

Checkpoint Contents

Federal Library

Federal Source Materials

IRS Rulings & Releases

Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents

Revenue Rulings (1954 to Present)

2008

Rev. Rul. 2008-22, 2008-16 IRB 796 -- IRC Sec(s). 2036; 2038, 04/17/2008

## Revenue Rulings

### **Rev. Rul. 2008-22, 2008-16 IRB 796, 04/17/2008, IRC Sec(s). 2036**

## **Inclusion in gross estate—trusts—retention of power to acquire property—effect on estate taxes.**

### **Headnote:**

IRS provides guidance regarding whether corpus of inter vivos trust is includible in grantor's gross estate under Code Sec. 2036; or Code Sec. 2038; if grantor retained power, exercisable in nonfiduciary capacity, to acquire property held in trust by substituting other property of equivalent value. IRS provides that, for estate tax purposes, substitution power will not, by itself, cause value of trust corpus to be includible in grantor's gross estate, provided trustee has fiduciary obligation (under local law) to ensure grantor's compliance with terms of this power by satisfying itself that properties acquired and substituted by grantor are of equivalent value and further provided that substitution power cannot be exercised in manner that can shift benefits among trust beneficiaries.

**Reference(s):** ¶ 20,365.02(5); ¶ 20,385.01(10); Code Sec. 2036; Code Sec. 2038;

### **Full Text:**

### **Issue**

Is the corpus of an *inter vivos* trust includible in the grantor's gross estate under § 2036 or 2038 of the Internal Revenue Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value?

### **Facts**

In Year 1, *D*, a United States citizen, established and funded Trust. Trust is an irrevocable *inter vivos* trust for the benefit of *D*'s descendants. *T* is the trustee of Trust, and *D* is prohibited from serving as trustee under the terms of Trust. The governing instrument

provides that *D* has the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value. The power is exercisable by *D* in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, *D* must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, *T* has a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Under local law, if a trust has two or more beneficiaries, the trustee has a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Further, under local law and without restriction in the trust instrument, *T* has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

*D* dies in Year 2.

## Law And Analysis

Section 2036(a) provides that 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 made a transfer (except in the case of a *bona fide* sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's 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 from the property.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the 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 the decedent's 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 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.

In *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1, the decedent created an *inter vivos* trust. Under the terms of the trust, the decedent reserved the power to substitute other securities or property for those held in trust, provided the substituted property was equal in value to the property replaced. After the decedent's death, the Service argued that the trust assets were includible in the decedent's gross estate under § 2038 because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The court determined, however, that because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the court held that the substitution power was not a power to alter, amend, or revoke the trust within the meaning of § 2038.

In general, a trustee has a fiduciary duty to the trust and its beneficiaries. As a result, the trustee is held to a high standard of conduct with respect to the administration of the trust. A trustee is under a duty to the beneficiaries of the trust to administer the trust

solely in the interest of the beneficiaries. The trustee must act fairly, justly, honestly, in the utmost good faith, and with sound judgment and prudence. 90A C.J.S. Trusts § 323 (2007). The trustee is also subject to a duty of impartiality that requires the trustee to take into account the interests of all the beneficiaries for whom the trustee is acting. Restatement (Third) of Trusts §§ 183 and 232 (2007); 76 Am. Jur. 2d Trusts § 434 (2008). A trustee must administer the trust solely in the interests of the beneficiaries. Generally, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests may be voidable by a beneficiary affected by the transaction. Uniform Trust Code § 802 (2005). If a trust has two or more beneficiaries, the trustee must act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests. Uniform Trust Code § 803 (2005). See also, *Sallee v. Fort Knox National Bank, et. al.*, 286 F.3d 878, 891 (6th Cir. 2002) (distinguishing between a duty of good faith and fair dealing, requiring parties to "deal fairly" with one another, and the more onerous fiduciary duty that requires a party to place the interest of the other party before one's own interests).

In situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. If the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being replaced, the trustee has a fiduciary duty to prevent the exercise of the power. See Restatement (Third) of Trusts § 75 (2007) and Uniform Trust Code §§ 801 and 802 (2005).

In the instant case, unlike the situation presented in *Estate of Jordahl*, the trust instrument expressly prohibits *D* from serving as trustee and states that *D*'s power to substitute assets of equivalent value is held in a nonfiduciary capacity. Thus, *D* is not subject to the rigorous standards attendant to a power held in a fiduciary capacity. However, under the terms of the trust, the assets *D* transfers into the trust must be equivalent in value to the assets *D* receives in exchange. In addition, *T* has a fiduciary obligation to ensure that the assets exchanged are of equivalent value. Thus, *D* cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase *D*'s net worth. Further, in view of *T*'s ability to reinvest the assets and *T*'s duty of impartiality regarding the trust beneficiaries, *T* must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by *D*. Under these circumstances, *D*'s retained power will not cause the value of the trust corpus to be included in *D*'s gross estate under § 2036 or 2038.

## **Holding**

A grantor'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 grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's

investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

## **Drafting Information**

The principal author of this revenue ruling is Mayer Samuels of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Samuels at (202) 622-3090 (not a toll-free call).

© 2008 Thomson/RIA. All rights reserved.