

## **Taxes—Oops! What I Meant to Say Was...**

Remember those Bush Era tax cuts associated with acronyms like EGTRRA 2001? Ordinary income tax rates were compressed and reduced. Rates on investment capital gains and dividends were slashed. The estate and generation-skipping transfer (GST) taxes were repealed. Of course you remember, because you've been reminded lately that unless Congress acts this year, those tax breaks are set to expire at the end of 2010 and we'll return to the way things used to be in the "good old days" circa 2001.

Interestingly, those same tax laws included some special rules for 2010 that have not received as much attention as the income tax cuts and estate and GST tax repeal. One of the special rules is imbedded in IRC Section 2511(c). Haven't heard of IRC Section 2511(c)? Well, you're probably not alone, but this little known provision is at the heart of a mini-firestorm ignited by the recent issuance of Internal Revenue Service Notice 2010-19.

Unlike the estate and GST taxes, the federal gift tax remains in full force and effect for 2010. Enacted as part of EGTRRA 2001 along with the estate and GST repeal, Section 2511(c) potentially impacts all gifts in trust made in 2010 in which the grantor retains an interest in the transferred property.

### **IRC Section 2511(c)**

IRC Section 2511 is the section that defines the types of transfers that are subject to the federal gift tax. The law is explicit in saying that the gift tax applies to transfers both in trust or otherwise, direct or indirect, tangible or intangible.

On the surface, "new" Section 2511(c) appears to be relatively innocuous. It reads simply as follows:

“(c) 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.”

IRC Section 2511(c) applies only to transfers made in 2010.

Even the IRS concedes that a reasonable read of this provision is that it excludes from the gift tax 2010 transfers made to grantor trusts for income tax purposes, even though those transfers would normally be considered gifts for gift tax purposes.

If this reading of Section 2511(c) were correct, presumably a 2010 transfer to an irrevocable trust in which the donor or donor's spouse retained an income interest for life with the remainder passing to a child at death of the income beneficiary would escape gift tax entirely. This would be the result because the retained income interest makes the grantor taxable on the income of the

trust and notwithstanding the fact that had the gift been made prior to 2010, the remainder interest would have been treated as a completed gift upon transfer to the trust.

*One implication is that just because a 2010 transfer is made to a trust deemed wholly owned by the grantor or grantor's spouse for income tax purposes, the transfer will not necessarily escape gift taxation— notwithstanding a plain reading of Section 2511(c).*

#### **Notice 2010-19**

But not so fast. As straightforward as Section 2511(c) appears to be, Notice 2010-19 says that Congress never intended to carve out an *exception* to pre-2010 law as suggested above. Instead, says the IRS, Section 2511(c) is to be read as an *addition* to pre-2010 gift tax law. Specifically, according to the IRS, Section 2511(c) “broadens the types of transfers subject to the transfer tax under Chapter 12 to include certain transfers to trusts that, before 2010, would have been considered incomplete and, thus, not subject to the

gift tax.” Specifically, transfers made in 2010 to a trust that is not treated as wholly owned by the donor or the donor's spouse for income tax purposes is considered to be a transfer by gift “*of the entire interest in the property under section 2511(c).*”

This reading of the Section 2511(c) has potentially unexpected implications and potentially unintended consequences.

#### **2010 Transfers to Grantor Trusts**

One implication of this reading is that just because a 2010 transfer is made to a trust deemed wholly owned by the grantor or grantor's spouse for income tax purposes, the transfer will not necessarily escape gift taxation—*notwithstanding the plain reading of Section 2511(c) first suggested above.*

Consequently, in the IRS' view, a 2010 transfer to an irrevocable trust with a life income interest retained by the donor, remainder to child, constitutes a gift, notwithstanding the fact that the donor is taxable on all trust income.

This was the law prior to 2010 and, according to the Service, remains the law in 2010.

