INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

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LEGEND:

Decedent=
Spouse =
C =
State 1=
$x =

Issue:

Whether seven discretionary trusts established by the decedent in 1969 are includible in the decedent's gross estate under § 2036(a)(1) and § 2038 of the Internal Revenue Code.

Conclusion:

The seven irrevocable trusts established by Decedent in 1969 are includible in Decedent's gross estate under § 2036(a)(1) and § 2038, because, under applicable state law, the Decedent's creditors could reach trust income and corpus.

Facts:

Decedent, a resident of State 1, died on, survived by his spouse, Spouse. On December 5, 1969, the Decedent created 7 irrevocable trusts and transferred approximately 60% of his assets to these trusts. The terms of each of the trusts are substantially the same, except for the identity of the ultimate beneficiaries following the death of the survivor of Decedent and Spouse. Under the terms of each of the seven trusts, until Decedent's death, the net income is to be accumulated and added to principal at the end of the calendar year. The trustees are permitted to pay or apply for the benefit of Decedent so much of the principal and accumulated income of the trust as the trustees determine in their absolute and uncontrolled discretion. The trusts also provide that Spouse, in her individual capacity, must give her written consent prior to any distribution being made to or for the benefit of Decedent. Upon the Decedent's death, the trust income is payable to or for the benefit of Spouse during her lifetime. Spouse is also entitled to receive discretionary distributions of principal from the trust. Upon Spouse's death, Spouse may appoint the trust property by will among a group of "eligible appointees", including her children, grandchildren, and a qualified charity. The validity, construction and administration of the trusts is to be governed by the law of California.

Spouse and C, a California resident, were the initial trustees of the trusts. C is now deceased and Spouse resigned as trustee in 1991. There are currently two individual trustees for each trust.

In 1969, Spouse also created seven irrevocable trusts. Under the terms of Spouse's trusts, until Spouse's death, the net income of the trusts is to be accumulated and added to principal at the end of the calendar year. The trustees are permitted to pay or apply for the benefit of Spouse so much of the principal and accumulated income of the trust as the trustees determine in their absolute and uncontrolled discretion. The trusts also provide that Spouse's children, in their individual capacities, must give their written consent prior to any distribution being made to or for the benefit of Spouse. Upon Spouse's death, the trust income is payable to or for the benefit of Spouse's children during their lifetimes. The Decedent was the trustee of Spouse's trusts from the time of creation of the trusts until the date of Decedent's death. The validity, construction and administration of Spouse's trusts is to be governed by the law of California.

In April 1970, Decedent filed a federal gift tax return for information purposes, on which Decedent reported the transfers to the seven trusts as incomplete gifts, citing Rev. Rul. 62-13, 1962-1 C.B. 181. The Service initially concluded that the transfers were completed gifts, but subsequently reconsidered and concluded that the transfers were incomplete gifts and no gift tax was due. See PLR 7307180120A and PLR 8350004.

The federal estate tax return filed by Decedent's estate reported a gross estate of $x. The seven irrevocable trusts were disclosed on Form 8275 and were not included in the gross estate.

Law and Analysis:

Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2036(a)(1) 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 case of a bona fide sale for an adequate 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 death or for any period which does not in fact end before death, the possession or enjoyment of, or the right to the income from, the property.

Section 2038 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, where the enjoyment thereof was subject at 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.

In Rev. Rul. 76-103, 1976-1 C.B. 293, pursuant to the terms of an irrevocable trust, during the lifetime of the grantor, the trustee may, in its absolute discretion, distribute income and/or principal to the grantor. Upon the death of the grantor, any remaining principal is payable to the issue of the grantor. Under applicable state law governing the administration of the trust, the trust is a "discretionary trust" and the entire trust corpus may be subjected to the claims of the grantor's creditors.

