By Celia R. Clark

A Senior Trust

Tell clients about this way to protect themselves and their loved ones now against being unduly influenced later

Often, estate planners and elder law attorneys are faced with the challenge of trying to protect an aging client who's gradually descending into dementia or becoming emotionally needy, making him vulnerable to unscrupulous caregivers, friends and relatives. Typically, while the client is still in full control of his mental functions, he wants to ensure that his testamentary plans won't be changed if he later becomes vulnerable. But he's equally adamant about not stripping himself of control over his assets unless he's certified as incapable of managing them (that is to say, completely disabled).

These competing desires create a serious dilemma: If the client retains the power to revoke or amend his estate plan, when he becomes vulnerable a third party might exert undue influence to persuade him to make changes contrary to his original (and presumably true) intentions. But depriving him of such power when he's vital frustrates his desire for autonomy. Also, irrevocably transferring the client's control to a fiduciary may create difficult gift tax issues.

A senior trust resolves these problems in a way that is acceptable to many clients. Indeed, all attorneys should consider suggesting senior trusts to elderly clients, and maybe even to younger clients, as a form of insurance against later vulnerability to undue influence.

It Happens

This general scenario is all too common: *The New York Times* on Dec. 24, 2007, reported on an elderly man's struggle with vulnerability. An engineer by training, 73-year-old Robert Pyle was accustomed to complete control over his affairs. When his wife died, he became withdrawn and seemed depressed until he met and befriended a young neighbor named Wendy, a single mother who was struggling financially. Robert encouraged her to get a menial job and began driving her to work every day. Over the next eight years Robert became increasingly generous; all told, he spent more than $650,000 helping Wendy. Too embarrassed to explain the situation to his family, he borrowed money until he was forced to sell his home and move in with his stepdaughter.[1]

Robert filed suit under a California statute designed to protect seniors from elder abuse.[2] He sued his mortgage brokers and banks, claiming they had defrauded him in helping him obtain loans they knew he could not afford.[3] According to the *Times*, these types of lawsuits often settle. Sharon Merriman-Nai of the National Center on Elder Abuse told the *Times*: "Figuring out how to protect senior citizens from victimization, even when it's caused by their own mistakes, is one of the biggest issues facing us right now...[b]ut we also have to figure out how to balance our desire to protect vulnerable seniors with their rights to autonomy."[4]

Because of Robert's unusual lawsuit, this story made it into the papers. But there are many similar situations that go unpublicized. Becoming vulnerable later in life is a real concern.

Recently, a remarkably articulate couple came to our firm's office seeking advice on these issues. Ralph, a successful author, and his wife Marjorie (these are their real names, used with permission) were living in a retirement community. He was 87-years-old; she, 85. Together they had three adult children, each of whom has one or more children.

Ralph and Marjorie were clear in expressing a desire

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that their property be left one-third to each child (or descendants of a predeceased child), and that this plan never be altered by anyone, including their children. During the couple's joint lifetimes, income and principal of their property would be payable to them exclusively. Gifts to children and grandchildren would continue to be made according to a pattern established over several years.

The couple wanted to retain full control of their affairs as long as they are both alive and competent. Their stated concern was that, after one of them died or became disabled, the other could become emotionally or psychologically vulnerable to the influence of a third party. If, in that situation, the spouse retained power to change the gift and testamentary plans, he or she might be prevailed upon to do so, frustrating the couple's plans.

> A senior trust is one in which, after an "irrevocability event" occurs, a special trustee must join the grantor in making decisions.

The Solution

As the clients requested, we created trusts which become irrevocable and unamendable when either Ralph or Marjorie dies or becomes disabled (an "irrevocability event"). Until that time the trusts are revocable, and the couple retains full control of trust assets as sole trustees.

Ralph's intentions are clearly stated in the trust agreement: "The Grantor has designed this Agreement to provide for the appointment of a Special Trustee... effective upon the first occurrence of an Irrevocability Event, defined elsewhere in this Agreement to include the Grantor's disability and the death or disability of the Grantor's Wife. It is the Grantor's intention to ensure that he will be protected, during a period of possible vulnerability, against inappropriate influence and pressure from persons... who may seek to benefit from trust property. The Grantor requests that the Trustees will utilize their powers over trust property to assist the Grantor in implementing the plan expressed herein... The Grantor understands that in some circumstances complying with this request may require the Trustees to oppose the Grantor's wishes at a later date; the Grantor assures the Trustees that it is his desire that they do so."