### **2010 Transfers to Certain Non-Grantor Trusts**

If one were wily enough, it would be possible to imagine transfers in trust designed to be *complete* for income tax purposes but *incomplete* for gift tax purposes. Such transfers would be of little value in a world in which incomplete gifts would be subject to estate and potentially GST taxes, but in a 2010 world in which the estate and GST taxes are repealed, such transfers would have the effect of shifting income to lower-taxed beneficiaries at *no transfer tax cost*.

A trust that is complete for income tax purposes, but incomplete for gift tax purposes, runs counter to the typical intentionally defective trust and could be called a *reverse intentionally defective trust*. The typical intentionally defective trust serves to make transfers complete for transfer tax purposes, but incomplete for income tax purposes, thus shifting post-transfer appreciation to the donees while reserving income tax deductions and other income tax benefits to the donor. On the other hand, the *reverse intentionally defective trust*, seeks to shift income without incurring transfer taxes.

Arguably, one rationale for the Service's reading of Section 2511(c), as articulated in Notice 2010-19, is its concern that astute tax planners might be looking to take advantage of Section 2011(c) and the 2010 estate and GST tax repeal through the use of *reverse intentionally defective trusts*.

The Service's position has merit, because when the estate and GST taxes were repealed way back in 2001, Congress explained its intent in enacting Section 2511(c) in terms of a backstop to the income tax law. Thus, even in 2001 Congress was concerned that planners might take advantage of the estate and GST tax repeal in 2010 to shift income free on transfer taxes. *See*

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*Joint Committee on Taxation, Technical Explanation of the “Job Creation and Worker Assistance Act of 2002” (JCX-12-02), March 6, 2002.*

## **Unintended Consequences**

Beyond these implications, some have expressed concern that the IRS’ view of Section 2511(c) as expressed in Notice 2010-19 has unintended consequences, especially in connection with charitable gifts. Writing to the IRS in his capacity as counsel for the American Council on Gift Annuities (ACGA), Conrad Teitell has expressed concern that as interpreted by the IRS Section 2511(c) could apply to transfers to qualified charitable remainder trusts.

*However, the Service’s literal construction of Section 2511(c) hardly makes sense, because it suggests that donor’s could make gifts to themselves, a result that would be “wacko” in Mr. Teitell’s words.*

In his [letter](#), Mr. Teitell writes that: “A literal reading of section 2511(c) could apply to charitable remainder trusts because those trusts are not grantor trusts. Section 2511(c) was enacted to thwart income shifting. That shifting is not possible with charitable remainder trusts.”

He goes on to cite the following examples to illustrate his concerns:

In Example 1—Ann creates a CRT providing payments to her for life and then payments to her brother, Bob, if he survives her. Typically, Ann reserves the right, exercisable only by her will, to revoke Bob's successor interest. The right is reserved to avoid a gift to Bob for gift tax purposes.

As Mr. Teitell points out, the IRS’s reading of Section 2511(c) could result in Ann being treated as if she made a gift to Bob, even though no income shifting occurs. Normally, the retention of the right to revoke Bob’s interest in Ann’s will would prevent a complete gift. Furthermore, under the IRS’s reading of Section 2511(c), Ann could be deemed taxable on the CRT's income during her life—hardly a reasonable or intended result.

In Example 2, the CRT is for one life, funded by Ann to make payments to for life with remainder to charity.

As Mr. Teitell points out, under a literal reading of section 2511(c), it could be said that the entire amount transferred is a gift. The reason is that in Notice 2010-19, the IRS specifically says that transfers of this nature are considered to be a transfer by gift “*of the entire interest in the property under section 2511(c).*”

However, this hardly makes sense, because it suggests that Ann is making a gift to herself as well as a gift of the remainder to charity. If so, she could be taxed on a transfer of property she already owns, a result that would be “wacko” in Mr. Teitell’s words.

### **Bottom Line**

The IRS says it will issue regulations under Section 2511(c) shortly. No doubt, parties of both sides are lining up their arguments and getting their ducks in a row.

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