26] For example, the trust should not permit the trustee to make loans to the grantor without adequate security and adequate interest, and it should not permit anyone in a non-fiduciary capacity to substitute trust property with other assets of equivalent value.

Conclusion

It used to be axiomatic that trusts limit the way in which property is held, managed and enjoyed by beneficiaries. However, trusts are becoming more sophisticated, and able to better address competing objectives. A trust designed with the intent of the beneficiary serving as trustee illustrates the flexibility that can be afforded to the grantor and beneficiary from these new trust designs.

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Footnotes

1 IRC §§2036, 2038; Treas. Reg. § 25.2511-2.
2 Treas. Reg. §§ 25.2514-1(b)(2), 25.2514-3(e), example 3; *Estate of Regester v. Comm'r*, 83 TC 1, 8 (1984); Ltr. Rul. 8535020 (May 30, 1985); Ltr. Rul. 9451049 (September 22, 1994).
3 IRC §§ 2041(b)(1) and 2514(c).
4 IRC § 2514(b).
5 IRC § 2041(a)(2).
6 IRC § 678(a). But see IRC § 678(b) (Section 678(a) does not apply if the grantor is otherwise treated as the owner of the trust property).
7 IRC §§ 2041(b)(1)(A), 2514(c)(1).
8 *See* "What Language Should be Used to Avoid a General Power of Appointment Over a Trust," 36 *Estate Planning Journal* 40 (April 2009).
9 See IRC § 2514(e).
10 IRC §§ 2041, 2514.
11 Treas. Reg. §§ 20.2041-1(b)(1), 25.2514-1(b)(1).
12 *See* Rev. Rul. 95-58, 1995-2 C.B. 191 (August 4, 1995) and Ltr. Ruls. 9607008 (February 16, 1996), 200404005 (January 23, 2004), 200404006 (January 23, 2004), and 200404007 (January 23, 2004).
13 As a general rule, the trustee should, within six months after appointment, deliver a formal waiver to the beneficiaries. Rev. Rul. 66-167, 1966-1 C.B. 20. An implied waiver may also be deemed if the trustee "fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve on a gratuitous basis." *Id.*
14 Rev. Rul. 66-167, 1966-1 C.B. 20 (An implied waiver may be deemed if the fiduciary "fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a *fixed and continuing* intention to serve on a gratuitous basis.") (emphasis added).
15 Rev. Rul. 64-225, 1964-2 C.B. 15.
16 Rev. Rul. 66-167, 1966-1 C.B. 20.
17 IRC § 671.
18 *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.
19 *See* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
20 *See* IRC § 675(4).
21 *See* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
22 IRC § 1014.
23 IRC § 675(2).
24 IRC § 675(2).
25 IRC § 674(a); *See* also *Madorin v. Comm'r*, 84 T.C. 667 (1985) (power of nonadverse trustee to add charitable beneficiaries caused grantor trust status); IRC § 672(b) defines "nonadverse party" as any person who is not an "adverse party." IRC § 672(a) defines an "adverse party" as any person having a substantial beneficial interest in the trust who would be adversely affected by the exercise or nonexercise of the power that he possesses with respect to the trust.
26 *See* I.R.C. § 678 (b) (providing that 678 grantor trust status will not apply to power over income if settlor is otherwise treated as owner for income tax purposes).

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