INCLUDING ALL TRUSTS IN THE SETTLOR'S ESTATE – THE SKINNY ON *HELMHOLZ* AND SECTIONS 2036 AND 2038 RECALLING THE TALE: THE EMPEROR'S NEW CLOTHES

by Les Raatz[*]

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I. ESTATE TAX INCLUSION TOOL AND OPENING DISCUSSION

Internal Revenue Code §§ 2036 and 2038 are known by most estate planning lawyers.[1] They are two of the "estate tax string" provisions that haul assets formerly held by a decedent back into the gross estate.[2] The

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1. I.R.C. §§ 2036, 2038 (2006).
2. Matthew A. Reiber, *Untangling the Strings: Transfer Taxation of Retained Interests and Powers*, 48 AKRON L. REV. 455, 456 (2015) ("The presence of these strings – or, more accurately, the ability to pull them – draws some or all of the encumbered property back into the transferor's gross estate at death for estate tax purposes.").

sections generally provide that when an individual gifts property or control over property, but retains or thereafter acquires either the right to benefits from the property or the power to control rights of others in the property, the value of all or a portion of the property will be includable in her gross estate.[3]

Sections 2036 and 2038 can be applied to achieve tax-free step in basis of trust assets upon the settlor's death.[4] This tool can be the best method to cause inclusion of the trust and its assets in the gross estate of the settlor.[5] Sections 2036 and 2038 are the preferable route to the inclusion of trust assets under other estate string sections because application of §§ 2036 and 2038 will avoid the following concerns that exist with the other methods to affect estate inclusion: (i) potential creditor exposure; (ii) the need for further cooperation of beneficiaries and others; and (iii) the risk that trust beneficiaries and distribution methods may be changed by others.

Even without any action, a supportable position can be taken that both §§ 2036 and 2038 apply when the common law or statute permits the settlor of a trust, revocable or not, when the settlor is not a beneficiary, to modify or terminate a trust when acting with all of the beneficiaries of a trust. Most of this article is devoted to establishing that there is authority that §§ 2036 and 2038 apply to include trust property of virtually all trusts settled by a decedent when the applicable law applies the common law rules concerning the settlor's power to join in modifying or terminating such trusts.

The use of §§ 2036 or 2038 to cause inclusion is potentially better than use of other estate string sections, such as §§ 2033 or 2041. Section 2033 includes property directly owned by the decedent.[6] Obviously, if it is desired to avoid the reach of the decedent's creditors or the decedent's power of control to change beneficial interests, direct ownership of property should be avoided.

Treasury Regulation § 20.2041-1(b)(2) provides that § 2041 will not apply in cases when §§ 2036 or 2038 apply.[7] In the situation at hand, any power held by a settlor that would implicate § 2041 should be subject to one or both of those sections.[8] Section 2041(a)(2) provides that the gross estate includes all property over which a decedent has a general power of appointment ("GPA") at the time of death.[9] A GPA permits appointment of trust property or interests to oneself, one's estate, or the creditors of either.[10] A power is still a GPA if the consent of one or more nonadverse parties is required.[11] A power is not a GPA—in other words, it is a special or limited

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3. I.R.C. §§ 2036, 2038.
4. I.R.C. § 1014(b)(4) (2006).
5. *See* Reiber, *supra* note 2 and accompanying text.
6. *See* I.R.C. § 2033 (2006); *see* Treas. Reg. § 20.2033-1 (as amended 1963).
7. Treas. Reg. § 20-2041-1(b)(2) (as amended 1961).
8. *Id.*
9. I.R.C. § 2041(a)(2) (2006).
10. I.R.C. § 2041(b)(1).
11. 26 C.F.R. 20.2041-3 (1997).

power of appointment, or SPA—if the property cannot be appointed to the power holder, her estate, or the creditors of either.[12] One concern is that the powerholder's creditors may reach property subject to the GPA. If the consent of a nonadverse party is necessary for the powerholder to exercise the power, it remains a GPA under common law.[13] As such, it might be subject to the powerholder's creditor's claims, although the author has searched but has never found a case that so held one way or the other on that narrow issue.

Finally, with the intent to cause inclusion in her gross estate, if the settlor acquires a power of appointment even with another party's consent, and even if the power is an SPA which should generally protect trust property against the reach of the settlor's creditors, the possibility of exercise by the settlor away from existing beneficiaries is at least enhanced. Despite this creditor reach and wayward appointment risk, the decision is often made to modify the trust to grant the settlor the sole power to appoint to his estate upon death to make estate tax inclusion as clean and clear as possible. However, that does not mean that the common law alone is not sufficient to cause inclusion of trust property in the settlor's gross estate.

This article examines the application of §§ 2036(a)(2) and 2038(a) to the common law power of the settlor of an irrevocable trust to terminate or modify a trust with the consent of all beneficiaries. The power is well known and generally universal in the United States, except for Louisiana,[14] and is described in Restatement (Second) of Trusts, Section 338(1), and Restatement (Third) of Trusts, Section 65(2).[15] Any intent of the settlor to prohibit termination or modification is irrelevant and does not impede this joint action.[16] This common law was also codified in Uniform Trust Code ("UTC") Section 411(a), although in a later revision of the UTC the provision was made optional.[17] This change in the UTC, as well as a change in its virtual representation provisions, was due to the ruckus in Arizona that resulted in the repeal of the first UTC act there.

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12. I.R.C. § 2041.

13. RESTATEMENT OF PROPERTY (THIRD) § 17.3 Comment e and Illustration 6, Westlaw (database updated Mar. 2019).

14. LA. STAT. ANN. § 9:2028 (2015).

15. This power is not to be confused with the common law power of beneficiaries alone to terminate or modify at trust, which, under the *Claflin* doctrine (the American, as opposed to the English, rule) could be effected only if the termination or modification did not violate a material purpose of the trust. *See* Claflin v. Claflin, 20 N.E. 454 (1889); RESTATEMENT (SECOND) OF TRUSTS § 337 (AM. LAW INST. 1959); Restatement (Third) § 65 (AM. LAW INST. 2003).

16. *See* Alan Newman, *The Intention of the Settlor Under the Uniform Trust Code: Whose Property Is It, Anyways?*, 38 AKRON L. REV. 649, n. 38 (2005).

17. UNIFORM TRUST CODE § 411(a) (UNIF. LAW COMM'N 2000).

Section 2036(a) reads:

> (a) **General rule.** The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after September 7, 1916, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
> (1) the possession or enjoyment of, or the right to the income from, the property, or
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[18]

Section 2038(a) reads:

> (a) **In general.** The value of the gross estate shall include the value of all property—
> (1) . . . To the extent of any interest therein of which the decedent has at any time made a transfer (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.[19]

The common law rule discussed above remains unchanged between the Restatements of Trusts.[20] Section 338(1) of the Restatement (Second) of Trusts reads: "If the settlor and all of the beneficiaries of the trust consent and none of them is under an incapacity, they can compel termination or modification of the trust, although the purposes of the trust have not been accomplished."[21] It is important to note that comment (a) confirms that the power of the settlor cannot be waived: "The rule stated in the Section is applicable although the settlor does not reserve a power of revocation, and

18. I.R.C. § 2036(a) (2006).
19. *Id.* § 2038(a) (2006).
20. *See* RESTATEMENT (SECOND) OF TRUSTS § 338(1) (AM. LAW. INST. 1959); RESTATEMENT (THIRD) OF TRUSTS § 65 (AM. LAW. INST. 2003).
21. RESTATEMENT (SECOND) OF TRUSTS § 338(1) (AM. LAW. INST. 1959).

even though it is provided in specific words by the terms of the trust that the trust shall be irrevocable."[22]

In the absence of authority that §§ 2036 and 2038 do not apply to an irrevocable trust, fiduciaries of estates may have an opportunity to treat trust property as includable in the deceased settlor's gross estate. So, like the grantor trust rules, taxpayers may use this potentially detrimental IRS weapon to their advantage.[23] This sword cuts both ways, and what is good for the goose is good for the gander.[24]

To the extent each section applies if a right or power is held solely by the decedent at the time or death, each section also applies if that right or power cannot be exercised alone, but is only effective when exercised, under § 2036 "in conjunction with any person" or under § 2038, "in conjunction with any other person."[25] The regulations make it clear that those estate tax string sections also apply if actions of more than one person are necessary.[26]

The power must be held solely or jointly, but cannot be conditioned on an event.[27] The power exercisable alone or in conjunction with any person includes the power to act jointly, even if the other persons are adverse.[28] However, § 2038 does not apply to a settlor's power to act only after another grants the power if the settlor cannot unilaterally cause himself to acquire the power.[29] Therefore, in a simple case, if a settlor of an irrevocable trust for the sole benefit of his brother could appoint trust property to his sister, but only with the consent of the brother, the property would be included in the settlor's gross estate if the joint power were held by him at his death.[30]

The recent holding in *Estate of Powell v. Commissioner* demonstrates that the Internal Revenue Service continues to assert the unique provisions in both Code sections broadly.[31] The Tax Court applied § 2036(a)(2) and its "in conjunction with" language to grant the IRS partial summary judgment that

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22. RESTATEMENT (SECOND) OF TRUSTS § 338 cmt. a (AM. LAW. INST. 1959).

23. *See id.*

24. *See id.* at 420–21.

25. I.R.C. §§ 2036, 2038.

26. 26 C.F.R. § 20.2038-1(a) (2015) ("[I]t is immaterial in what capacity the power was exercisable by the decedent or by other person or persons in conjunction with the decedent, whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest. . ."); 26 C.F.R. § 20.2036-1(a)(3)(ii) (2011) ("A decedent's gross estate includes the value of any interest in property . . . if the decedent retained or reserved . . . [t]he right, either alone or in conjunction with any other person or persons, to designate the person or persons who shall possess or enjoy the transferred property or its income. . ."); 26 C.F.R. § 20.2036-1(b)(3) (confirms that even the necessary consent of those adverse to the decedent does not prevent application of § 2036.).

27. 26 C.F.R. § 20.2038-1(a).

28. 26 C.F.R. § 20.2038-1(a); Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 86 (1935); Rev. Rul. 70-513, 1970-2 CB 194; Austin Bramwell & Elisabeth Jo Madden, *Toggling Gross Estate Inclusion On and Off: A Powerful Strategy*, 44 ETPL 3 (Mar. 2017).

29. Rev. Rul. 55-393, 1955-1 CB 448; *see* Bramwell & Madden, *supra* note 28 ("Indeed, it appears that a longstanding ruling, Rev. 55-393, compels the IRS to view another person's ability to confer a taxable power on the donor as a contingency that defeats application of Section 2038(a)(1).").

30. 26 C.F.R. §§ 20.2038-1(a), 20.2036-1(a)(3)(ii), 20.2036-1(b)(3).

31. Estate of Powell v. Comm'r, 148 T.C. 392 (2017).

the transfer of cash and securities to a limited partnership was subject to a retained right of the decedent "to designate the persons who shall possess or enjoy" those assets "or the income therefrom."[32]

This was not the first time the Tax Court had done so.[33] The *Powell* court recalled the earlier case of *Estate of Strangi v. Commissioner*.[34]

In *Adolphson v. U.S.*, the decedent held a 100% interest in an Illinois land trust.[35] She gifted 38.5% of the beneficial interest to her children.[36] Under the amended trust agreement, the vote of the holders of 75% of the beneficial interest could modify or terminate the trust.[37] The government asserted that because less than the act of all beneficiaries in conjunction with the decedent was necessary to terminate the trust, the entirety of the trust property was includable in her estate under § 2038. The district court granted summary judgment to the government.[38] This is akin to the holding in *Swain v. U.S.*, discussed below, which involved a settlor who held the express power in a trust agreement to modify the trust with less than all beneficiaries.[39]

Some quarters of the estate planning community are wary that the potential reach of §§ 2036 and 2038 may be long enough to grab transfers in partnership or limited liability company member interests that had been gifted away if the donor, in conjunction with the other partners or members, has the power to dissolve or otherwise liquidate the entity.[40] That may upend many estate plans if §§ 2036 and 2038 do in fact reach that far.[41]

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32. *Id.* at 392–93.

