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Distributions From Revocable Trusts and Estate Inclusion

Mark A. Segal

DISTRIBUTIONS FROM REVOCABLE TRUSTS AND ESTATE INCLUSION

by

MARK A. SEGAL*

Revocable trusts constitute one of the most commonly employed tools in estate planning. Revocable trusts hold appeal in that their utilization can enable avoidance of the delays and expense associated with probate, and can allow for the desired management of a grantor's estate despite the grantor's incapacity. In many instances the revocable trust is created to operate in conjunction with pour over provisions in a decedent's will. Pursuant to Internal Revenue Code (I.R.C.) section 2038, the value of a revocable trust in which the grantor possesses an interest at death will be includible in the grantor's estate.[1] More precisely Treasury Regulation section 20.2038-1(a) provides that:

> A decedent's gross estate includes the value of any interest in property transferred by the decedent, whether in trust or otherwise, if the enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power by the decedent to alter, amend, revoke or terminate, or if the decedent relinquished such power in contemplation of death.[2]

The phrase in contemplation of death is clarified by provisions in the I.R.C. and regulations to mean transfer within three years of death as provided for in I.R.C. section 2035.[3] In determining if the decedent possesses a proscribed power at death should the decedent have the unrestricted right to remove a trustee, the decedent will be imputed any powers held by the trustee.[4]

Avoidance of estate inclusion where a revocable trust is utilized is made difficult by the language of I.R.C. section 2035. I.R.C. section 2035(d)(2) provides that powers relinquished within three years of death for less than adequate and full consideration in money or money's worth, that would have resulted in estate inclusion under section 2038 if held at death, must be included in the decedent's gross estate.[5] Rulings and case law provide that a power to revoke will be found lacking where the grantor's exercise of the

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* Professor of Accounting, University of South Alabama

1. I.R.C. § 2038(a) (1988).

2. Treas. Reg. § 20.2038-1(a)(3) (as amended by T.D. 6600, 1962).

3. I.R.C. §§ 2035(d)(1), (2) (1988), 2038(a)(1) (1988); Treas. Reg. §§ 20.2035-1(b) (1958), 20.2038-1(a),(e) (as amended by T.D. 6600, 1962).

4. Treas. Reg. § 20.2038-1(a)(3) (as amended by T.D. 6600, 1962).

5. I.R.C. § 2035(d)(2).

power is limited by an ascertainable standard.[6]

In addition to having estate tax implications, section 2038, particularly when operating in tandem with section 2035, raises significant gift and income tax issues. Inter-vivos transfers made to a revocable trust are not considered completed gifts.[7] Instead, the grantor is still considered the owner of the property transferred to the trust.[8] As a consequence taxable income attributable to property situated in a revocable trust will be taxable to the grantor.[9] Recognition of the grantor of a revocable trust as the owner of the trust property is reflected in rulings allowing the I.R.C. section 121 exclusion to be qualified with regard to a principal residence placed into a revocable trust.[10]

Distribution from a revocable trust to someone other than the grantor will generally result in a completed gift being made at the time of distribution.[11] Since the distribution will presumably be enjoyable to the donee at the time the gift is made, it should be eligible for the annual exclusion.[12] The basis to the donee of any noncash assets received in turn will be determined pursuant to the rules set forth in the I.R.C. section 1015.[13]

In recent years, an issue of single importance concerns to what extent

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6. Note that by their very nature revocable trusts are not considered completed gifts due to the breadth of control held over the trust by the transferor/grantor to alter, amend, modify, revoke or terminate the trust. If the trust is limited by an ascertainable standard beyond the transferor/grantor's control, the transfer will not be considered revocable.

7. *See* Burnett v. Guggengeim, 288 U.S. 280 (1933); Treas. Reg. 25.2511-2 (as amended by T.D. 7910, 1983).

8. *See Burnett,* 288 U.S. at 288-89.

9. *Id.*

10. Rev. Rul. 66-159, 1966-1 C.B. 162; Rev. Rul. 85-45, 1985-1 C.B. 183; Priv. Ltr. Rul. 80-07-050 (Nov. 23, 1979). These rulings held that where a trust was to be considered a grantor trust, the grantor should be treated as the owner of the property in the trust for relevant income tax purposes.

11. Treas. Reg. 25.2511-2(b) (as amended by T.D. 7910, 1983).

12. Note that I.R.C. § 2503 (1988 & Supp. V 1993) provides for a gift tax exclusion for gifts other than future interests in property. The exclusion is limited to the first $10,000 of qualified gifts made to a person during a calender year, unless a split gift is considered made in conformity with I.R.C. § 2513 (1988). A split gift is a gift contributed equally by husband and wife with the annual exclusion amount being the first $20,000 of the qualified gifts made to a person during a calender year. I.R.C. § 2503(b).