The challenge for the estate planner is to design a trust that avoids a taxable gift to the children when the trust becomes irrevocable, but still limits the grantor's powers sufficiently to protect the elderly person against third parties' undue influence.

Our solution was for a special trustee to assume the role of co-trustee for each trust when an irrevocability event occurred. The special trustee—in this case, a cousin—would have to join with the grantor in any decisions regarding gifts, which were permitted to be made only to the grantor's descendants.[5] We call this structure a "senior trust." It could be applied to a variety of irrevocability events identified by a client.

How can we be sure this structure avoids a completed taxable gift at the time the trusts become irrevocable and unamendable, when both the date of irrevocability and the applicable law are uncertain? Under the gift tax principles codified at Treasury Regulations Section 25.2511-2(b), a transfer into a trust becomes a completed gift when the grantor reserves no power to change the disposition of the property. It's also clear that a gift is not considered incomplete merely because the donor reserves the power to change the manner or time of enjoyment.[6]

These straightforward rules were made much more complicated by the Economic Growth and Tax Relief Reconciliation Act of 2001,[7] which added subsection (c) to Internal Revenue Code Section 2511, effective for gifts made after Dec. 31, 2009.[8] Because it's quite possible that the irrevocability event referred to in Ralph and Marjorie's trusts will occur after Dec. 31, 2009, it's assumed that IRC Section 2511(c) will be in effect to determine whether a completed taxable gift occurs at that time.[9]

Section 2511(c) states, "Treatment of certain transfers in trust. Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I

of subchapter J of chapter 1."[10]

Subpart E of part I of subchapter J consists of the grantor trust provisions in IRC Sections 671 to 679. Commentators have suggested that Congress' intention in enacting this addition to Section 2511 was to address a concern that the repeal of the estate tax on Jan. 1, 2010, and the retention of the gift tax, would encourage incomplete gifts made in trust so as to shift the income tax burden to lower-bracket beneficiaries.[11] Section 2511(c) effectively precludes this strategy by coupling gift completion with grantor trust status, treating all trust transfers as taxable gifts—unless the trust is a grantor trust, the income of which is wholly taxed to the donor or the donor's spouse.

The legislative history gives no indication that Section 2511(c) was intended to supersede extant law regarding completed gifts in trusts.[12] But it's unclear how Section 2511(c) should be interpreted in the context of current law. The key question in Ralph and Marjorie's case is: If a trust is a grantor trust under subpart E, but there would be a completed gift under current rules because the grantor (upon the occurrence of an irrevocability event) releases power to change the disposition of the property, would it be a complete or incomplete gift after Dec. 31, 2009?

While Section 2511(c) suggests the gift may be treated as incomplete in this situation, the answer is uncertain.

Saved by Section 677(a)(1)

To be certain that a taxable gift will be avoided after Dec. 31, 2009, the clients' trusts need to be structured as both (1) grantor trusts under subpart E; and (2) incomplete gifts under the principles expressed in Treas. Regs. Section 25.2511-2(b).

Grantor trust status is commonly achieved by including among the grantor's retained rights the power to substitute assets of equivalent value in the trust,[13] but for the grantor of a senior trust to retain this power, it may undermine the protections sought from the trust structure.[14] In addition, there are technical difficulties involved in relying on this power to establish grantor trust status when the grantor will be a trustee.[15]

A lesser-known provision of the IRC, Section 677(a)(1), affords grantor trust status when trust income may be distributed to the grantor or the grantor's spouse, as long as the consent of an "adverse party" (as defined by the IRC) is not required.[16]

In Ralph and Marjorie's trusts, the grantor's right to receive distributions from income is governed by two separate provisions. Before an irrevocability event, the trustee must distribute to the grantor as much of the net income and principal of the trust as the grantor may direct in writing. After an irrevocability event, the trustee must distribute to, or for the benefit of, the grantor as much of the net income of the trust as the special trustee may from time to time determine, for any purpose.