33. *See id.*

34. *Id.* at 401–02 ("Our opinion in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, aff'd, 417 F.3d 468 (5th Cir. 2005), supports the conclusion that decedent's ability to dissolve NHP [the limited partnership that is the subject of the Powell case] with the cooperation of her sons constituted a 'right in conjunction with [others], to designate the persons who shall possess or enjoy the property [that she transferred to the partnership] or the income therefrom,' within the meaning of section 2036(a)(2). *Estate of Strangi*, like the present cases, involved a decedent who could act with others to dissolve a family limited partnership to which he had transferred property in exchange for a 99% limited partner interest. The ability to dissolve the partnership carried with it the ability to direct the disposition of its assets. In fact, because the decedent was a 99% partner in the partnership, its dissolution "would likely revest in decedent himself the majority of the contributed property." *Id.*, T.C. Memo. 2003-145 2003 WL 21166046, at *15. Therefore, we concluded that the decedent's ability to join with others to dissolve the partnership justified the application of section 2036(a)(2) to the property he transferred in exchange for his partnership interest.").

35. Adolphson v. U.S., No. 87-1236, 1990 WL 300361 at *1 (C.D. Ill. Oct. 29, 1990).

36. *Id.* at *2.

37. *Id.* at *1.

38. *Id.*

39. *See generally* Swain v. U.S., 147 F.3d 564, 567 (7th Cir. 1998) (holding that because the settlor could "exercise a power of direction to alter, amend, revoke or terminate the transferees' enjoyment of the property within three years of her death, the value of the transferred property [is] included in her gross estate").

40. *See e.g.*, Katy A. Wiles, *Closely Held Business Succession Planning: How a Family Limited Partnership Can Still Work to Your Advantage in Spite of Section 2036*, 1 ENTREPRENURIAL BUS. L.J. 213, 213–14 (2006) (discussing tactics to structure family limited partnerships to avoid § 2036).

41. *Id.*

More conventionally, the boundaries of §§ 2036 and 2038 are pretty well defined.[42] But, one fundamental power of a settlor that may exist in every trust has not been cleared from literal application of the estate tax strings of §§ 2036 and 2038.[43]

What prompted researching this article was the first enactment of the Uniform Trust Code in Arizona.[44] The Arizona estate planning community was alarmed and concerned, as it was enacted without any material change from the model act, and was thought to be too closely tied to the Restatement (Third) of Trusts, creating subjectivity and uncertainty.[45] Another concern was whether aspects of the UTC created estate tax inclusion risks for irrevocable trusts, both prospective and those already in place, because all are generally subject to law changes made in the UTC.[46] In fact, as stated above, some of the expressed estate tax concerns caused the National Conference of Commissioners on Uniform State Laws (NCCUSL), now the Uniform Law Commission, to revise at least two provisions of the UTC.[47]

Why did the concern about the power expressed in UTC Section 411(a), reflecting the common law, not cause concern about application of §§ 2036 and 2038? There was no definitive authority that put this issue to bed.[48] This article is organized to describe the effect of the common law and the UTC on estate tax inclusion.[49] The issue is hidden in plain sight.[50] One may draw an analogy to the Emperor in Hans Christian Andersen's tale, who paraded down the street very satisfied with his fine new wardrobe until a little child pointed and said "But he hasn't got anything on!"[51] The crowd of the Emperor's subjects, formerly pretending he had clothes, repeated the child's observation.[52]

II. ESTATE TAXATION RELATED TO THE UNIFORM TRUST CODE AND POWERS

The Restatement of Trusts is followed in Arizona.[53] Section 338(1) of the Second Restatement permits the settlor and all beneficiaries to modify or

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42. *See* I.R.C. §§ 2036, 2038.
43. *Id.*
44. *See generally* Gordon Waterfall, *The Uniform Trust Code is Arizona Bound*, ARIZ. ATT'Y at 19 (Oct. 2003) [perma.cc/KP9Y-LFX9].
45. *Id.* at 20.
46. *Id.* at 19.
47. *Id.*
48. *Id.*
49. *See infra* Parts III–IV.
50. *See infra* Parts III–IV.
51. Hans Christian Anderson, *The Emperor's New Clothes*, THE LITERATURE NETWORK (Feb. 2, 2019), www.online-literature.com/hans_christian_anderson/967 [perma.cc/vz68-j68m].
52. *Id.*
53. Olivas v. Bd. of Nat'l Missions of the Presbyterian Church, 405 P.2d 481, 486 (Ariz. Ct. App. 1965) (The case was transferred from the Arizona Supreme Court under then ARS § 12-120.23).

terminate a trust, regardless of the purposes of the trust.[54] It is questioned in Arizona whether that could be accomplished out of court, but some authority that such is the law in other jurisdictions. If it had become effective, former A.R.S. Section 14-10411(A) (assuming it had the language of Uniform Trust Code ("UTC") Section 411(a)), may have restated the law, subject to the requirement of court participation under existing law.[55]

A. Brief Statement of the UTC and the Estate Tax Concern

NCCUSL first published the UTC on March 10, 2000.[56] UTC Section 411(a) expressly provides that the settlor and all beneficiaries can modify or terminate the trust, impliedly outside of court.[57] Sections 2036 and 2038 provide the power of a decedent-donor (whether or not exercisable in conjunction with others, whether or not adverse) over gifted property to terminate or alter the beneficial enjoyment of the property, causing the property to be includable in the gross estate of the decedent.[58] Many experts believe inclusion is more likely due to this interplay. Some strongly advocate against changing Section 411(a). They reason that since Section 411(a) merely incorporates Section 338(1) of the Second Restatement of Trusts, which describes the settlor's power described above, any adverse tax result arising from the language of Section 411(a) is a problem under existing law.[59] Therefore, codification of long established law will not adversely affect a settlor because there is no realistic possibility that an estate tax problem can now surface when it had not already.[60]

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54. RESTATEMENT (SECOND) OF TRUSTS § 338 (AM. LAW. INST. 1959).

55. *See* Waterfall, *supra* note 44.

56. *See generally* UNIF. TRUST CODE (UNIF. LAW COMM'N 2000).

57. Current UTC § 411(a) was not added to the Model UTC until April 14, 2000, in an interim draft, without comment regarding any estate tax issues, but the comment in the April 25, 2001 versions of the July 28–August 4, 2000 NCCUSL Annual Conference Draft and Final Act dismisses any tax concern:

> The settlor's right to join the beneficiaries in terminating or modifying a trust under this section does not rise to the level of a taxable power. *See* Treas. Reg. § 20.2038-1(a)(2). No gift tax consequences result from a termination as long as the beneficiaries agree to distribute the trust property in accordance with the value of their proportionate interests.

The Amendments to the UTC made at the July 30 – August 6, 2004 NCCUSL gathering now provide that the entire subsection is optional, or if adopted that perfunctory court approval may be obtained. However, even after amendment, there is neither 1) an express requirement that court approval be obtained (although it is questionable what benefit such a requirement would provide), nor 2) a negation of the existing common law recognizing the power of a settlor to consent to trust modification or termination. The 2004 Amendments are discussed below, *infra* Part II.C.

58. I.R.C. §§ 2036, 2038.

59. *See id.*

60. *See id.*

B. UTC Section 411(a) Highlights Existing Estate Tax Risk

The codification by NCCUSL of the settlor power of Second Restatement Section 338(1) has the effect of clarifying the interaction between the power and §§ 2036 and 2038.[61] There were, however, at least two other sections of the UTC (Sections 303 and 304 that aggravated the tax problem by permitting less than all the beneficiaries to consent to modify or terminate a trust.[62] The estate tax issue is discussed in depth in Part III below.[63]

C. UTC Section 303 Virtual Representation Power No Longer Increases Estate Tax Risk (Except for States That Enacted the Pre-2004 UTC)

UTC Section 303 permits a parent to act for a minor child.[64] Prior to the August 2004 changes to the UTC, a parent could set up a trust for the child and then modify it unilaterally until the child reaches majority.[65] The comment to UTC Section 303 provides that the parent cannot act for the child if the parent has a conflict of interest.[66] The comment lists the parent acting as a trustee as being a conflict, but does not list as a conflict the parent being a settlor.[67] Perhaps a conflict would exist if the parent acted for his benefit, like revoking the trust or modifying it to permit satisfaction of the parent's support obligations; but, there would be no conflict if the parent terminated the trust or merely changed the method of determining distributions to the trust. Following consensus at an ACTEC meeting in Vancouver in July in which this issue was again validated, the August 2004 change to Section 301 adds a subsection (d), which now prohibits a settlor-parent from possessing such a power with respect to his or her child.[68] However, beneficiaries of trusts governed under the laws of states that had enacted, but not amended, the original UTC Section 303 and beneficiaries of estates of their settlors may remain tax affected: some beneficially through basis step up, and others adversely if the estate tax increased. No comments were published with the August 2004 amendments, although in the March 7, 2005 NCCUSL UTC release, NCCUSL, in its comment to UTC Section 411, states "[t]he Drafting Committee recommends that all jurisdictions enact the amendment to Section 301(d)."[69]

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61. *See* UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N).
62. *See* Les Raatz, *The Arizona Trust Code*, ARIZ. ATT'Y 20, 28 (2009) [perma.cc/VK6L-RB6J].
63. *See infra* Part III.
64. UNIF. TRUST CODE § 303 (UNIF. LAW COMM'N 2000).
65. *See id.*
66. *See id.*
67. *See id.*
68. *See* UNIF. TRUST CODE § 301 (UNIF. LAW COMM'N); *see* UNIF. TRUST CODE § 411 cmt. (UNIF. LAW COMM'N).
69. *See* UNIF. TRUST CODE § 411 cmt. (UNIF. LAW COMM'N).

D. UTC Section 304 Virtual Representation Power Increases Estate Tax Risk

The virtual representation provision of UTC Section 304 further empowers the settlor by permitting less than all beneficiaries to act with the settlor to modify or terminate a trust if one or more of such beneficiaries has a "substantially identical interest" to another who is "a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable."[70] The section and the comment to it do not limit its application to court proceedings.[71] Therefore, under any interpretation of *Helvering v. Helmholz*,[72] discussed below, the existence of the power at death of the settlor in such fact pattern may cause estate tax inclusion.[73] This issue remains outstanding.[74]

E. Can Settlor Waive a UTC Section 411(a) Power or the Common Law Power? Can Virtual Representation Powers Be Waived or Denied?

An ancillary issue is whether Section 304 is so integrally incorporated into Section 411(a) in a manner that will also negate any attempt to waive out of it pursuant to Section 105(b).[75] This same issue exists as to Section 303, and continues to remain important in jurisdictions that adopted the pre-2004 UTC.[76] Some read UTC Section 411(a) to be nonwaivable, but others believe that it may be "drafted around."[77] The law should expressly permit the power to be waivable by the settlor, regardless of UTC enactment.[78] The UTC comments provide no guidance, but comment (a) to the Restatement (Second) of Trusts, Section 338, indicates the power is not waivable.[79] In enacting the UTC, what if the legislature determines not to enact optional UTC Section 411(a)? Does that not extinguish the common law power? In its comment to UTC Section 411, NCCUSL said "no:"

> Section 411(a) was amended in 2004 on the recommendation of the Estate and Gift Taxation Committee of the American College of Trust and Estate Counsel (ACTEC). Enacting jurisdictions now have several options all of which are indicated by brackets:

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70. UNIF. TRUST CODE § 304 (UNIF. LAW COMM'N 2000).
71. *Id.*
72. Helvering v. Helmholz, 296 U.S. 93 (1935).
73. *See infra* Part III
74. *See infra* Part III.
75. *See* Newman, *supra* note 16, at 663.
76. *See* UNIF. TRUST CODE § 303 (UNIF. LAW COMM'N 2000).
77. *See* Appendix A for a discussion of this issue.
78. *Id.*
79. RESTATEMENT (SECOND) OF TRUSTS § 338 cmt. a (AM. LAW INST. 1959).

• delete subsection (a), meaning that the state's prior law would control on this issue. 80

. . .

F. UTC Virtual Representation Powers are New and Not Codification of Existing Law

The UTC comments confirm that the virtual representation provisions are not existing law, such that any enhanced risk of federal estate taxation resulting from the settlor's power to modify or terminate a trust with less than all beneficiaries arises solely from the UTC, and not from the law as it existed in Arizona prior to the UTC.[81] If such cannot be waived by the terms of the trust instrument, then unavoidably IRC §§ 2036 and 2038 have even greater likelihood of application under the UTC than is argued to arise under existing law. In any event, the estate tax issue is extant, even without consideration of UTC Sections 303 and 304.[82]

G. Section 2036 Power Must Be "Retained," But § 2038 Power Need Merely be Held at Death

Section 2036 should not apply if a new law grants a power to a settlor after the trust is created because the power was not "retained." The reach of § 2038 is different.[83] Section 2038 does not require a power be "retained" to create gross estate inclusion, only that it be held at death of a decedent, "without regard to when or from what source the decedent acquired the power."[84] Revenue Ruling 70-348, 1970 CB 193, makes this clear in holding that a subsequently acquired custodianship of a UGMA account by a donor trips § 2038(a)(1).[85]

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80. *See* UNIF. TRUST CODE § 411 cmt. (UNIF. LAW COMM'N 2005).