13. I.R.C. § 1015(a) (1988 & Supp. V 1993) provides that as a general rule a donee will attain a carryover basis in property received as a gift. The basis received will be adjusted upward for gift tax paid on the transfer by multiplying such tax by the amount by a fraction. The numerator of the fraction equals the fair market value of the gift property minus the basis to the transferor of the property given. The denominator equals the fair market value of the property. The maximum allowable increase in basis allowed under this rule is limited to the amount by which the fair market value exceeds the adjusted basis. I.R.C. § 1015(d) (1988 & Supp. V 1993).

distributions made from a revocable trust within three years of the grantor's death must be included in the grantor's gross estate. Traditionally, it has been accepted that where the grantor of a revocable trust relinquishes his powers to alter, amend, modify, revoke or terminate within three years of death, the value of the trust at the time of death will be included in the grantor's gross estate.[14] This in itself can pose estate tax complications as the value must be included in the gross estate, despite the actual assets being under the control of another. This problem is mitigated by two factors. First, the fact that gift taxes attributable to the relinquishment may be taken into account in determining estate tax. Second, that the transferee obtains the assets in question at approximately the same time as the decedent's death. These factors make the estate tax attributable to the operation of section 2038 amenable to satisfaction from the transferee's attained interest.[15] Mitigating any income tax consequences associated with sale of the assets received to satisfy the tax is the transferee's receipt of an adjustment to basis consistent with the value of the asset on the date of death or the alternate valuation date.[16]

In contrast to the traditionally accepted view of how section 2038 and section 2035 operate in tandem, a position increasingly asserted by the Internal Revenue Service (the Service) in recent years is that distributions made from a revocable trust within three years of death must be included in the grantor's estate.[17] At present, cases are pending in which the Service's position is being challenged.[18] There exist several major problems inherent including the value of property previously distributed in the gross estate. Not only may such inclusion extend to property distributions believed free from transfer tax due to the annual exclusion, but may result in the inclusion of the gross estate of property no longer in the possession of the original distributee. For example, if a noncash asset land, is distributed within three years of

I.R.C. § 1015(a) provides that where the fair market value of the property given is less than the donor's basis at the time of the gift, the basis used for computing gain or loss on an eventual sale or exchange by the donee depends upon the amount realized. If the amount realized is less than the fair market value, the fair market value constitutes basis. If the amount realized exceeds the transferor's basis such basis will be used to determine gain. Should the amount realized exceed the fair market value, but be less than the transferor's basis, neither recognized gain nor loss will result. I.R.C. § 1015(a).

14. I.R.C. §§ 2035(d)(2) & 2038.

15. *Id.*

16. I.R.C. §§ 2031 (1988) & 2032 (1988 & Supp. V 1993). Note, valuation is also possible under I.R.C. § 2032A (1988 & Supp. V 1993) (special use valuation), but this method of valuation is unlikely to arise when dealing with revocable trusts.

17. *See* Priv. Ltr. Ruls. 90-15-001 (Dec. 29, 1989), 90-16-002 (Dec. 29, 1989), 90-49-002 (Aug. 29, 1990), 91-39-001 (June 14, 1991), 92-26-007 (Feb. 28, 1992), 93-01-004 (Sept. 25, 1992), 93-42-003 (Oct. 22, 1993).

18. *See, e.g., Estate of Lambertus,* No. 16201-93 (T.C. 1993).

death and then sold by the recipient, which then undergoes substantial appreciation, the value of the land at the decedent's death must generally be included in the decedent's estate even if it is in the possession of an unrelated party.[19] Thus, a substantial amount of the grantor's estate tax may be attributable to assets with regard to which no member of the grantor's family has access. As a consequence, a significant burden will be encountered in satisfying the tax. In this article analysis is made of the tax law and issues concerning the estate tax treatment of distributions made from a revocable trust within three years of death.