The special trustee selected by the clients has no beneficial interest in the trust property. Therefore, the special trustee is a non-adverse party.[17] Moreover, the special trustee's power to cause the distribution of all trust income to the grantor is exercisable in his sole discretion, and therefore without the consent of any adverse party. Thus, the conditions of IRC Section 677(a)(1) are met, and the trusts continue to be grantor trusts after an irrevocability event.[18]

Incomplete Gift

Once grantor trust status after an irrevocability event is established for purposes of Section 2511(c), the next challenge is to ensure that, regardless of the applicability or exclusivity of that statute, the changes triggered by an irrevocability event will not cause a completed gift to occur. The desired result is accomplished by providing that the grantor retains a limited power of appointment after the occurrence of an irrevocability event, exercisable jointly with the special trustee. The power permits the grantor, in conjunction with the special trustee, to direct payment of net income and/or principal in any amounts, and in any proportions, to one or more of the grantor's descendants.[19]

Under Treas. Regs. Section 25.2511-2(b), the grantor's retention of a power to appoint trust property among his descendants makes the transfer into the trust an incomplete gift for gift tax purposes. Similarly, Treas. Regs. Section 25.2511-2(c) states that a gift is incomplete "if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard."[20]

The fact that in our senior trust the retained limited power of appointment can be exercised only in conjunction with the special trustee does not change the analysis. That's because Treas. Regs. Section 25.2511-2(e) specially provides, "A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom." The same regulation states that a "trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income." Thus, the grantor's limited power of appointment, exercisable jointly with the special trustee, is considered to be held by the grantor for gift tax purposes.

Irrevocability Event

What if Ralph had first approached us after Marjorie's death or disability, expressing the same concerns of vulnerability? We would have advised a trust structured immediately as an irrevocable trust, with a reserved limited power of appointment to avoid a completed gift. Because Section 2511(c) is not yet in effect, we would not be concerned about creating grantor trust status. But to protect Ralph from being persuaded to divert trust funds away from the family, or disproportionately within the family, one or more neutral co-trustees would be appointed with sufficient power to prevent him from acting contrary to his true intentions.

Raise the Issue

Few clients will walk into a lawyer's office and identify their need for protection during a future period of quasi-disability, as Ralph and Marjorie did. We recommend that estate planners let their clients know the senior trust is an option permitting them to balance the goals of autonomy with protection of the estate.

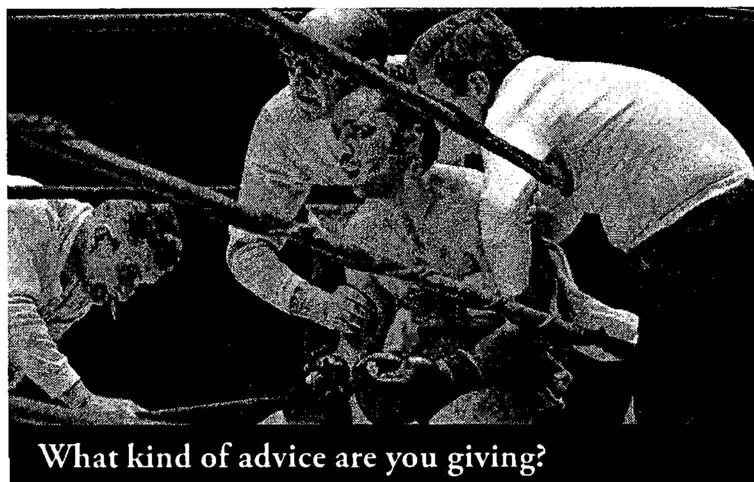
—Raymond Zeitoune, an associate at the Law Offices of Celia R. Clark, PLLC, assisted in research for this article.

