Understanding the Gift and Estate Tax Rules for MAPTs and VAPTs

General Trust Considerations

• Gift Taxes (is the transfer taxable?)
• Estate Taxes (are the assets includable?)
• Income Taxes (who pays it?)
• Lifetime Capital Gains Exclusion
• Basis Adjustment at Death

General Trust Considerations

• Gift Taxes (is the transfer taxable?)
  – Is the transfer a gift?
  – Is the transfer a taxable gift?
  – Is the gift complete or incomplete?
General Trust Considerations

- Gift Taxes (is the transfer taxable?)
  - Completed Gifts
    - Requires a gift tax return, with limited exceptions
    - Amount of gift reduces unified credit or a tax is due
    - Date-of-death value of transferred assets could be included in gross estate, but not amount of tax paid (except for gifts within 3 years of death)

- Gift Taxes (is the transfer taxable?)
  - Incomplete Gifts
    - Could require a gift tax return
    - No reduction of unified credit and no tax is due
    - Date-of-death value of transferred assets included in gross estate

- Estate Taxes (are the assets includable?)
  - Transfers with Retained Life Estate (2036)
  - Revocable Transfers (2038)
  - General Powers of Appointment (2041)
General Trust Considerations

- Income Taxes (who pays it?)
  - Grantor Trust
    - Person treated as owner pays income tax
  - Nongrantor Trust
    - Trust or beneficiary pays income tax

General Trust Considerations

- Lifetime Capital Gains Exclusion
  - Exclusion of gain from sale of principal residence (121)
  - Applies only to principal residence
  - Subject to specific requirements and limitations
  - Applies to residence held in a grantor trust

General Trust Considerations

- Basis Adjustment at Death
  - Basis of Property Acquired From a Decedent (1014)
  - Property included in the estate of the decedent is "acquired from the decedent"
### MAPT and VAPT Characteristics

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>MAPT</th>
<th>VAPT*</th>
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</thead>
<tbody>
<tr>
<td>Irrevocable</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Income to Grantor</td>
<td>Optional</td>
<td>No</td>
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<tr>
<td>Retained SPOA</td>
<td>Optional</td>
<td>Optional</td>
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<tr>
<td>Grantor Trust</td>
<td>Usually</td>
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*Nongrantor Trust only

### Special Case VAPT Residence Trust

- Incomplete gift via power to add charitable beneficiaries
- Included in estate if retaining SPOA
- Grantor trust via various provisions
Transfers to MAPTs & VAPTs
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• When will they be treated as completed gifts?
• When will they be included in a decedent’s gross estate?
Part 1 – Completed Gifts
Part 2 – Estate Inclusion
Part 3 – Grantor Trusts

Tax Loopholes are like empty parking spaces
By the time you get there, they have already been filled.

Part 1: Completed Gifts

Imposition of the Gift Tax

• 2501 IRC Imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident
Taxable Gifts

• Either do not qualify or for an amount in excess of the annual exclusion allowed under IRC 2503

Applicable Exclusion Amount

• The Applicable Exclusion Amount excluded from gift tax for 2012 is $5,120,000. (IRC 2505 & 2010)
• Will revert back to $1,000,000 on January 1, 2013 unless Congress acts to the contrary.

Transfers Subject to Gift Tax

• Shall apply whether in trust or otherwise, whether the gift is direct or indirect, and whether property is real or personal, tangible or intangible.
When is a Gift Deemed to be a Completed gift?

- A gift is deemed to be a completed gift when the donor has so parted with dominion and control as to leave him no power to change its disposition. Treas. Reg. Sec. 25.2511-2(b)

Incomplete Gifts

- Sometimes a transferor would prefer not to make a completed gift of the transferred property.

Why Make an Incomplete Gift?

1. To retain control of the transferred property
2. To avoid filing a gift tax return and/or payment of gift tax
3. To have the transferred property included in the transferor’s estate for estate tax purposes
When is a Gift an Incomplete Gift?

- If the donor has not given up dominion and control of the transferred property, the gift is not complete.
- “For Example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift.”
  Treas. Reg. Sec. 25.2511-2(b)

When is a Gift an Incomplete Gift?

- A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.
  Treas. Reg. Sec. 25.2511-2(c)

When does an Incomplete Gift become a Complete Gift?

- When the donor has parted with dominion and control of the parted property.
- For example if a donor made a transfer that was deemed to be an incomplete gift because the donor retained the power to revoke or modify the gift, and the donor later relinquishes the power to revoke or modify the gift, the gift becomes a completed gift at the time the power is relinquished. Treas. Reg. Sec. 25.2511-2(f)
- See Also: Estate of Sanford v. Commissioner 308 U.S. 39 (1939)
When is an Incomplete Gift not an Incomplete Gift?

- A recent memo released by the Internal Revenue Service has clouded the issue of when a transfer will be considered an incomplete gift.
- Historically practitioners have relied on Treas. Reg. 25.2511-2(b), PLR 9437034 and PLR 124396-02 for the proposition that the retention of a testamentary special power of appointment by the transferor will be sufficient to make the transfer an incomplete gift.

Gift Tax Return

- A Gift Tax Return is required when a transfer is deemed to be a completed gift provided that the property gifted does not qualify for the annual exclusion of gift tax or is in excess of the annual exclusion amount.