FOUNDATION

In the Service's eyes, whether distributions made from a revocable trust within three years of death should be included in the grantor's estate is dependent upon whether inclusion of the trust in the grantor's estate is governed by I.R.C. section 2033 or I.R.C. section 2038.[20] Pursuant to I.R.C. section 2033, the value of all property to the extent of the interest possessed by the decedent at death shall be included in the gross estate.[21] Should both section 2033 and 2038 be deemed to apply, section 2033 shall control.[22] If section 2033 is found determinative, distributions made from the trust within three years of death will not be included in the decedent's gross estate, due to the provisions of I.R.C. section 2035 not applying in tandem with I.R.C. section 2033.[23]

The position taken by the Service in determining whether distributions made from a revocable trust must be included in the decedent's gross estate was first set forth in Revenue Ruling 75-553.[24] According to this Revenue Ruling, section 2038 is applicable to a revocable trust only where someone other than the decedent obtains a beneficial interest in the transferred property.[25] This ruling held that I.R.C. section 2033, and not I.R.C. sections 2036, 2037 or 2038 governed whether an interest in a revocable trust would be included in the grantor's estate, where the trustee was to pay net income from the trust to the decedent during the decedent's lifetime and distribute trust corpus to the decedent's estate.[26]

19. *See* Treas. Reg.20.335-1(e). *See also* Rev. Rul. 72-282, 1972-1 C.B. 306.
20. *See* I.R.C. §§ 2033 & 2038.
21. I.R.C. § 2033.
22. Rev. Rul. 75-553, 1975-2 C.B. 477.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*

The position taken in Revenue Ruling 75-553 appears supported by the legislative history of I.R.C. section 2038.[27] According to the legislative history, the statute only applied where the decedent made an inter-vivos transfer with regard to which a right to materially affect beneficial enjoyment existed.[28] In essence, the legislative history, much like the language of Revenue Ruling 75-553, indicates that where the decedent is the sole party holding an express vested or contingent interest in the trust, no change sufficient to trigger application of section 2038 will be deemed to have occurred.[29]

THE SERVICE SPEAKS

Some eleven years after issuance of Revenue Ruling 75-553, Private Letter Ruling 86-09-005 was issued.[30] This ruling was the first of several letter rulings concerning whether distributions made from a revocable trust within three years of the grantor's death should be included in the grantor's gross estate.[31] Following the precedent of Revenue Ruling 75-553, the precise language contained in the trust document has been the determining factor.[32] Private Letter Ruling 86-09-005 involved a revocable trust pursuant to which the trustees were given authority to make annual gifts to four individuals for amounts not to exceed the amount of the annual exclusion from gift tax.[33] The grantor died within three years of distributions having been made to the beneficiaries. In the Service's eyes, the distributions were includible in the grantor's gross estate pursuant to section 2038 operating in conjunction with section 2035.[34] As indicated in Revenue Ruling 75-553, the fact that beneficiaries other than the grantor were named resulted in estate inclusion under I.R.C. section 2038 rather than I.R.C. section 2033.[35]

Other private letter rulings have extended the grasp of section 2038 and section 2035 to require inclusion in the grantor's estate of distributions where the interests of the named beneficiaries were not to take effect until after the grantor's death.[36] Thus, in several letter rulings, inclusion was required where

27. *See* Revenue Act of 1924, Pub. L. No. 176, ch. 234, § 302(d), 43 Stat. 253 (the predecessor to I.R.C. § 2038 (1988)).

28. *Id.*

29. *Id.*

30. Priv. Ltr. Rul. 86-09-005 (Nov. 26, 1985).

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. Rev. Rul. 75-553, 1975-2 C.B. 477.

36. *See, e.g.*, Priv. Ltr. Rul. 93-01-004 (Sept. 25, 1992). Note that in this ruling the Service made mention not only of distributions to named beneficiaries upon the grantor's death, but

the trust provided for the trustee to use amounts for the grantor's benefit or as the grantor shall direct, with named beneficiaries to take upon the grantor's death.[37] Had the interest in the trust instead passed to the grantor's estate upon death, distributions made to others within three years of death would not have been includible in the grantor's estate.[38]

In adopting this position, the Service rejected the taxpayer's argument that having distributions made pursuant to the grantor's direction should be treated in the same manner as a situation involving a distribution to the grantor followed by a gift to the beneficiary.[39] If the taxpayer's approach to be accepted no inclusion would be necessary under section 2038 and 2035, as these Sections do not extend to direct gifts of a complete interest in property from one individual to another.[40]

According to the Service, adoption of the taxpayer view would vitiate the functioning of I.R.C. section 2035(d)(2).[41] In addition, the Service rejected the arguments that the trustee should be viewed as merely an agent of the taxpayer, and that the form of the arrangement should be ignored.[42]

The significance of naming other beneficiaries is also evident in rulings where the Service has found sections 2038 and 2035 inapplicable to distributions made from a revocable trust within three years of death.[43] In these Private Letter Rulings, the governing language of the trusts did not provide for distributions of principle to anyone other than the grantor or the grantor's estate, and only permitted the grantor to withdraw funds.[44]

RELEVANT CASE LAW

In recent years, the issue of whether distributions made from a revocable trust within three years of death must be included in the grantor's gross estate

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also the expensive view that named parties could take upon written request of the grantor. *Id.*

37. *See* rulings cited *supra* note 10.