Endnotes

1. Charles Duhigg, "When Shielding Money Clashes With Elders' Free Will," *The New York Times*, Dec. 24, 2007.
2. *See generally* California Welfare and Institutions Code Section 15610.30.
3. *See supra*, note 1.
4. *Ibid.* Additional examples of seniors' vulnerability appeared in a recent article in which a psychiatrist discusses mental health issues associated with aging. *See* Sanford I. Finkely, "Use a Geriatric Specialist?" *Trusts & Estates*, April 2008, at pp. 31-38.
5. The use of an independent special trustee to join in the grantor's limited power of appointment was desirable to ensure that the grantor could not be prevailed on by a child to favor certain descendants over others. The clients opted to impose minimal co-trustee obligations on their three children. In addition, the grantor trust issues, discussed in the text accompanying notes 16-18, *infra*, prevent an adverse party (such as a child who is a remainder beneficiary) from participating in decisions affecting the grantor's right to receive all trust income.
6. Treasury Regulations Section 25.2511-2(d). Note, however, that the retention of this power will cause the property to be included in the grantor's estate. Internal Revenue Code Section 2038(a)(1).
7. Public Law 107-16, The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).
8. *Ibid.*, Section 511.
9. It is also assumed that trusts created prior to the effective date of EGTRRA (IRC Section 2511(c)) are not grandfathered if the release of power that may constitute a completed gift occurs after the effective date. Under the sunset provisions of Section 901 of EGTRRA, the provisions of this statute do not apply to gifts made after Dec. 31, 2010. While it is by no means certain, it appears likely that if this statute becomes effective, it will be in the context of permanent estate tax repeal.
10. IRC Section 2511(c).
11. *See, for example*, Dana L. Mark and Sanford J. Schlesinger, "Changes in Estate and Gift Taxes Will Increase Exemption Amounts And Lower Federal Rates," *New York State Bar Association Journal*, September 2001, at p. 40.
12. The original form of the statute, included in the Conference Report (H.R. Rep. 107-84), stated that a transfer to a non-grantor trust would be treated as a "taxable gift." Section 411 of the Job Creation and Worker Assistance Act of 2002 includes a technical amendment clarifying that transfers to which the statute applies are treated as "transfers of property by gift." The amendment clarifies that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. *See* General Explanation of Tax Legislation Enacted in the 107th Congress, Jan. 24, 2003, Joint Committee of Taxation, Part 2, note 59.
13. *See* IRC Section 675(4)(c).
14. But in general, a grantor's non-fiduciary power to substitute assets of equivalent value is subject, under local law, to the trustee's fiduciary obligation to ensure that the properties are of equivalent value and that the exchange does not shift benefits among trust beneficiaries. *See* Revenue Ruling 2008-22; NY EPTL Sec. 11-2.1(a)(1).
15. When the power to substitute assets of equivalent value is exercised by a

trustee, it is presumed that the power was exercised in a fiduciary capacity. This presumption may be rebutted only by "clear and convincing proof" to the contrary. Treas. Regs. Section 1.675-1(b)(4)(iii). Therefore, when a grantor names himself as a trustee, as is typically the case with a revocable living trust, it is difficult to prove that the retained power to substitute assets is held in a non-fiduciary capacity. Further, the IRS has repeatedly refused to issue private letter rulings as to whether a power was exercised in a fiduciary or a non-fiduciary capacity. *See* Private Letter Ruling 9437023.

16. IRC Section 677(a)(1) provides that "[t]he grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse." An alternative method of achieving grantor trust status exists under IRC Section 674, applicable where the grantor reserves the power to control the beneficial enjoyment of corpus or income, exercisable without an adverse party's approval or consent. If this approach is used instead of relying on IRC Section 677(a)(1), the many exceptions to IRC Section 674, set forth in IRC Section 674(b), must be carefully avoided.
17. An "adverse party" is defined as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." IRC Section 672(a).
18. It does not appear that the final sentence of IRC Section 677(a) would apply to exclude the power of the special trustee on the grounds that its exercise "can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under Section 673 if the power were a reversionary interest." IRC Section 677(a). This limitation would seem to refer to powers affecting 5 percent or less of the value of any portion of a trust. *See* IRC Section 673(a).
19. *See supra*, note 5. If the grantor is disabled, the limited power of appointment is exercisable by his attorney-in-fact under a durable power of attorney granting the power to make gifts, or by the judicially appointed guardian of the grantor's property.
20. Treas. Regs. Section 25.2511-2(c). *See, for example, Estate of Goelet v. Commissioner*, 51 T.C. 352 (1968), holding that when the grantor, as co-trustee, reserved the power to appoint principal among one of four named beneficiaries, the grantor reserved more than a mere "power to change the manner or time of enjoyment," but rather the power to change interests of the beneficiaries as between themselves, and could, in effect, deny a beneficiary participation in the trust altogether. In PLR 200502014, the Internal Revenue Service took the same position.



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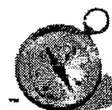

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