BOVE&LANGA
LAW FIRM

Ten Tremont Street, Suite 600 | Boston, MA 02108
www.bovelanga.com | p 617.720.6040 | f 617.720.1919

Back to the Books on Tax Law

Massachusetts Lawyers Weekly – The Trustworthy Advisor

Alexander A. Bove, Jr. & Melissa Langa

March 2022

It has been said that the study of tax law is a waste of a good mind. Perhaps this is because the law we studied last year is no longer applicable this year, and now we must disregard the old law and study the new law. For those of us whose practice involves certain irrevocable trusts, such as asset protection trusts, where the settlor (creator of the of the trust) remains discretionary beneficiary of the trust, the change in the tax law for these trusts sort of slipped by numerous practitioners, many of whom are still using the old law, resulting in the unintentional making of a reportable gift for federal gift tax purposes when an incomplete gift was the goal.

For many years, the rule has been and continues to be, that if the settlor of the trust retains the power to determine who will ultimately enjoy the trust assets, no gift of those assets will occur until such control is exercised or removed (U.S. Treasury regulation section 25.2511-2(b)). For example, if George creates an irrevocable trust naming himself the discretionary beneficiary and retaining a special testamentary power of appointment, the law provides that no completed gift of the trust assets has occurred unless George releases the power (in whole or in part) during his lifetime. For many years, especially with the growth of self-settled asset protection trusts, practitioners have used the retained testamentary special power of appointment to prevent the occurrence of a completed gift when the funding amount exceeded the available exemptions relying on the aforementioned regulation. Furthermore, settlors establishing asset protection trusts would often include their spouses and children as discretionary beneficiaries of their trust, which seemed like a good plan. But then, motivated perhaps by the increased use of such trusts, the Internal Revenue Service, took a "second look" at the relevant treasury regulation and concluded that the regulation clearly provided that no completed gift occurred where the settler was the sole lifetime beneficiary and held a retained special testamentary power, but if there were other beneficiaries, then there would be a completed gift of the full amount of the trust assets (see below). This is because the

retained special testamentary power would not apply until the settlor's death and then only to the extent of the assets remaining in the trust at that time.

For example, say that the settlor established a trust for the benefit of himself and his children, giving the trustee discretion to make income and principal distributions to any or all of the beneficiaries during his lifetime, and funded it with $500,000, retaining a special testamentary power. During the settlor's lifetime, the trustee could distribute up to all of the trust assets under the discretionary power. This would be considered a gift of $500,000 by the settlor, whether or not distributed! (The IRS does not wait to see how much is distributed.) Thus, if the settlor fails to retain the necessary control over the disposition of the trust assets to prevent a completed gift during his lifetime, a completed gift will occur.. The IRS position is clearly explained in Chief Counsel Memorandum 201208026.

Under this (tax) reasoning, it does not matter how many other beneficiaries there are besides the settlor. Even one other beneficiary would render the gift of the trust assets complete, and no value is attributed to the fact that the settlor is a beneficiary. In addition, there is another section of the tax code that complicates matters even further. Section 2702 (a) (2) and related regulations dealing with a "qualified interest" where a settlor retains a portion of a gift, produce the same result as noted above. The only relief from such a result then, is either for the settler to be the only beneficiary during his lifetime, or for the trust to provide that the trustee's discretion to make distributions from the trust are subject to the settlor's consent or right to veto the distribution.

Bottom line, if there are other beneficiaries, with an asset protection-type trust, the settlor's retention of a lifetime, as well as testamentary special power, or the retention to veto/approve the trustee's decisions to distribute, would also produce the same result (an incomplete gift), but it would not affect whatever asset protection features the trust offered, at least until the laws change again, so keep the books handy..