81. *Id.* ("The ability to use virtual and other forms of representation to consent on a beneficiary's behalf to a trust termination or modification has not traditionally been part of the law, although there are some notable exceptions."); *see also* UNIF. TRUST CODE § 304 cmt. ("Furthermore, this section extends the doctrine of virtual representation to representation of minors and incapacitated individuals.").

82. *See* discussion *infra* Part III.

83. White v. Poor, 296 U.S. 98, 102 (1935) (holding that a power was not "retained" under a predecessor provision to § 2038 when it was re-acquired by the decedent). This case prompted Congress to amend the provision to eliminate the word "retained" such that under modern § 2038(a)(1), it is not necessary that power held by a decedent have always been retained by a decedent. Revenue Act of 1936, § 805. The predecessor to § 2036 contained the same relevant language, but neither it nor modern § 2036 was changed as § 2038 was. However, in *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), § 2042 did not apply when the decedent had transferred insurance policies on his life to his wife, who died and left them to him as trustee of a trust for their daughter, in which decedent had absolute discretion to distribute all of the principal to her. The court noted the reacquisition of the power in the case was an independent event. Furthermore, based upon its legislative history, the court found that § 2042 was to be applied in a similar manner as §§ 2036 and 2038. *Skifter* can be distinguished from the trusts discussed in this article since in the facts of that case there was no continuing trust.

84. I.R.C. § 2038(a)(1) (2006).

85. Rev. Rul. 70–348, 1970 C.B. 193.

Theoretically, § 2036 may apply if a new power (UTC Section 411, as affected by UTC Sections 303 and 304) arises due to enactment of new law, and then thereafter the trust is created, even if the effective date of the new law occurs after the trust is created.[86]

H. Power Held under Operation of Law Alone Held a Taxable Power

It is not a defense against application of an estate string section to point out that if a right or power arises only by operation of law, then it is not subject to taxation. By such reasoning, if a statute or the common law provides that a trust is revocable in the absence of a provision to the contrary, then § 2038 will not apply. It should not matter if the law is statutory or common law. It has been held that a power granted under law alone will cause the estate of a donor of a UGMA to be taxable under *both* §§ 2036 and 2038.[87] The power provided by law of a minor as settlor of a trust to disaffirm rendered a gift incomplete, but was then taxable when power was lost under the applicable law of New Jersey.[88] The Tax Court in *Estate of Hauptfuhrer v. Commissioner*, discussed below, states "The [U.S. Supreme Court in *Helmholz*] did not say that Congress could not tax in the estate of a settlor property of a trust which he held a power to terminate, whether the power was reserved in the trust agreement or was conferred by state law."[89]

There is not much question that the source of the power is not determinative.[90]

I. Veto Power Can be a Taxable Power

Veto power of a settlor is treated as a comparable power to having the power subject to the veto.[91]

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86. *See* Treas. Reg. § 20.2036-1(b)(3); *see* UNIF. TRUST CODE § 411(a); *see* I.R.C. §§ 2036, 2038.

87. *See* Prudowsky v. Comm'r, 55 T.C. 890 (1971), *aff'd per curiam*, 465 F.2d 62 (7th Cir 1972).

88. *See* Comm'r v. Allen, 108 F.2d 961 (3d Cir. 1939) (holding that there is no gift when a settlor of a grantor trust incurs and pays the income tax of the trust. The ruling also holds that the right to reimbursement of income tax to settlor of trust taxable income will cause § 2036(a)(1) inclusion in the gross estate of the settlor, regardless of whether the right arises by terms of the trust instrument or "if, under applicable state law, the trustee must reimburse" the settlor for his or her personal income tax liability); *see also* Rev. Rul. 2004-64, 2004-2 C.B. 7.

89. Estate of Hauptfuhrer v. Comm'r, 9 T.C.M. (CCH) 974 (T.C. 1950).

90. *See* A. JAMES CASNER & JEFFREY N. PENNELL, 2 ESTATE PLANNING § 7.3.4.2 (6th ed. 1999); *see also* Wyly's Estate v. Comm'r, 610 F.2d 1282, 1291–92 (5th Cir. 1980).

91. Rev. Rul. 70-513, 1970-2 CB 194; *see, e.g.*, Thorp's Estate v. Comm'r, 164 F.2d 966, 967 (3d Cir. 1947), *cert. denied*, 333 US 843 (1948); *see also* CASNER & PENNELL, *supra* note 90, at § 7.3.3, n.52 and accompanying text.

J. Requirement of Perfunctory Court Approval is Not Determinative

NCCUSL's 2004 Amendments additionally provide for optional language (if Section 411(a) is not omitted entirely) to require a court to order modification or termination—if petitioned to so do and the settlor and all beneficiaries agree: "If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of an irrevocable trust, the court shall enter an order approving the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust."[92]

If this provision does not "modify" the existing common law right of such persons to modify or terminate the trust *out of court*, but merely permits elective access to a forum, then, pursuant to UTC Section 106, that extra-judicial right may remain unabated.

Even if it were found that such language requires court approval to exercise the right in all circumstances, such essentially ministerial act would not likely be seen to be any real impediment to the joint exercise of the suspect power of a settlor in a way that would insulate against the estate tax risk identified in this outline. In *Estate of Gutchess v. Commissioner*, the court held that § 2036 did not apply to an estate of a husband who gifted his residence to his wife, but continued to reside therein.[93] The Tax Court dismissed the government's argument that such use was a retention of use or enjoyment because he retained the right to reside there unless and until his spouse obtained a court decree to evict him, and no such decree was obtained.[94] In 1977, the Tax Court discussed *Gutchess* in *Castleberry v. Commissioner*:

> We do not think that *Estate of Gutchess* is applicable. In that case, the decedent lived in the residence only at the sufferance of his wife. He would not have been able lawfully to continue to reside in the residence if his wife withdrew her consent. She could, had she chosen to do so, have had him ejected by court order. In this case, however, decedent's right to the community income was not defeasible. His right was not dependent upon the actions or inactions of his spouse. The dictum regarding rights under Ohio law referred, in context, to the mere requirement that an action be brought and a court decree obtained in order to remove the husband. The "requirement" referred to a mere procedural difficulty in the enforcement of the transferee's right to exclude the transferor, not a substantive diminution of the right itself.[95]

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92. *See, e.g.*, OHIO REV. CODE ANN. § 5804.11 (2007).
93. *See* Estate of Gutchess v. Comm'r, 46 T.C. 554, 558 (1966).
94. *Id.*
95. *See infra* Part III; Castleberry v Comm'r, 68 T.C. 682, 687 (1977).

If the purpose of NCCUSL adding the optional sentence was to attempt to avoid possible application of §§ 2036 or 2038 to the powers otherwise possessed by a decedent under Section 411(a), then it may well have missed the mark. Adding "mere procedural difficulty," and perhaps voluntary at that, runs against the grain of Tax Court holdings that would ignore such requirements.

K. Amount Includable Under § 2038 Determined Differently Than if Under § 2036

The amount includable in the gross estate of a settlor under § 2038 is more limited than if includable under § 2036.[96] "The amount includible under § 2038 of the Code is limited to the value of the property interest that was subject to the decedent's power."[97] The amount includable under § 2036 is generally the entire property interest with respect to which the transferor retained the right to income or retained the relevant power to control enjoyment of others in its corpus or income.[98]

III. *HELMHOLZ* AND TREASURY REGULATION § 20.2038-1(a) DISCUSSION

The United States Supreme Court case, *Helvering v Helmholz*, held in favor of the taxpayer.[99] *Helmholz* involved a joint power only to terminate a trust held by a beneficiary who was also the settlor (and therefore held the power redundantly), and did not involve a joint power held by a settlor who was not a beneficiary; the latter overwhelmingly being the fact pattern that would arise under the UTC Section 411(a)/common law estate tax issue.[100]

The facts of the case are atypical of irrevocable gifting trusts.[101] The trust that is at the center of the case is similar in effect, if not also by intent, to a voting trust. The decedent and her parents and siblings transferred their respective shares of stock in a corporation to a trust, wherein decedent and the others each received his or her share of income. On death, he or she retained a special power of appointment to appoint his or her income share to natural persons, and if none, then to his or her issue, and if none of the others, and on termination the shares, they would be distributed to the remaining income holders in the same proportions as they were receiving the income. At death of the decedent, no estate tax section equivalent to § 2036 existed, and retained interests subject to special powers of appointment were not

96. *See id.*; I.R.C. § 2036.
97. *See* Rev. Rul. 70-513, 1970-2 CB 194.
98. *Id.*
99. *See* Helvering v. Helmholz, 296 U.S. 93, 98 (1935).
100. *Id.*
101. *Id.*

automatically includable in the gross estate of the donor.[102] The only estate tax issue (other than constitutionality) was whether the predecessor to § 2038 (section 302(d) of the Revenue Act of 1926) applied.[103] The Court stated:

> The petitioner [the government], however, pitches upon the only remaining event of termination, asserting it to be the equivalent of a power to revoke, or to amend, to be exercised by the settlor with others. This is found in the clause providing that the delivery to the trustee of a writing signed by all the then beneficiaries (other than testamentary appointees), declaring such purpose, shall be effective to end the trust. He points out that such a writing might have been executed by Mrs. Helmholz and her cobeneficiaries while she was alive, with the effect of revesting in her the shares which she had delivered into the trust. This argument overlooks the essential difference between a power to revoke, alter, or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.[104]

This discussion assumes *Helmholz* remains good law. There is a belief that those who are asserting application of § 2038 to UTC Section 411(a) and Second Restatement Section 338(1) to cause inclusion in the settlor's gross estate for federal estate tax purposes are arguing *Helmholz* is not precedent. As mentioned below, some have questioned its efficacy. It is not necessary to take a position that the holding is suspect in order to put forth an argument of estate tax risk. The issue is the proper interpretation of the opinion, and proper application to the relevant set of facts. In *Helmholz*, the facts and applicable tax law are so unique that it is difficult to be comfortable that any typical trust arrangement is likely to be sufficiently similar to warrant any reliance on the holding. Additionally, Justice Roberts's exact reasoning is not the apex of clarity. The holding may be limited to its facts: a situation in which the settlor of an irrevocable trust is a beneficiary, and not when the settlor is not a beneficiary.[105] The holding may be further limited to facts involving multiple settlors who also are beneficiaries.[106] Therefore, if one is presented with a scenario not within the unique facts of *Helmholz*, no comfort can necessarily be taken from the case.

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102. *Id.*
103. *Id.* at 94–98 (The Court also found that the application of the statute violated the Fifth Amendment as a retroactive taking of property.).
104. *Id.* at 97.
105. *Id.*
106. *Id.*

A. Treasury Regulation § 20.2038-1(a)

Treasury Regulation § 20.2038-1(a) contains the following language derived from *Helmholz*:

> However, section 2038 does not apply—
>
> . . . . .
>
> (2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; . . .[107]

The term "parties" most likely means the trust beneficiaries exclusively, including settlors who are beneficiaries. The context of the use of the word "parties" is important. It is applied in the context of an economic or property interest: "parties having an interest (vested or contingent)." A settlor, as such, does not have such an interest.[108] Other authority also exists for this construction.[109] From *Estate of Hauptfuhrer v. Commissioner*:

> The [U.S. Supreme Court in *Helmholz*] did not say that Congress could not tax in the estate of a settlor property of a trust which he held a power to terminate, whether the power was reserved in the trust agreement or was conferred by state law. This was the position taken by the Circuit Court of Appeals for the Third Circuit in *Commissioner v. Allen*, 108 Fed. (2d) 961 [40-1 USTC ¶ 9133], *certiorari denied*, 309 U.S. 680, where it said:
> *** In the Helmholz [296 U.S. 93, 36-1 USTC ¶ 9003] case the settlor was one of the beneficiaries to whom the power was given by the trust indenture to terminate the trust and return the property to the settlor if all of the beneficiaries agreed in writing that that should be done. No power to revoke the transfer or change the beneficiaries was reserved to the settlor as such. Her only power in connection with a possible termination of the trust and a return of the property to herself came to her as one of the beneficiaries and not as the settlor. Hence, the case was not within the intent of the statute.***
> *** The thing of importance in the *Helmholz* case was that the power of revocation there rested with the beneficiaries and not with the settlor as such. ***[110]

The estate tax concern with respect to § 2038 is presented as follows: because the regulation section is conjunctive, both conditions must be met to *exclude* a settlor power from the application of § 2038(a)(1).[111] Otherwise it is taxable under § 2038(a)(1). Let's recap the two conditions to be satisfied to avoid

107. Treas. Reg. § 20.2038-1(a)(2) (1962).
108. *Id.*
109. *See* Comm'r v. Allen, 108 F.2d 961, 965 (3d Cir. 1939).
110. Estate of Hauptfuhrer v. Comm'r, 9 T.C.M (CCH) 974 (1950).
111. I.R.C. § 2038(a)(1) (2006).

application of the statute: (1) the decedent's power could be exercised only with the consent of all "parties" having an interest (vested or contingent) in the transferred property; and (2) the power adds nothing to the rights of the "parties" under local law.[112]

The first condition is clearly satisfied by UTC Section 411(a), and presumably Second Restatement Section 338(1).[113] However, the second condition is not satisfied.[114] The decedent's power is necessary to affect interests in the trust because, without the decedent's act, UTC Section 411(a) is inoperative.[115] In other words, decedent's power as settlor only, if exercised, adds something to the power of beneficiaries alone.[116] Therefore, the power of a non-beneficiary settlor of the type described in Section 411(a) is *not excluded* from being a power described in § 2038(a)(1) by the regulation provision above, and is *taxable*.[117]

The Seventh Circuit in the 1998 case *Swain v. U.S.* decided a plain vanilla case involving a settlor having an express power in a trust agreement to modify the trust *with less than all* beneficiaries.[118] The court held the power was clearly within § 2038(a)(1).[119] The court reiterated its prior decision, in which it had not considered "whether Section 2038(a)(1) covers powers exercisable by the decedent in conjunction with all the beneficiaries."[120] So, it is an expressly open question in the Seventh Circuit, even without UTC Sections 303 and 304.