- Failure to file a gift tax return or pay a gift tax may result in a failure to file and/or failure to pay penalty under IRC 6651
- Penalty assessed for failure to file is 5% of the amount of the tax shown to be due for each month the return is filed late, up to a maximum 25%. Penalty assessed for failure to pay is .5% of the amount of the tax shown to be due for each month the payment is late, up to a maximum 25%. Amount of any failure to file penalty is reduced by any amount assessed for failure to pay.
PLR 9437034

- Decedent’s mother established an SNT for decedent with proceeds payable to decedent from a negligence action.
- Trustee had authority to make discretionary payments of principal and income to decedent.
- Decedent has a testamentary special power of appointment over the trust.
- The IRS found the transfer to the trust was an incomplete gift and cited Treas. Reg. 25.2511-2(b) in support of its position.
- The IRS also found that the trust assets were includable in the decedent’s estate because of the retained power of appointment under IRC Sec. 2036(a) Sec.2038.

PLR 124396-02

- Taxpayer A proposed to establish trust from which income and principal could at discretion of the trustee be paid to the descendants of A's parents and any organization described in Sec. 501(c)(3) of the IRC.
- The decision to make discretionary distributions was to be made by a "Distribution Committee" consisting of A’s brother and sister.
- A retained a testamentary special power of appointment over the trust assets.
- A may at any time during her life limit the person or entity in whose favor said power of appointment may be exercised.
- Remainder of incorporated property to pay upon A’s death to her descendants per stirpes.

Findings of PLR 124396-02

1. Taxpayer not considered owner of trust under IRC Sec. 673-678 so trust not a grantor trust and income not taxable to grantor.
2. Trust treated as an incomplete gift in light of testamentary special power of appointment.
4. IRS opined that gift would be complete once distribution were made or when A relinquished Special Power of Appointment Sec 25.2511-2(f).
Donors A & B establish an Irrevocable Trust for benefit of donors descendants with the trust to terminate upon death of both donors.

Donors retain no interest in the trust other than a testamentary special power of appointment.

Trustee (Child A) may make discretionary distributions of income and principal to donors' descendants and their spouses.

Income and principal may also be distributed to a charitable organization.

Trust grants beneficiaries withdrawal demand rights (e.g., crummery powers) but precludes them from enforcing them in a state or federal court.

The IRS found that the testamentary special power of appointment relates only to the remainders of the trust and that the donor retained no power to affect the trust beneficiaries rights during the term and that in fact the Trustee without any consent of the donors was free to distribute the entire trust to the beneficiaries during the lifetime of the donors.

The IRS held that the transfers of the beneficial interest during the trust term was complete when the assets were transferred to the trust.

The IRS further held that the value of the interest (Special Power of Appointment) retained by the donors had to be valued under the special valuation rules pursuant to the IRC Sec. 2702 and that the retained interest must therefore be valued at $0.

The IRS found that no annual exclusion would be allowed as the demand rights were unenforceable and illusory.
Primary distinction between CCM, prior rulings Sec. 25.2511-2117: In CCM donors did not retain right to receive discretionary distribution of principal and income during life

Suggestions for Ensuring Treatment as an Incomplete Gift

1. Retain an inter vivos power of appointment
2. Retain the ability to add charitable beneficiaries during trust term
3. Retain discretionary right to income coupled with a testamentary power of appointment (???)

Part 2: Estate Inclusion
• Why would a transferor want transferred assets to be included in his estate?

ANSWER: To obtain a step up in basis for income tax purposes

Causes of estate tax inclusion for previously transferred assets

• A variety of retained powers may cause estate tax inclusion. These powers include but not limited to the following
  1. Transfers with Retained Life Estate IRC Sec 2036(a)(1)
  2. Transfers with the Retained Power to designate persons who shall possess or enjoy the income from therein Sec 2036(a)(2)
  3. Revocable Transfers the power to alter, amend, revoke or terminate the transferred interest Sec 2038
  4. Retentions of General Powers of Appointment Sec 2041

Part 3: Grantor Trusts
When will the transferor be considered the owner of a trust for income tax purposes?

- Section 671 provides the general rule that in cases where the grantor or another person is regarded as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or such other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits against the tax of an individual.

- Section 672(a) defines adverse party as any party having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.
- Section 673: Grantor retains reversionary interest of 5% or more.
Retained Power of Disposition
• Section 674 provides generally that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Power to Sell for Less Than Fair Market Value
• Section 675 (1) (2): Retention of power to dispose of trust assets for less than adequate consideration

Retained Power to Borrow
• Section 675(3) provides that under certain circumstances, the grantor shall be treated as the owner of any portion of a trust where the grantor has borrowed trust corpus or income.
Other Administrative Powers

- Section 675(4) provides that the grantor shall be treated as the owner of a portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.
- Section 675(4)(c): Power to substitute property of equivalent value

Power to Revest Title in Grantor

- Section 676(a) provides that the grantor shall be treated as the owner of any portion of a trust, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Power to Distribute Income to Grantor or Spouse

- Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not treated as such owner under § 674, whose income, without the approval or consent of any adverse party, or both, may be distributed to the grantor or the grantor’s spouse or held or accumulated for future distribution to the grantor or the grantor’s spouse.
• Section 678(a)(1) provides a general rule that a person other than a grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.

Why would the grantor want to be considered the owner of a trust for income tax purposes?

• ANSWER: To allow the assets of the trust to grow income tax free for benefit of the beneficiaries during the grantors lifetime

• Desired or not, Grantor Trust treatment is often a byproduct of incomplete gifts and/or retained interests requiring estate inclusion
Grantor Trust treatment should be avoided for VAPTs
It is likely to have an adverse impact on eligibility for VA Benefits

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Questions?