38. *See* Estate of Jalkut v. Comm'r, 96 T.C. 675 (1991), *acq.*, 1991-2 C.B. 1; Rev. Rul. 75-553, 1975-2 C.B. 477.

39. *See Jalkut*, 96 T.C. at 680-81.

40. Note that the provisions with regard to which I.R.C. § 2035 operates in conjunction with, require that the transferor either retain some interest in the property transferred or have held an incident of ownership in such property within three years of death. An exception to this exists with regard to gift taxes paid within three years of death. I.R.C. § 2035(c) (1988).

41. *See Jalkut*, 96 T.C. at 681.

42. *Id.*

43. *See* Priv. Ltr. Ruls. 89-40-003 (June 30, 1989), 90-10-005 (Nov. 17, 1989), 90-11-014 (Dec. 18, 1989), 90-17-002 (Jan. 5, 1990), 90-18-004 (Jan. 24, 1990).

44. *See* sources cited *supra* note 43

has been dealt with by several courts.[45] Examination of these cases and their holdings provides insight into the position taken by courts on this issue. These cases have also been cited in subsequent Service rulings, with the Tax Court decision in *Jalkut* gaining the most prominence and being acquiesced to by the Service.[46]

The 1990 District Court decision in *Estate of Perkins*[47] signaled concern that reliance upon Revenue Ruling 75-553 and Service pronouncements may be an inadequate safeguard to avoidance of estate inclusion for revocable trust distributions.[48] *Perkins* concerned a revocable trust executed for the benefit of the donor, and certain contingent beneficiaries.[49] According to the terms of the trust, the grantor possessed

> the unrestricted right at any time . . . to withdraw from the operation [of the trust] all or any part of the Trust estate contributed by the Donor, to change the beneficiaries [under the trust], their shares and the plan of distribution to each, to revoke [the trust] in whole or in part . . . and, to modify [the trust] in any other manner . . . .[50]

Pursuant to the grantor's direction, distributions were directed to be made to each of the donees in an amount (made up of shares of stock) to approximate the amount of the annual exclusion.[51] According to the Court, the use of a revocable trust and the type of transfer necessarily dictate the application of section 2038. In this instance, since distributions were made from the trust within three years of death, in the court's opinion I.R.C. section 2035 requires inclusion of the distributions in the grantor's estate.[52]

Analysis of the facts of *Perkins* pursuant to Revenue Ruling 75-553 and letter rulings indicate that the court reached the right result. The Court's statement concerning use of that revocable trust necessitates application of section 2038, however, appears likely to result in a far more expansive finding of estate inclusion than would have previously been thought.

Further guidance was provided in *Estate of Jalkut*.[53] *Jalkut* is of particular interest in that it concerned a grantor who became incapacitated,

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45. *See, e.g.*, Estate of Perkins v. United States, Na 1:89 CV 1937, 1990 WL 300357 (N.D. Ohio Sept. 20, 1990); *Estate of Jalkut*, 96 T.C. 675 (1991).

46. Estate of Jalkut v. Comm'r, 96 T.C. 675 (1991), *acq.*, 1991-2 C.B. 1.

47. Estate of Perkins v. United States, No. 1:89 CV 1937, 1990 WL 300357 (N.D. Ohio Sept. 20, 1990).

48. *Id.*

49. *Id.*

50. *Id.* at *1.

51. *Id.*

52. *Id.* at *1-*2.

53. *Jalkut*, 96 T.C. at 675.

and the effect that the incapacity had upon the determination of estate inclusion.[54] *Jalkut* concerned a funded revocable trust with regard to which the grantor was to serve as the trustee and as the only permissible beneficiary while alive.[55] The trust was amended to provide that if the grantor became incapacitated, the trust could expend amounts for his care, support and comfort, and that of his descendants.[56] Subsequently, the grantor became incapacitated and a trustee was appointed to administer the trust.[57] According to the Court, the gifts made prior to the grantor becoming incapacitated could be viewed as having been constructively withdrawn by him and given to others.[58] Thus, amounts distributed from the trust during this period were not subject to estate inclusion under section 2038 and section 2035.[59] Amounts distributed during the period of incapacity were subject to estate inclusion due to the nature of the trust providing for beneficiaries other than the grantor during such period.[60] *Jalkut* is an important case, particularly in light of the frequency of grantor incapacity, for example, the onset of Alzheimer's disease.