The language of the opinion at least invites the question of whether the Court properly understood and considered the relevant trust law.[121] It appears the court believed the law of Wisconsin (presumed to be the First Restatement of Trusts) to permit living beneficiaries alone to terminate a trust.[122] The Court did not discuss the "*Claflin* doctrine," i.e., the requirement that no material purpose of the trust would be frustrated as a condition to permitting the beneficiaries alone to terminate the trust if the settlor's consent is not forthcoming.[123] The Court noted that the trust instrument permitted "the then beneficiaries, other than testamentary appointees" to terminate the

112. Treas. Reg. § 20.2038-1 (1962).

113. RESTATEMENT (SECOND) OF TRUSTS § 338(1) (AM. LAW INST. 1957).

114. *Id.*

115. *See* UNIF. TRUST. CODE § 411 (UNIF. LAW. COMM'N 2000).

116. *See id.*

117. I.R.C. § 2038 (2006).

118. Swain v. U.S., 147 F.3d 564, 567 (1998), *accord* Estate of Thorp v. Comm'r, 7 T.C. 921 (1946).

119. *See id.* (stating UTC § 411 in conjunction with UTC § 303 (in pre-2004 UTC legislation) or 304, when facts so dictate, may tee up the ball for , by permitting the settlor with less than all of the beneficiaries to modify or terminate a trust).

120. *See id.* at 566.

121. *See id.*

122. *Id.* at 96; RESTATEMENT (SECOND) OF TRUSTS §§ 337–38 (AM. LAW INST. 1935) (referring to no authority to the contrary in Wisconsin, the place of the transaction).

123. *See* Claflin v. Claflin, 20 N.E. 454 (1889).

trust.[124] Nonetheless the Court stated: "Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits *all the beneficiaries* to terminate the trust [emphasis added]."[125] In at least one treatise it is questioned whether the Court ignored its own findings of fact: "Consequently, the power which the decedent reserved in the *Helmholz* case went beyond anything to which she would have been entitled in the absence of the explicit reservation of the right to revoke the trust and according to the Court's own reasoning should have made the trust taxable."[126]

An argument might be made that if the modification does not violate a material purpose of the trust, then the consent of the settlor is neither necessary under the common law nor UTC Section 411(b).[127] So then, the Treas. Reg. § 20.2038-1(a) condition that the settlor's consent would add nothing to the ability to effect that modification, thus § 2038 does not apply. But that reasoning misses the point. It is not whether a certain modification would not require the settlor's consent, it is whether there are *any* modifications affecting beneficial interests that would require the consent of the settlor (so the consent of the settlor adds something). That would implicate § 2038.

Justice Roberts emphasizes that the most important issue in the holding of *Helmholz* is the retroactive application of the predecessor to § 2038(a)(1):

> Another and more serious objection to the application of section 302(d) in the present instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter, or to amend. Under the revenue act then in force, the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. *Reinecke v. Northern Trust Company*, 278 U. S. 339, 49 S. Ct. 123, 73 L. Ed. 410, 66 A. L. R. 397. If section 302(d) of the Act of 1926 could fairly be considered as intended to apply in the instant case, its operation would violate the Fifth Amendment. *Nichols v. Coolidge*, 274 U. S. 531, 47 S. Ct. 710, 71 L. Ed. 1184, 52 A. L. R. 1081.[128]

This specific constitutional impediment to application of § 2038 (and also § 2036 discussed below) is not present with respect to any trust today, because it would only apply to trusts created before 1926 (1931 in the case of the § 2036(a)(2) predecessor, Section 302(c)) by settlors presently living. To the extent due process protection against retroactive legislation offered shelter from taxation to the Irene C. Helmholz Estate, it is unavailable now.

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124. *Helmholz*, 296 U.S. at 94–95.
125. *Id.*
126. LOWNDES, KRAMER, & MCCORD, FEDERAL ESTATE AND GIFT TAXES § 8.3 (3d ed. 1974).
127. RESTATEMENT (THIRD) OF TRUSTS § 65(1) (AM. LAW INST. 2003).
128. *Id.*

The Court held that either defense (the "more serious" unconstitutional retroactivity or, the less serious: the settlor a "party in interest") would protect against taxation.[129] The loss of the constitutional defense of unfair retroactivity in a case today is not necessarily fatal to protection, but it exposes some additional weakness in application of the *Helmholz* holding to assist in avoiding the estate string provisions.[130]

B. Does Helmholz *Control IRC § 2036? Does Treasury Regulation § 20.2038-1(a) Control § 2036?*

Helmholz and the Treas. Reg. § 20.2038-1(a) apply to § 2038. The rationale for the application of constitutional due process requirements by *Helmholz* to § 2038 seems to be the same for § 2036(a)(2). However, the regulation literally does not apply to § 2036, and the IRS has so determined in a General Counsel Memorandum (GCM).[131]

GCM 33512 (1967) involved a contribution to a non-profit corporation, in which the decedent contributor became a voting member of the corporation.[132] For purposes of § 2036, the contributor's capacity as a member was a retained power.[133] Implicit in the holding was the determination that Treas. Reg. § 20.2038-1(a) does not apply to § 2036.

In the GCM, the IRS noted the application of § 2038 depended on application of Treas. Reg. § 20.2038-1(a). For purposes of § 2038, because the potential charitable recipients of the corporation were not known until distributions were made, the IRS reasoned "that only the corporation possesses an interest in the property under the regulations. . . ."[134] Following that, the IRS found that the corporation's consent alone would satisfy the regulation and the powers of the members (and directors) added nothing to the rights of the corporation under state law.[135] The IRS stated:

> In spite of the fact that the language in section 2038 is broader than the language in section 2036, we believe that section 20.2038-1(a)(2) of the regulations precludes inclusion of the property under section 2038 . . . [W]e agree that the value of the property transferred . . . is includible in the decedent's gross estate, but only under section 2036 . . .[136]

It is important to note that the IRS focused on the corporation's interest in the property in applying the regulation. This is, of course, instructive in

129. *Id.* at 98.
130. *See id.* at 93.
131. I.R.S. Gen. Couns. Mem. 33512 (May 18, 1967).
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*

determining the meaning of who are "all parties [vested or contingent] in the transferred property" in interpreting Treas. Reg. § 20.2038-1(a)(2).[137] This memorandum is consistent with excluding from "parties" settlor as such who is not also a beneficiary or has a property interest in the transferred property.

As discussed above, inclusion under § 2036(a)(2) does not concern application of Treas. Reg. § 20.2038-1(a). Therefore, in analyzing estate tax inclusion of trust property because of the common law (or UTC Section 411(a)) power of a settlor under § 2036(a)(2), the following language from the *Helmholz* Supreme Court is the only primary authority beyond the statute as to the determination of who is a party in interest:

> The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.[138]

The view of the IRS, as articulated in GCM 33512, is that interpretation and application of § 2036 is not affected by Treas. Reg. § 20.2038-1(a)(2). Under a plain reading of § 2036(a)(2), as interpreted by Treas. Reg. § 20.2036-1(a), the retained common law power of a settlor to modify or terminate a trust in conjunction with all beneficiaries, adverse or not, is a "right to designate the person or persons who shall possess or enjoy the transferred property" that is the subject of the power, to be included in the gross estate of the settlor.[139]

C. *If Holding the Power is Not Taxable, Then its Exercise and Holding the Power After Exercise Should Not Be Taxable*

If §§ 2036 and 2038 do not apply to cause the common law power to be includable in the gross estate of the settlor, then does the exercise of the power by the settlor modifying the trust cause inclusion of the trust property in the gross estate? If yes, why? Obviously, at the time of the exercise, §§ 2036 and 2038 do not apply because the settlor is living. Immediately after the exercise, the settlor is in exactly the same situation and holds the same powers as immediately before the exercise. The sections should not apply after the trust modification any more than they would apply before modification. Therefore, if the sections do not apply to the common law power before an exercise, the settlor has a continuing joint option with the beneficiaries to modify the trust, regardless of whether the modification violates a material purpose of the trust and the settlor should have no risk of

137. *See* Treas. Reg. § 20.2038-1(a)(2).
138. *Id.* at 97.

estate tax inclusion, whether or not he exercises the joint power. This example points out the incongruity of non-application of §§ 2036 and 2038 to the holding of the common law power by a settlor who is not a beneficiary of the trust.

IV. Marital and Community Property Cases; Death Benefits to Families of Shareholder-Employees Cases; Other Cases; Form Over Substance Doctrine

There are some lines of cases in which powers possessed at death by creators of rights were found nontaxable.[140] The cases involved the issue of federal estate tax inclusion: (1) arising from retained rights in gifts of community property between Texas spouses; (2) in connection with powers of an employee-shareholder of a corporation to affect death benefits paid to his family; (3) arising from gifts to a spouse, followed by life estate created when the donee-spouse died; and (4) when the decedent held a power as a beneficiary of the type in *Helmholz*. These holdings were all favorable to the taxpayers. A discussion of these decisions follows.

A. Marital and Community-Property Cases

In Texas, income from separate property, whether or not gifted from a spouse, is community property.[141] In *Wyly's Estate v. Commissioner*, the Fifth Circuit (historically sympathetic to taxpayers in estate tax cases), in a two-to-one decision, held that the income right of the donor spouse granted by operation of law in the gifted property is not an § 2036(a)(1) retained right.[142] In the facts of the case, the husband gave his wife property to be her sole and separate property.[143]

The majority found that the income right held by the husband at death was too speculative and contingent to be taxable under § 2036.[144] It extensively analyzed Texas community property law, and at one point stated:

> Thus, existing Texas law in the area teaches that the only relevant consequence of a spouse's ownership of a community property interest in income from the other spouse's separate property is an inchoate standing to complain that the other spouse made an excessive or capricious gift to a third party, or to demand an accounting on dissolution of the marriage or partition, alleging the income was used to improve the other spouse's

140. *See infra* Sections IV.A–D.
141. Arnold v. Leonard, 273 S.W. 799, 803 (Tex. 1925).
142. Wyly's Estate v. Comm'r, 610 F.2d 1282, 1294 (5th Cir. 1980).
143. *Id.* at 1288.
144. *Id.* at 1294–95.

> separate property. Does this constitute a "right to the income?" We think not, and proceed to an examination of the Act to explain why.[145]

The *Wyly's Estate* majority also held that retention of a right by operation of law will not be sufficient to cause application of § 2036(a)(1), specifically when the transferor has done all he can do to part with the transferred interest:

> We do not believe that an interest, created solely by operation of law as the unavoidable result of what was in form and within the intendment of the parties *the most complete conveyance possible*, is a retention within the Act. There must be some act or omission on the part of the donor, such as an express or an implied agreement between donor and donee at the time of the transfer, which provides for retention. *See, e.g.*, *Guynn v. U.S.*, 437 F.2d 1148 (4th Cir. 1971); *First National Bank of Shreveport v. U.S.*, 342 F.2d 415 (5th Cir. 1965) (per curiam); *Skinner's Estate v. U.S.*, 316 F.2d 517 (3d Cir. 1963); *Estate of McNichol v. Comm'r*, 265 F.2d 667 (3d Cir. 1959).[146]

Certainly this is hopeful. However, Judge Roney dissented in *Wyly's Estate* for the sole purpose of disagreeing with the majority's conclusion that an interest retained by operation of law would not come within the grasp of § 2036:

> I concur in the result and that portion of the opinion which holds that the community interest of the donors in the income of the donated property was insufficient to amount to "the right to income from, the property" as provided in 26 U.S.C.A. § 2036(a)(1). Thus, I agree that no portion of the donated property should be included in the estates of the deceased taxpayers. I respectfully dissent, however, from that portion of the opinion which holds that such interest was not "retained" "under" the transfers here made. If after the transfers the donors' remaining interest in the gifted property had been such as to qualify as 'the right to income' under § 2036(a)(1), the tax consequences should be the same whether that interest was retained by the express provisions of donative instruments, or arose by operation of law in effect at the time of the gift. The cases relied upon by Judge Garza do not compel a contrary decision. They hold only that a retained interest taxable under § 2036 may be created by an express or an implied agreement between the donor and donee at the time of transfer. *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975); *First National Bank of Shreveport v. United States*, 342 F.2d 415 (5th Cir. 1965); *Guynn v. United States*, 437 F.2d 1148 (4th Cir. 1971); *Estate of Skinner v. United States*, 316 F.2d 517 (3d Cir. 1963); *Estate of McNichol v. Commissioner*, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829, 80 S. Ct. 78, 4 L. Ed. 2d 71 (1959); *Estate of Gilman*, 65 T.C. 296 (1975). Those cases do not support the

145. *Id.* at 1290.
146. *Id.* at 1294 (emphasis added).

> proposition that the creation of a § 2036 retained interest may not arise solely by operation of law, but requires an act or omission of the donor. While the opinion of the Tax Court in *Estate of Gutchess*, 46 T.C. 554 (1966), gives some support to the proposition, the statutory homestead residence rights involved in that case were not the kind of retained interest at which § 2036 was aimed. Had it been otherwise, it is doubtful the Tax Court would have used the language that it did. In any event, a thorough discussion here is not called for because the point does not control the outcome of this case. The taxpayers' community interest in the separate property of their wives not being "the right to income from, the property" within the meaning of § 2036(a)(1), it makes no difference whether or not that community interest was "retained" "under" the transfers.[147]

Wyly's Estate was followed in Rev. Rul. 81-221, 1981-2 CB 178, revoking Rev. Rul. 75-504, in holding that gifts between Texas spouses will not implicate § 2036.[148]

The *Wyly's Estate* court dealt with a situation in which the taxpayer decedent had done all he could do to rid himself of the property rights and powers in it.[149] In other words, the settlor affected "in form and within the intendment of the parties the most complete conveyance possible."[150] In a trust structure, such is not the case because the settlor determined to put it in a trust, which creates the problem, and instead could have given it outright and relied on conservatorship law to protect minor or incompetent beneficiaries. The settlor could waive the power to modify or terminate the trust, assuming the law so permits. Or maybe the settlor could have created a trust authorizing and requiring the trustee to settle a second trust with specified terms so the settlor would not be a settlor with Restatement Section 338(1) or UTC Section 411(a) powers. Therefore, a settlor transferring property to a trust did not part with the corpus "in form and within the intendment of the parties the most complete conveyance possible," because he could have avoided possessing the power by one means or another.

It has been asserted that because this income right retained as a matter of law is not includable in the gross estate of the donor spouse, the *Wyly's Estate* case stands for the proposition that other rights retained as a matter of law (e.g., UTC Section 411(a) and Restatement (Second) of Trusts Section 338(1) powers of settlors) are also not includable. The Texas community property situation is unique to only a couple of states at best, and the court was not going to find that this anemic income right was the kind of right to which § 2036(a)(1) would apply. Therefore, the breadth of the holding is likely limited to the specific facts. Furthermore, the fact pattern of the case is narrow, and a court could, without much difficulty, distinguish the case.

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147. Wyly's Estate v. Comm'r, 610 F.2d 1282, 1296 (5th Cir. 1980) (Roney, J., concurring).
148. Rev. Rul. 81-221, 1981-2 CB 178.
149. *Wyly's Estate*, 610 F.2d at 1294.
150. *Id.* at 1294.

As mentioned in Part II in this discussion, the Seventh Circuit has held powers retained as a matter of law are within the reach of both §§ 2036 and 2038.[151] As a final caution, the Tax Court also unambiguously weighed in: the source of the retained right is of no consequence to the application of § 2036.[152] In *Castleberry v Commissioner*, a regular decision in a reviewed case, the court so held, quoting *Estate of McNichol v. Commissioner*:

> This [the concept that rights retained solely by virtue of state law are not retained for purposes of Section 2036(a)(1)] is too constricted an interpretation to place on the statute. The statute means only that the life interest must be retained in connection with or as an incident to the transfer.[153]

Castleberry was reversed by the Fifth Circuit in *Wyly's Estate* discussed above.[154] Excluding cases appealable to that circuit and possibly if Texas community property law is involved, it remains clear precedent.[155]

In *Estate of Gutchess v. Commissioner*, the Tax Court held that a right of occupancy granted under Ohio law to a spouse of the owner of a residence gifted by the spouse was not a taxable right possessed by the gifting spouse.[156] The reason, as succinctly articulated by Judge Hall in *Castleberry* when discussing *Gutchess*, was because it was not a substantive right.[157] It could be swept away by obtaining a court order:

> He would not have been able lawfully to continue to reside in the residence if his wife withdrew her consent. She could, had she chosen to do so, have had him ejected by court order.[158]

B. Death Benefit Cases

The other rationale supporting the position that a settlor's power to terminate or modify a trust in conjunction with others under UTC Section 411(a) or Second Restatement Section 338(1) does not increase estate tax risk emanates from the death benefit cases decided by the old U.S. Court of

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151. *See supra* Part II; Prudowsky's Estate v. Comm'r, 55 T.C. 890, 892 (1971), *aff'd per curiam*, 465 F.2d 62 (7th Cir. 1972); *see also* Estate of Hauptfuhrer v. Comm'r, 9 TCM 974 (1950), *aff'd*, 195 F.2d 458 (3d Cir. 1952).

152. Estate of Castleberry v. Comm'r, 68 T.C. 682, 690 (T.C. 1977).

153. *Id.* at 687 (quoting Estate of McNichol v. Comm'r, 265 F.2d 667, 670 (3d Cir. 1959), *cert. denied*, 361 U.S. 829 (1959)).

154. Wyly's Estate v. Comm'r, 610 F.2d 1282, 1296 (5th Cir. 1980).

155. *Id.*

156. Estate of Gutchess v. Comm'r, 46 T.C. 554, 558 (T.C. 1966); *see supra* Part II.

157. *Id.*

158. *Castleberry*, 68 T.C. at 687.

Claims.[159] This belief may be whistling in the dark.[160] The court concluded that the exercise of the power by an ostensible donor was merely speculative because it required the 50% shareholder to persuade the other 50% shareholder to agree to a change in a contractual death benefit to a spouse.[161] The court said it was not a power other than a "power of persuasion," which is not a § 2036(a)(2) power.[162] That is a slippery slope because the same could be said of any power under § 2036(a)(2) that requires consent of other parties, adverse or not.[163] Both cases involved power held by shareholders of corporations (with different issues of fiduciary obligations) and not by settlors of trusts.[164] Furthermore, by that reasoning, no settlor power that is exercisable in conjunction with others is immune from the analysis in the death benefit cases because others must be "persuaded" in the same context.[165] If the logic of these cases applies to trusts, it would therefore follow that the statutory language "[by the decedent] alone or in conjunction with any person" in both §§ 2036 and 2038 would have to be flat out ignored.[166] More recently, in both *Powell* (2017) and *Strangi* (2003) (each discussed above), the Tax Court applied § 2036(a)(2) "in conjunction with" language regarding partnership interests in both cases and additionally referenced the corporate general partner of which the decedent had 47% of the stock in *Strangi*.[167]

C. Clark *Case*

Clark v. U.S. concerned a decedent who transferred property outright to her husband.[168] He made a will that on his death gave her a life estate in a trust funded at least in part with those assets.[169] In short, the court found she was not the settlor, so the ruling that her power to modify the trust with adverse parties—her son—was not within § 2038.[170] The court said "[I]t is not possible to read a retained life estate into this kind of arrangement."[171]

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159. *See* Kramer v. U.S., 406 F.2d 1363 (Cl. Ct. 1959); *see also* Estate of Tully v. US, 528 F.2d 1401 (Cl. Ct. 1976).
160. *See Kramer*, 406 F.2d at 1369; *see also* Estate of Tully, 528 F.2d at 1406.
161. *Id.*
162. *See Kramer*, 406 F.2d at 1369.
163. *See id.*
164. *See id.* at 1369; *see also* Estate of Tully, 528 F.2d at 1406.
165. *Id.*
166. *See Kramer*, 406 F.2d at 1368.
167. *See* Estate of Powell v. Comm'r, 148 T.C. 392, 396 (2017); *see also* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003).
168. Clark v. U.S., 209 F. Supp. 895, 896 (D. Colo. 1962).
169. *Id.* at 897.
170. *Id.* at 901.
171. *Id.* at 902.

D. Bowgren *Case*

In *Estate of Bowgren v. Commissioner*, Tax Court Judge Tannenwald held that a decedent's estate did not include any interest in an Illinois land trust because the settlor only retained distribution powers over the trust as a beneficiary, and no such powers as a settlor.[172] In other words, it appears that the powers retained were no broader than the powers held by the decedent in *Helmholz*.[173] The Tax Court stated near the end of the decision:

> We conclude that the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself under the reserved power of direction but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries. Such a power is not a retained power under § 2036(a)(2); *see* Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6th ed. 1991), and is a power to which § 2038(a) does not apply, see sec. 20.2038-1(a)(2), Estate Tax Regs.[174]

The case was reversed by the Seventh Circuit in *Estate of Bowgren v. Commissioner*, finding that the decedent separately, and in addition to the power she possessed described above, "retained the power to direct the trustee to convey title to a separate trust and to designate whomever she pleased as the beneficiary."[175] Although the IRS had asked the court to also address the Tax Court's finding quoted above, the Court of Appeals declined, because it was not necessary to so do.[176] Footnote 20 reads:

> Because we conclude that Mrs. Bowgren retained the power of direction specifically granted to her by name in the trust agreement, we need not reach the issue whether a power to direct the trustee held by the settlor in conjunction with all the beneficiaries would be sufficient to require that the value of the units be included in the gross estate.[177]

E. Form Over Substance Doctrine

If the estate of the decedent takes the position that the trust assets are includable in the gross estate of a decedent, may the IRS successfully assert the doctrine of form over substance to deny inclusion? The answer is likely no.

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172. Estate of Bowgren v. Comm'r, 70 T.C.M. (CCH) 748 (1995), *judgment reversed by* Estate of Bowgren v. Comm'r, 105 F.3d 1156 (7th Cir. 1997).
173. Helvering v. Helmholz, 296 U.S. 93, 98 (1935).
174. Estate of Bowgren v. Comm'r, 70 T.C.M. (CCH) 748 (1995).
175. Estate of Bowgren v. Comm'r, 105 F.3d 1156, 1156 (1997).
176. *Id.* at 1164, n. 20.
177. *Id.*

Generally, it is understood that the taxpayer cannot successfully argue that the substance of a transaction should determine tax treatment when it produces a reduced tax or tax benefit not available when respecting the form of the transaction structured by the taxpayer.[178] The government, however, may readily apply the doctrine of substance over form when warranted and advantageous to assert higher tax liability.[179]

Assume the following: The settlor settles a trust in which the settlor provides that the trust cannot be revoked, altered, amended, or terminated by the settlor.[180] The law of the applicable jurisdiction (UTC Section 411(a) or the common law—collectively the "Common Law") permits the settlor, in conjunction with all beneficiaries, to modify or terminate the trust, regardless of the settlor's express statement in the trust to the contrary.[181] The Common Law is equally applicable to all trusts.[182] In other words, from the analysis of this article, it can be reasonably asserted that the settlor retains a power that would cause inclusion in her gross estate if she possesses the power at death. The settlor files a gift tax return reporting the gift to the trust as a completed gift.[183] Settlor dies and the person authorized to file the estate tax return for the settlor's estate (the "Executor") includes the trust in the settlor gross estate.[184]

Does this implicate the form over substance rule annunciated in certain decisions to deny the Executor from asserting inclusion in the estate? The gift tax return reported a completed gift.[185] A gift is complete when the donor no longer has dominion and control, which leaves him no power of disposition over the transferred property.[186] A power exercisable with other nonadverse parties is incomplete, but if exercisable only with the consent of adverse parties, then the gift is complete.[187]

In this case, the gift is complete because the beneficiaries have interests in the trust adverse to those of the settlor.[188] The continuing retention of the power described in § 2036 and the holding of a power described in § 2038 is entirely consistent with reporting a completed gift.[189] Remember, the

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178. *In re* Steen, 509 F.2d 1398, 1402–03 (9th Cir. 1975); *see also* Howard M. Zaritsky, *Getting Irrevocable Trust Assets Back in the Grantor's Gross Estate*, 45 EST. PLAN 46, Westlaw (Sept. 2018).