Recent court decisions have generally held against estate inclusion of distributions made from a revocable trust within three years of death. For example, in *Estate of Kisling*,[61] the Eighth Circuit reached such a decision with respect to the irrevocable assignment of shares of an otherwise revocable trust.[62] In the court's view, the grantor's making of the irrevocable assignment was tantamount to withdrawal and direct gifting of the irrevocably assigned portion.[63]

A similar result was reached by the Eighth Circuit in *McNeely v. United States*.[64] *McNeely* involved a trust arrangement in which the grantor retained the unilateral power to amend or revoke the trust as well as direct that distributions be made to others.[65] Accordingly, distributions made pursuant to the grantor's direction were viewed as involving the withdrawal of the distributed

54. *Id.*
55. *Id.* at 676.
56. *Id.*
57. *Id.* at 676 & 682.
58. *Id.* at 685.
59. *Id.*
60. *Id.* at 685-86.
61. Estate of Kisling v. Comm'r, 32 F.3d 1222 (8th Cir. 1994), *rev'd*, 65 T.C.M. 2956 (1993).
62. *Id.*
63. *Id.* at 1227.
64. 16 F.3d 303 (8th Cir. 1994).
65. *Id.* at 304.

amount and directed gifting of the amount by the grantor.[66]

THE PRIVATE LETTER RULING LEGACY CONTINUED

The Service's harsh stance regarding the estate inclusion of distributions made within three years of death is not evident in all rulings.[67] Rulings not adopting a rigid stance toward estate inclusion provide insight into arguments that can be raised to defend against inclusion.[68] These rulings however do not constitute a safe harbor upon which further actions can be safely based. Recent Private Letter Ruling 93-09-003 exemplifies these type rulings.[69]

Private Letter Ruling 93-09-003 concerned a revocable trust which required the trustee to distribute net income and principal as the grantor directed, and provided the trustee with the power to distribute for the decedent's benefit so much of the net principal of the trust as required for her support, comfort, enjoyment and medical care during any period in which the trustee determined the grantor was unable to administer the payments.[70] Subsequently, the grantor became incompetent and the appropriate court appointed a guardian.[71] Prior to the appointment of the guardian, the grantor had engaged in a pattern of gift giving.[72] The guardian made distributions from the trust consistent with the pattern established by the grantor.[73] Certain distributions were made by the grantor within three years of the grantor's death.[74] At issue in the ruling was whether these distributions were includible in the grantor's estate pursuant to section 2038 and section 2035.[75]

The Service ruled that the distributions were not includible in the grantor's gross estate.[76] Looking carefully at the relevant facts and circumstance in reaching this decision, it was noted that:

> 1. The express provisions of the trust provided that the decedent (grantor) was the only person entitled to trust corpus or income during her life regardless of whether she was competent.[77]

66. *Id.* at 305.

67. *See* Priv. Ltr. Ruls. 89-40-003 (June 30, 1989), 90-10-005 (Nov. 17, 1989), 90-17-002 (Jan. 5, 1990), 90-18-004 (Jan. 24, 1990).

68. *See id.*

69. Priv. Ltr. Rul. 93-09-003 (March 15, 1993).

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

2. The decedent's actions with regard to the trust can not properly be characterized as the relinquishment of a power to revoke the trust with respect to the distributed assets as contemplated by section 2038 operating in conjunction with section 2035.[78]

As a result of these factors, the court held that the distributions should be characterized as a distribution to the decedent followed by a gift to her relatives.[79] Thus, the distributions were considered outside of the ambit of section 2038 and section 2035.[80]

CONCLUSION

The revocable trust enjoys a major role in modern day estate and financial planning. A fine line separates whether distributions made from a revocable trust within three years of death should be included or excluded from the grantor's gross estate. Whether these distributions merit disparate treatment from that accorded to direct gifts is open to debate. Clearly, however, the determination holds significant implications with regard to who will bear tax consequences, when a tax will be owed, and what will be the amount of such tax.

The lack of clear guidance in the Code and regulations has resulted in uncertainty and unnecessary litigation concerning the scope of the section 2038-section 2035 interplay. It is suggested that amendments be made to the Internal Revenue Code and commensurate regulations be issued to provide further guidance on this important issue. Until such steps are taken, care must be exercised to follow the guidance of case law and rulings in devising and drafting revocable trusts in order to avoid unintended estate inclusion. In particular, consideration should be given to whether trustees should be given the authority to distribute principal or income to parties other than the grantor or the grantor's estate, as cases and rulings on point indicate this to be a factor of major significance.

78. *Id.*
79. *Id.*
80. *Id.*