179. Estate of Skinner v. U.S., 316 F.2d 517, 520 (3d Cir. 1963).

180. *See generally* TEX. PROP. CODE ANN. § 112.051 (Supp.) (setting out the settlor's power to modify, amend, or revoke express trust terms).

181. UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N 2010).

182. *See* Shire v. Unknown Heirs, 907 N.W.2d 263, 268 (Neb. 2018); Trust Under Agreement of Taylor, 164 A.3d 1147, 1161 (Pa. 2017); Matter of Bradley K. Brakke Trust dated November 11, 2013, 890 N.W.2d 549, 555–57 (N.D. 2017).

183. I.R.C. Form 709.

184. *Instructions for Form 709 (2018)*, I.R.S., https://www.irs.gov/pub/irs-pdf/i709.pdf [perma.cc/C8AJ-23TH] (last visited Apr. 2, 2019).

185. *Id.*

186. Treas. Reg. § 25.2511-2(b) (as amended in 1999).

187. Treas. Reg. § 25.2511-2(e) (as amended in 1999).

188. Treas. Reg. § 25.2511-2; I.R.S. Priv. Ltr. Rul. 201426014 (June 27, 2014).

189. I.R.C. §§ 2036, 2038.

settlor's power under the Common Law, even with adverse parties, implicates §§ 2036 and 2038.[190] The provision in the trust instrument regarding of irrevocability has that the effect of limiting all powers over the trust, save the Common Law power, so the provision has independent consequences, including the protection of trust assets from the settlor's creditors.[191] The Executor has taken no position different than either the form or the substance of the transaction (the creation of the trust), and has not asserted facts inconsistent with gift treatment. Perhaps the government would assert that the "irrevocably" provision in the trust is the "form" the taxpayer is stuck with. That assertion is itself advocating supremacy of form over substance, because, in many states, the taxpayer would retain the Common Law power whether or not it was excepted out of the powers the settlor was purporting to waive.[192] It would make the tax result dependent on whether the settlor provided that he or she reserved the power to terminate or modify the trust with all beneficiaries, when omitting that clause would not change her retention of that power.[193]

V. PRIVATE LETTER RULINGS

PLRs 200247037, 200303016, 200919008, 200919009, 200919010, and 201233008 are signs that the government may not assert that powers held by a settlor under Second Restatement Section 338(1) and UTC Section 411(a) are subject to the claws of §§ 2036 and 2038.[194] Taxpayers cannot rely upon private letter rulings, nonetheless "such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."[195] In the rulings discussed below, it could be inferred that the IRS does not interpret either §§ 2036 or 2038 to automatically apply to the common law powers under the Restatement of Trusts.[196] This would, of course, contradict the government's position, as set forth in this discussion, throughout the 20th century.

A. PLR 200247037

In PLR 200247037, the government ruled that with respect to a trust in which a settlor is not a beneficiary, the settlor's petition, in which all the beneficiaries requested that a probate court modify the trust by creating

190. *See id.*
191. I.R.S. Priv. Ltr. Rul. 201426014 (June 27, 2014).
192. Nelson v. Nelson, 206 So. 3d 818, 821 (Fla. Dist. Ct. App. 2016).
193. *See* RESTATEMENT (SECOND) OF TRUSTS § 338 cmt. a (AM. LAW. INST. 1959).
194. *See* I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002); I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003); I.R.S. Priv. Ltr. Rul. 200919008 (May 8, 2009); I.R.S. Priv. Ltr. Rul. 200919009 (May 8, 2009); I.R.S. Priv. Ltr. Rul. 200919010 (May 8, 2009); I.R.S. Priv. Ltr. Rul. 201233008 (Aug. 17, 2012).
195. Hanover Bank v. Comm'r, 369 U.S. 672, 686 (1962).
196. *See infra* Sections V.A–D.

separate trusts for each beneficiary, will not result in inclusion in the settlor's estate under §§ 2036 or 2038.[197] However, the effect of the ruling is unclear. There is no representation that the settlor is deceased, and it is not clear why such a ruling was requested and what would be accomplished by obtaining the ruling. There is no understandable analysis of the issue of application of § 2036. The analysis of § 2038 applicability is conclusory.[198] The relevant ruling requested was limited as follows:

> (1) Consent by [the settlor] to the Petition to modify Trust will not result in N having a power to alter, amend, revoke, or terminate Trust or result in N retaining a right with respect to Trust with the effect that would cause the Trust property to be includible in N's estate under §§ 2036 or 2038.

The relevant ruling given was:

> Accordingly, we conclude that the consent by N to the Petition to modify Trust will not result in N having a power to alter, amend, revoke, or terminate Trust or result in N retaining a right with respect to Trust with the effect that would cause the Trust property to be includible in N's estate under § 2036 or 2038.[199]

The ruling is that the *act of consenting* to change the terms of a trust as to the referenced probate proceeding will not result in inclusion in the gross estate of a living person of the property of the original trust.[200] Objectively, §§ 2036 and 2038 either apply or do not apply due existence of a power and are not dependent on whether the power is exercised. The rulings are arbitrary and without support, but they are nice to have when asserting non-inclusion in the estate.

B. PLR 200303016

PLR 200303016 is stronger evidence that the government is not presently looking askance at Second Restatement Section 338(1) and UTC Section 411(a) type powers.[201] The ruling focused on the merger of four trusts settled by the same individual.[202] The settlor and all the beneficiaries (excluding unborns—whether or not conceived, which the ruling found were not "beneficially interested persons" whose consent is required under the applicable state law) proposed to agree to amend the trusts by merger

197. I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002).
198. *Id.*
199. *Id.*
200. *Id.*
201. I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003).
202. *Id.*

pursuant to applicable state law.[203] The amendment could be made in writing, meeting the requirements of "recording a conveyance of real property," which presumably is affected without court involvement.[204] One ruling requested was: "The proposed amendments to the four trusts and the merger of the four trusts into one trust will not cause the value of any assets under the four trusts to be included in Trustor's gross estate under §§ 2033, 2035, 2036, 2038, 2041, and 2042."[205] However, the IRS gratuitously issued the following ruling:

> Trustor has not retained any interest in the property in the four trusts for purposes of § 2033. The amendments to the four trusts and the merger of the four trusts into one trust will not considered a transfer of an interest or a relinquishment of a power by Trustor for purposes of § 2035. Trustor has not retained, for his life, the right, either alone or in conjunction with any person, to designate who will possess or enjoy the property or income from the merged trust, within the meaning of § 2036. Trustor has not retained any power, either alone or in conjunction with another person, to alter, amend, revoke, or terminate the merged trust within the meaning of § 2038. Further, Trustor will not possess a general power of appointment as defined under § 2041 with respect to the merged trust. The merged trust, not the Trustor, will be the owner of the life insurance policies for purposes of § 2042. Additionally, Trustor has represented that he possesses no incidents of ownership in the policies, under § 2042. Accordingly, we conclude that the value of the property in the merged trust will not be includible in Trustor's gross estate under § 2033, 2035, 2036, 2038, 2041, or 2042.[206]

The relevant portion of the ruling pertaining to §§ 2036 and 2038 were limited to restating § 2036(a) and § 2038(a)(1), and then concluding:

> Section 20.2038-1(a)(2) of the Estate Tax Regulations provides that § 2038 does not apply if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law. Similarly, § 2038 does not apply to a power held solely by a person other than the decedent. However, if the decedent had an unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.[207]

203. *Id.*
204. *Id.*
205. *Id.*
206. *Id.*
207. *Id.*

There was no analysis of § 2036 in either ruling.[208] They only recite the statute and portion of the regulations that deals with the right to "remove and discharge a trustee at any time and appoint himself as trustee."[209] The same Senior Counsel authored both rulings within a two month period.[210] That having been said, it cannot hurt to have these rulings available if the need arises. The holdings in relevant PLRs are stated below:

PLR 200247037:

> Accordingly, we conclude that the consent by N to the Petition to modify Trust will not result in N having a power to alter, amend, revoke, or terminate Trust or result in N retaining a right with respect to Trust with the effect that would cause the Trust property to be includible in N's estate under § 2036 or 2038.[211]

PLR 200303016:

> Trustor has not retained any interest in the property in the four trusts for purposes of § 2033. The amendments to the four trusts and the merger of the four trusts into one trust will not considered a transfer of an interest or a relinquishment of a power by Trustor for purposes of § 2035. Trustor has not retained, for his life, the right, either alone or in conjunction with any person, to designate who will possess or enjoy the property or income from the merged trust, within the meaning of § 2036. Trustor has not retained any power, either alone or in conjunction with another person, to alter, amend, revoke, or terminate the merged trust within the meaning of § 2038. Further, Trustor will not possess a general power of appointment as defined under § 2041 with respect to the merged trust. The merged trust, not the Trustor, will be the owner of the life insurance policies for purposes of § 2042. Additionally, Trustor has represented that he possesses no incidents of ownership in the policies, under § 2042. Accordingly, we conclude that the value of the property in the merged trust will not be includible in Trustor's gross estate under § 2033, 2035, 2036, 2038, 2041, or 2042.[212]

C. PLRs 200919008, 200919009, and 200919010

These identical rulings involved a state statutory codification of the common law, which was exercised by the settlor to make administrative

208. *Id.*; I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002).
209. I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003); I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002).
210. I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003); I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002).
211. I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002).
212. I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003).

changes pursuant to a court proceeding.[213] The changes were purely administrative and did not alter the beneficial rights in the trust.[214] They had identical analysis and holding, stated in part as follows:

> As for Donor, on the creation of the trusts, Donor made a transfer of property to each trust but retained no interest in, or power over, the income or corpus of the transferred property. Although Donor has exercised a power to amend the trusts, this power derived not from the trust instruments, but from a state statute that required the consent of all the respective trust beneficiaries and, in this case, a guardian ad litem to represent the minor and unborn trust beneficiaries. The modifications will not cause any portion of the trust property to be includible in the gross estate of Donor.[215]

These three rulings hold that because the power arose from state law independent of the trust agreement, the estate tax string provisions would not apply.[216]

D. PLR 201233008

In the facts of PLR 201233008, the state had enacted a UTC Section 411(a) type statute, which tracks the common law.[217] The author of this ruling was the same Senior Counsel at the IRS that authored PLR 200247037 and PLR 200303016.[218] The IRS made the following finding:

> Section 20.2038-1(a)(2) of the Estate Tax Regulations provides that § 2038 does not apply if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law.
>
> In this case, Settlor is the transferor of the property in Trust for purposes of §§ 2036 and 2038. However, Settlor has not retained for any period which does not in fact end before his death, the possession or enjoyment of, or the right to the income from the trust property. Further, pursuant to Agreement, the consent of all of the parties who have an interest in Trust is required under State Statute 1. Any right Settlor has to participate in the partial termination and modification of Trust arises solely from rights granted under State Statute 1 and may be exercised only with the consent of all of the parties having an interest (vested or contingent) in the transferred

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213. I.R.S. Priv. Ltr. Rul. 200919008 (May 8, 2009); I.R.S. Priv. Ltr. Rul. 200919009 (May 9, 2009); I.R.S. Priv. Ltr. Rul. 200919010 (May 8, 2009).

214. *Id.*

215. *Id.*

216. I.R.S. Priv. Ltr. Rul. 201233008 (Aug. 17, 2012); UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N 2000).

217. I.R.S. Priv. Ltr. Rul. 20123308 (Aug. 17, 2012); *see also* I.R.S. Priv. Ltr. Rul. 200247037 (Nov. 22, 2002); I.R.S. Priv. Ltr. Rul. 200303016 (Jan. 17, 2003).

218. *Id.*

> property. Accordingly, based on the facts submitted and the representations made, we rule that the partial termination and modification of Trust will not cause any property of Trust to be includible in the gross estate of Settlor under § 2036 or 2038. [emphasis added][219]

What was referenced, *but ignored in the ruling*, was the second condition in Reg. § 20.2038-1(a)(2), the satisfaction of which is necessary to avoid application of § 2038, highlighted as follows: "If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; . . ."[220]

Does this ruling herald a free reign to modify trusts by the settlor with all beneficiaries without concern about estate tax inclusion?[221] Does it assure that § 2036 and § 2038 does not apply to a settlor at death?[222] The answer to both questions is "no."[223] On first read, it seems a very good sign that the common law rule will not alone cause inclusion in the gross estate.[224] However, the ruling does not literally say such.[225] The ruling applies with respect to the effect of the modification itself, while the settlor is alive, so it is not much of a concession by the IRS, because it is then impossible for the estate string provisions to operate.[226] The ruling says nothing about the inclusion at death with continued retention of the power.[227] Plus, it is only a private letter ruling.[228]

Although the rulings are great to have, it is clear that an independent state law power or right held by a settlor is not necessarily a protected power.[229]

VI. LEGISLATIVE RECOMMENDATION AND PLANNING

A. Legislative Recommendation

Until such time as it is established that the estate tax concern is thoroughly discredited, whether or not the UTC is enacted in any particular jurisdiction, each jurisdiction should consider the following proposed legislation:

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219. I.R.S. Priv. Ltr. Rul. 201233008 (Aug. 17, 2012).
220. Treas. Reg. § 20.2038-1(a)(2) (1962).
221. *See* I.R.S. Priv. Ltr. Rul. 201233008 (Aug. 17, 2012).
222. *See id.*; *see also* I.R.C. §§ 2036, 2038.
223. *See* I.R.S. Priv. Ltr. Rul. 201233008 (Aug. 17, 2012).
224. *Id.*
225. *See id.*
226. *See id.*
227. *See id.*
228. *Id.*
229. *See supra* Part II.

(i) Confirm that a settlor may irrevocably waive the power to consent to modification or termination provided by UTC Section 411(a), Second Restatement Section 338(1), and Third Restatement Section 65.[230]
(ii) Retroactively eliminate the power of a settlor with respect to a trust, including trusts that became irrevocable prior to such legislation, if it is established that a principal purpose of the trust was to avoid inclusion of its property in the gross estate of the settlor for purposes of federal estate taxation.[231]

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230. Of all the states, apparently only settlors of trusts governed by Louisiana trust law do not have this power. *See* LA. STAT. ANN. § 9:2028 (2015) ("The consent of all settlors, trustees, and beneficiaries shall not be effective to terminate the trust or any disposition in trust"); is it enough to permit sophisticated estate planners to navigate the estate tax labyrinth by means of drafting waivers of subtle yet critical powers? Legislation could provide that statements of a settlor indicating an intent to cause a trust to become irrevocable will cause automatic waivers of such powers, except to the extent expressly provided otherwise in the trust instrument.

An alternative is to take the opposite tack and absolutely confirm that the power is unwaivable. The approach banks on the efficacy of the "*Wyly's Estate* defense" described above in the part of this discussion entitled "Community Property Cases." This Hail Mary may be an all-or-none proposition. It might protect everybody, or it might fail completely. If it works, then settlors can continue to have their cake and eat it, too—have exclusion, but continue to retain a joint power to modify. But without a revenue ruling blessing this legislation, it seems unnecessarily risky when there is a road out of the fog.

231. I.R.C. §§ 2035, 2038(a)(1) (2006). The statutory banishment of the power is preferable to waiver of the power by a settlor for the reason that there should be no three year survival requirement to avoid estate tax exclusion under IRC §§ 2035 and § 2038(a)(1). This is so because the settlor will apparently not have "relinquished" the power. Revenue Procedure 94-44, in § 4.02, held that Florida's legislative "curtailment" of a beneficiary's withdrawal power to an ascertainable standard (health, education, maintenance, and support) was not a "lapse" of the power under IRC §§ 2041(b)(2) and 2514(e). So there is no "release" of the power that could activate the three-year rule in spite of the fact that the statute permitted "all parties in interest" to elect out; *see also* I.R.S. Priv. Ltr. Rul. 199909016 (Mar. 5, 1999) and I.R.S. Priv. Ltr. Rul. 200530020 (July 29, 2005), following Rev. Proc. 94-44.

Some suggested retroactivity should be limited to requiring a court order to exercise the power. A variant of this approach is taken in an optional provision added in the 2004 Amendments to the Model UTC that seems to permit (but not require) the settlor and the beneficiaries to command an order, but only to trusts becoming irrevocable *after* enactment (in optional last sentence to UTC § 411(a)). As discussed in Part II, the concern is whether merely permitting or requiring a perfunctory proceeding is enough of an impediment that will successfully negate application of the estate tax string provisions.

An issue in some minds (but dismissed as extremely weak by others) is whether such a retroactive provision causes a denial of due process because a settlor is ". . . deprived of . . . property without due process of law. . ." proscribed by the Fifth Amendment, applied to the states through the Fourteenth Amendment. State constitutional law may also restrict such legislation and should be examined (*see, e.g.*, ARIZ. REV. STAT. ANN. CONST. art. 2 § 4 (1912)). If constitutionality is a serious issue, the provision could be drafted to give the settlor, with the consent of the beneficiaries, of an existing irrevocable trust the ability for a limited period of time after enactment to elect out of the clause, in order to mitigate the risk of constitutional infirmity. However, does the presence of such an opt-out power to put the settlor in the position of relinquishing the power if he fails to exercise it, thereby implicating the three year survival requirement. Rev. Proc. 94-44 ruled otherwise with respect to similar situation. Rev. Proc. 94-44 involved a legislative curtailment of a right of a trustee to directly benefit himself (arguably a more obvious deprivation), but permitted "all parties in interest" to elect out. The Service found no lapse of the power, and no taxable release. (The persons who could permit election out are essentially the same group described in UTC § 411(a) and Second Restatement § 338(1). Note that model UTC § 814(b)(1) contains a HEMS standard curtailment clause similar to the Florida statute discussed in Rev. Proc. 94-44, but does not have an opt-out right when applied retroactively (as is generally the case with the UTC). A statutory retroactivity issue was discussed in *Helmholz*.

B. Application of Common Law May Not Cause Estate Tax Inclusion

If the IRS asserted that property in an irrevocable trust was includable in the gross estate of the settlor under §§ 2036 or 2038 due to the universal common law rule articulated in section 338(1) of Restatement (Second) of Trusts, section 65 of Restatement (Third) of Trusts, and codified in UTC Section 411(a), I believe the best defense would be that the settlor had done all she could to shed herself of powers over the gifted property.[232] Therefore, if the settlor involuntarily retains the power to terminate or modify the trust with the consent of all beneficiaries, it would be unfair to impose the estate tax upon trust property.[233] There is no authority for this reasoning concerning the common law power with respect to trust assets.[234] Also, as discussed above, the settlor could have done more to shed the power by making a transfer not in trust. Nonetheless, there is a supportable basis to assert that such property is not includable in the gross estate of the settlor.[235]

1. Helmholz *and Treasury Regulation § 20.2038-1(a)*

A ruling against inclusion in the gross estate of the taxpayer would not be based on *Helmholz* or Treas. Reg. § 20.2038-1(a).[236] Both of those authorities have been misinterpreted by many.[237]

2. Wyly's Estate *Defense*

The court could hold that, in cases in which the settlor had waived to the greatest extent permitted by law, all rights and powers to direct enjoyment of, or to alter, amend, revoke, or terminate the trust, then §§ 2036 and 2038 will not apply to the trust property.[238] The reason would be based on the *Wyly's Estate* defense[239]—that, when the settlor had transferred his interest in trust "in form and within the intendment of the parties the most complete conveyance possible," § 2036 (and when applicable § 2038) would not apply.[240] But such a decision has yet to be seen in the trust context.[241] The only authority for that reasoning is limited to a gift of a community property interest by one spouse to another as separate property in Texas, in which, as

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232. *See* I.R.C. §§ 2036, 2038; RESTATEMENT (SECOND) OF TRUSTS § 338(1) (1959); RESTATEMENT (THIRD) OF TRUSTS § 65 (2003); UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N 2000).
233. *See* I.R.C. §§ 2036, 2038.
234. *See id.*
235. *Id.*
236. *See Helmholz*, 296 U.S. 93, 97–98 (1935); *see also* Treas. Reg. § 20.2038-1(a) (1958).
237. *See Helmholz*, 296 U.S. at 97–98; Treas. Reg. § 20.2038-1(a).
238. *Id.*
239. *See supra* Section IV.A.
240. Wyly's Estate v. Comm'r, 610 F.2d 1282, 1294 (5th Cir. 1980).
241. *See, e.g.*, *id.*

a matter of law, spouses are entitled to a share of the income as community property from the separate property of the other spouse.[242] Another rationale that § 2036 and 2038 won't apply is what I think of as the "Too Big to Fail" defense. The consequence of §§ 2036 or 2038 applying to most trusts due to the common law would be so systemically disastrous throughout high-end estate planning that it just won't be so adjudicated.

3. Fit into Helmholz *Fact Pattern*

In *Helmholz*, the settlor was also a beneficiary.[243] The trick would be to cause the settlor to have a sufficiently compartmentalized right or power that would make him or her a beneficiary for purposes of being a party in interest under *Helmholz* and Treas. Reg. § 20.2038-1(a)(2), yet not cause inclusion of the bulk of the trust estate under these estate string provisions.[244] Even then, § 2036 may apply due to the common law power retained by the settlor.[245]

4. Have UTC States that Opted Out of Section 411(a) Abrogated the Common Law Rule?

Some states have omitted enactment of UTC Section 411(a).[246] The issue is whether that impliedly "repealed" the existing common law rule recited in trust restatements that the settlor with all beneficiaries may modify or terminate the trust.[247]

The court in one Arizona case held that the omission of an estate tax apportionment provision in the Arizona Uniform Probate Code was intended by the legislature to reject that apportionment rule.[248] However, in *Barton v. Cruce*, the court's additional reason for adopting a rule opposite of the omitted provision was that it resulted in retention of the common law apportionment rule.[249] In the case of the Arizona Trust Code, a court's determination that the common law rule to permit modification or termination of a trust is extant may hinge on whether it found, or did not find, substantive legislative intent to change existing law as a result of its omission of the "optional" uniform law provision.[250] NCCUSL, in its comment to UTC Section 411(a), states that "[the deletion of] subsection (a), mean[s] that the

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242. *See, e.g.*, TEX. EST. CODE ANN. § 101.052 (Supp.).
243. *Helmholz*, 296 U.S. at 94.
244. *See* Treas. Reg. § 20.2038-1(a)(2); *Helmholz*, 296 U.S. at 94.
245. I.R.C. § 2036 (2006).
246. *See, e.g.*, Les Raatz, *The Arizona Trust Code*, 45 JAN. ARIZ. ATT'Y 20, n. 2 (2009).
247. UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N 2000).
248. Barton v. Cruce, 947 P.2d 886, 888–89 (Ariz. App. Div. 2 1997).
249. *Id.*
250. Raatz, *supra* note 246.

state's prior law would control on this issue."[251] So, a court in Arizona following the direction of the comment would hold that the applicable common law would continue to be the law, unaffected by the omission of UTC Section 411(a) in the Arizona Trust Code.[252]

5. Get a Court Order

If a court has jurisdiction over the trust, the trustee, and the settlor, it can order that the settlor does not have the power to modify or terminate the trust, with or without consent of any or all beneficiaries. The order is binding on the IRS with respect to tax events occurring afterwards.[253] That should foreclose application of §§ 2036 or 2038, subject to the three-year look back rules of § 2035 or § 2038(a)(1), barring any other express rights or powers directly or indirectly granted to or retained by the settlor.

6. Specific Regulation Exceptions

There are specific grants of exception to application of §§ 2036, 2038, and 2042 to gross estates of settlors.[254]

C. Application of Common Law May Cause Estate Tax Inclusion

Because there is no overriding authority that §§ 2036 and 2038 do not generally apply to trust property settled in trust by the settlor due to the power held by the settlor under the common law or optional UTC Section 411(a), there is a supportable basis to assert that such property is includable in the gross estate of the settlor.[255]

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251. *Id.*

252. *See id.*

253. Rev. Rul. 73-142, 1973-1 C.B. 405.

254. Rev. Rul. 95-58, 1995-2 C.B. 191 (When decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent does not retain a trustee's discretionary control over trust income.); Rev. Rul. 2004-64, 2004-2 C.B. 7 (When the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate.); Rev. Rul. 2008-22, 2008-1 C.B. 796 (A settlor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the settlor's gross estate under §§ 2036 or 2038.); Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (A settlor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the settlor's gross estate under § 2042).

255. *See* I.R.C. §§ 2036, 2038; *see also* UNIF. TRUST CODE § 411(a) (UNIF. LAW COMM'N 2000).

D. Use Common Law, Judicial, or Nonjudicial Settlement Agreement

There is a way to further confirm that application of § 2038 may cause inclusion in the gross estate of the settlor.[256] Following the holdings of *Adolphson* and *Swain*, discussed above, if a trust could be modified or terminated by the settlor with the consent of *less than all* the beneficiaries, the trust would be includable in the gross estate of the settlor.[257] Utilizing the common law, with the consent of the settlor and all beneficiaries, the trust terms could be amended to permit modification of the terms of the trust that could alter beneficial interests if, for example, the consent of the settlor with all but one of the beneficiaries agreed.

This change to the terms of the trust might be permitted without the necessity of court approval based on common law.[258] If the governing law of the trust is that of a UTC state, the nonjudicial settlement agreement provision (UTC Section 111) should permit modification with the consent of interested parties without court approval, so long as the modification "does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court under the UTC or other applicable law."[259] For this purpose, the interested persons should include the beneficiaries, the trustee, and the settlor.[260] The settlor should be an interested person, because this modification would cause inclusion of the settlor's estate.[261]

If the trust provides for a trust protector or special trustee, then depending on the scope of the power granted in the trust agreement, such person may have the power to modify the trust terms.[262]

If the state has enacted a decanting statute, then the trustee may have the power to appoint the trust to another trust that may provide that the settlor may modify or terminate a trust with less than all beneficiaries.[263] The conditions permitting decanting and the scope of what is permitted depend on the state's decanting statute.[264] For example, in Arizona the trustee can appoint to another trust (or restate the trust) if the trustee has discretion to make distributions, if the discretion is in favor of the beneficiaries, and the appointment "does not adversely affect the tax treatment of the trust, the

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256. I.R.C. § 2038 (2006).

257. *See* Adolphson v. U.S., No. 87-1236, 1990 WL 300361, at *1 (C.D. Ill. Oct. 29, 1990); Swain v. U.S., 147 F.3d 564, 567 (7th Cir. 1998).

258. *See id.*

259. UNIF. TRUST CODE § 111(c) (UNIF. LAW COMM'N 2000).

260. *See id.*

261. *Id.*

262. *Id.* at § 410.

263. Steven J. Oshins, *Decanting an Irrevocable Trust—The Process*, ULTIMATE ESTATE PLANNER (Mar. 1, 2015), https://ultimateestateplanner.com/2015/03/01/decanting-irrevocable-trust-process/ [perma.cc//2QED-LUE9].

264. *Id.*

trustee, the settlor or the beneficiaries."[265] If inclusion of the trust in the settlor's gross estate does not cause or is likely to cause any increased estate tax to the settlor, such decanting by the trustee should be permitted.[266] This can be bolstered if the settlor provides an affidavit to that effect and followed by a confirming court order, which would be binding on the IRS for tax events occurring thereafter.[267]

E. Modification to Confirm Estate Tax Inclusion

Finally, modification could be undertaken in a judicial proceeding.[268] In UTC states, modification is permitted to, among other things, carry out the tax intentions of the settlor (UTC Section 416), or if unanticipated circumstances (such as a great increase in the estate tax exemption) dictate that modification will further the purposes of the trust (UTC Section 413).[269]

The alternative method to further confirm inclusion in the gross estate of the settlor is to modify the trust to grant the settlor the special power to appoint the trust property, whether an SPA or GPA, with or without the consent of others.[270] The risk of granting a GPA is the potential reach of creditors of the settlor.[271] The risk of granting any power of appointment, whether GPA or SPA, is its exercise by the settlor, although that can be mitigated by the requirement of others' consents. The number of persons that can be selected to consent to the SPA may be as great the number that would be selected to consent to trust modification. In such case, either power would be equivalent in consequence; the modification to create an SPA may be better because the power of appointment may, for example, be limited to only selecting between a very small number of beneficiaries.[272] Whether a general or special power of appointment, it will still be treated as includable in the settlor's estate under § 2036 or § 2038, and will not be subject to § 2041 or its regulations.[273]

F. How Gross Estate Inclusion under §§ 2036 and 2038 is Reported

On Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, the trust property includable in the gross estate pursuant to

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265. ARIZ. REV. STAT. § 14-10819(a)(5) (2018).
266. *See generally id.*
267. Rev. Rul. 73-142, 1973-1 C.B. 405.
268. *See* UNIF. TRUST CODE § 202 (UNIF. LAW COMM'N 2000).
269. *See id.* at §§ 413, 416.
270. *See id.* at § 411.
271. *See id.* at § 505.
272. *See generally* UNIF. TRUST CODE § 411 (UNIF. LAW COMM'N 2000).
273. I.R.C. § 20.2041-1(b)(2) (2012).

§ 2036 or § 2038 is to be reported on Schedule G—Transfers During Decedent's Life.[274] Form 8971 should also be considered.[275]

VII. CONCLUSION

This discussion does not prove that an estate tax inclusion is a certitude for all trusts under the common law (outside Louisiana) or optional UTC Section 411(a), but it establishes that there is a reasonable basis to treat trust property of many trusts, whether or not revocable, as includable in the gross estate of the settlor when the trust terms and applicable law that grant the settlor the power to modify or terminate a trust are carefully analyzed.[276] The recent *Powell* decision[277] may herald a trend toward more likely application of §§ 2036 and 2038 when the settlor holds a joint power with others to determine or modify rights of persons in property transferred by the settlor. The analysis may offer a significant opportunity to many beneficiaries when the estate of a settlor decedent is nontaxable.[278]

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274. *See id.* at §§ 2036, 2038 (including property subject to settlor's power of apportionment on schedule G of Form 706).

275. *See also id.* at § 6662; Rev. Proc. 2019-9, 2019-2 IRB (filing forms related to trust property).

276. *See supra* Section VI.C.

277. Estate of Powell v. Comm'r, 148 T.C. 392 (2017).

278. *See supra* Section VI.C.

APPENDIX A

CAN A SETTLOR DRAFT AROUND UTC SECTION 411(a) OR THE COMMON LAW POWER?

Which UTC section trumps the other? Section 411(a) or Section 105(b)? The UTC, on its face, is ambiguous as respects this issue.

UTC Section 105(b) provides that the terms of the trust are to prevail over the UTC. Therefore, if a provision of the trust states that "the Settlor has no power to alter, revoke, amend or terminate the trust," then the settlor cannot agree to so do, alone or in conjunction with anyone.[279]

UTC Section 411(a) provides that the settlor and the beneficiaries can modify or terminate the trust, regardless of whether a material purpose of the trust is frustrated.

The comment to UTC Section 411 provides that first sentence of Section 411(a) was added to confirm that the settlor and beneficiaries may modify or terminate the trust, regardless of the purpose of the trust. The power of modification presumably includes the power of revocation. It follows, then, that Section 411(a) should apply to permit the settlor and beneficiaries to modify or terminate a trust, notwithstanding anything that would be set forth in the terms of the trust instrument. If so, it also logically follows that Section 411(a) prevails over Section 105(b).

The issue is then whether the settlor can independently irrevocably waive such a power, regardless of which section controls. If so, then where and how? Can the Settlor waive the power in the trust document? If the settlor cannot waive the power in the trust document, then the settlor should also be unable to waive it thereafter. It makes little sense to deny a settlor a waiver power if seconds later it could be validly exercised in another document. The 2004 Amendments to the Model UTC do not address this issue.

As for the common law rule, there does not seem to be a means to assure that the settlor can waive his or her power in conjunction with all beneficiaries. Specifically, comment "a" to Restatement (Second) of Trusts, Section 338, provides that the power is unwaivable:

> The rule stated in this Section is applicable although the settlor does not reserve a power of revocation, and even though it is provided in specific words by the terms of the trust that the trust shall be irrevocable.

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279. Such provision may be a material purpose of the trust or may further a material purpose of the trust. But the issue of materiality is not relevant in answering the above question.

UTC § 105(b)(4) prohibits the trust terms from abrogating (and, perhaps, from enhancing) the power of *a court*, and does not prevent trust terms from affecting the power of settlors and beneficiaries to modify or terminate a trust. This clause also does not affect the analysis in answering the question.

The Restatement (Third) of Trusts does not have any discussion of the ability of a settlor to waive the joint power of modification. However, the reporter's notes to Section 65 reference that the settlor-beneficiary "cannot terminate the trust without the consent of the other beneficiaries," citing *Fewell v. Republic National Bank of Dallas*, 513 S.W.2d 596 (Tex. App.—Eastland 1974, writ ref'd n.r.e.), which so held. There is nowhere in the notes or in the case any mention of the issue of waiver or any condition limiting the power of the settlor with all beneficiaries to terminate the trust. Presumably, if the intent was to change the statement of the law, there would have been some comment.[280]

Two Possible Means to Effectively Waive the Power: (a) What if, instead of a gift by a settlor to a trust, the would-be settlor contributes the to-be-gifted property to a single member limited liability company, of which the person is sole member and manager? Then, as manager of the LLC, the person causes the LCC to settle the trust. Finally, the person dissolves or dissociates the settlor-LLC. The result will be a taxable transfer by the person, the settlor of the trust no longer exists, and the §§ 2036 and 2038 concern is eliminated.

(b) Alternatively, a court order confirming the irrevocable waiver of the power of the settlor is obtained.

280. For example, the Restatement (Third) of Trusts, § 50, The Reporter's Notes to Comment e confirms that the Third Restatement "adopts a position different from that stated in prior Trust Restatements. . ." The position shifted from a presumption in the Second Restatement that the trustee not to consider other resources when determining distributions to be made under an objective standard, such as support, to a presumption to consider other resources.

APPENDIX B

SELECTED MODEL UTC SECTIONS

(a) Except as otherwise provided in the terms of the trust, this [Code] governs the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary.
(b) The terms of a trust prevail over any provision of this [Code] except:
(1) the requirements for creating a trust;
(2) the duty of a trustee to act in good faith and in accordance with the purposes of the trust;
(3) the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;
(4) the power of the court to modify or terminate a trust under Sections 410 through 416;
. . .

Section 106 and Selected Comment to Section 106:
"SECTION 106. COMMON LAW OF TRUSTS; PRINCIPLES OF EQUITY. The common law of trusts and principles of equity supplement this [Code], except to the extent modified by this [Code] or another statute of this State.
Comment
"The Uniform Trust Code codifies those portions of the law of express trusts that are most amenable to codification. The Code is supplemented by the common law of trusts, including principles of equity, particularly as articulated in the Restatement of Trusts, Restatement (Third) of Property: Wills and Other Donative Transfers, and the Restatement of Restitution. The common law of trusts is not static but includes the contemporary and evolving rules of decision developed by the courts in exercise of their power to adapt the law to new situations and changing conditions. It also includes the traditional and broad equitable jurisdiction of the court, which the Code in no way restricts.
. . ."

Section 411(a) and (b):
SECTION 411. MODIFICATION OR TERMINATION OF NONCHARITABLE IRREVOCABLE TRUST BY CONSENT.
[(a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.] [If, upon petition the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court

shall approve the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.] A settlor's power to consent to a trust's modification or termination may be exercised by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust; by the settlor's [conservator] with the approval of the court supervising the [conservatorship] if an agent is not so authorized; or by the settlor's [guardian] with the approval of the court supervising the [guardianship] if an agent is not so authorized and a conservator has not been appointed. [This subsection does not apply to irrevocable trusts created before or to revocable trusts that become irrevocable before [the effective date of this [Code] [amendment].]]

(b) A noncharitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.[281]

281. A later iteration of the Model UTC was made in August 2004. NCCUSL's patch to attempt to address the estate tax concerns raised in earlier versions of this outline is to make § 411(a) completely optional. But, as discussed above, that may not be enough to avoid possible application of the estate tax string provisions. Model UTC § 106 confirms the application of common law except to the extent inconsistent with the UTC. Second Restatement of Trusts § 338(1) is assumed to be the common law, and therefore ". . . supplements this [Code], except to the extent modified by this [Code] . . .". It is unlikely that complete omission of any discussion of this power in the UTC (if § 411(a) is not adopted) would be seen to modify the power of a settlor to consent to modification or termination of an irrevocable trust. The 2004 final comments to § 411 provide the option to "delete subsection (a), meaning that the state's prior law would control on this issue." NCCUSL further provides optional language if § 411(a) is retained to require a court to order modification or termination if petitioned to so do and the settlor and all beneficiaries agree. This provision again does not necessarily "modify" the existing common law right of such persons to modify or terminate the trust out of court.