Accordingly, the grantor has retained dominion and control over the trust property, and therefore, the grantor's transfer of property to the trust does not constitute a completed gift for federal gift tax purposes. See, Commissioner v. Vander Weele, 254 F.2d 895 (6th Cir. 1958), holding that a transfer to a discretionary trust was an incomplete gift because "The settlor could in actuality retain the economic benefit and enjoyment of the entire trust income and corpus of the trust estate by borrowing money or by selling, assigning, or transferring her interest in the trust fund and relegating her creditors to the trust fund for payment"; Paolozzi v. Commissioner, 23 T.C.182 (1954). See also, Rev. Rul. 77-378, 1977-2 C.B. 348, holding that if, under state law, the grantor's creditors cannot reach the trust assets, then the gift to a "discretionary trust" would be a completed gift for gift tax purposes.

The revenue ruling further concludes that the value of the trust corpus will be includible in the grantor's gross estate under § 2038, because the grantor has retained the power to, in effect, terminate the trust by relegating the grantor's creditors to the entire trust corpus. See also, Estate of Paxton v. Commissioner, 86 T.C. 785, 818 (1986), holding that the corpus of a self-settled discretionary trust is includible under § 2036(a)(1), because the decedent's creditors could reach the trust income and corpus under applicable Washington law and therefore, the decedent retained the "possession or enjoyment of, or the right to income from, the property."

In Outwin v. Commissioner, 76 T.C. 153 (1981), acq.,1981-2 C.B. 2, the grantor and his wife, who were residents of Massachusetts, each created trusts. Under the terms of each trust, the trustees had the power at any time during the life of the respective grantor to pay or apply for the grantor's benefit such part or all of the income and/or principal as the trustees determined in the trustees' absolute and uncontrolled discretion. The trustees were not required to consider the grantor's other resources in making any decisions regarding distributions. However, no distributions of income or principal could be made without the prior written consent of the grantor's spouse in his or her individual capacity. The spouse of each grantor was named as a succeeding income beneficiary of each trust in the event that the spouse survived the grantor, in which case the succeeding income beneficiary became entitled to mandatory distributions of trust income at least annually.

The Tax Court concluded that the trusts could be subjected to the claims of the grantor's creditors under Massachusetts law, and therefore, the transfer of property to the trusts was an incomplete gift. In reaching its conclusion, the court stated:

"The established policy of this Commonwealth long has been that a settlor cannot place property in trust for his own benefit and keep it beyond the reach of creditors", citing Ware v. Gulda,331 Mass. 68,117 N.E.2d 137 (1954) and Pacific National Bank v. Windram, 133 Mass. 175. The court also relied on Restatement (Second) of Trusts, § 156(2) to the effect that: "Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount by which the trustee under the terms of the trust could pay to him or apply for his benefit." [1]

The court concluded that the trusts at issue were discretionary trusts described in § 156(2) of the Restatement (second) of Trusts, that would be subject to creditor's claims under Massachusetts law, notwithstanding that the trustees' discretionary power to make distributions was subject to the prior approval of the grantor's spouse, who was a successor beneficiary of the trust. The court stated:

> [I]t is our opinion that the veto power bestowed upon the grantor's spouse in connection with the trusts herein is insufficient to render the Gulda rule inapplicable. The Gulda opinion and the cases cited evidence a strong public policy in Massachusetts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors. That policy would be easily frustrated if creditors were prevented from reaching the trust assets merely because the settlor's spouse is given an interest in the trust and the right

[1] Section 155(1) of Restatement (Second) of Trusts, defines a discretionary trust as one in which "by the terms of [the] trust it is provided that the trustee shall pay or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply."

> to veto discretionary distributions which might deplete that interest. It is not unreasonable to assume that, because of the marital relationship, the settlor could anticipate the complete acquiescence of his spouse in any discretionary distributions which he might receive, regardless of their effect on her interest as remainderman. Thus, in the absence of unforseen circumstances, such as divorce, the possibility of a spousal veto in such a situation may be at least a remote possibility. This is particularly true in the present case, where the fact that each spouse has a right to veto distributions from the other's discretionary trust(s) could discourage the exercise of that authority through fear or reprisal.

Outwin v. Commissioner, 76 T.C. at 166.

The Service also argued that generally, a power in a grantor to revoke or alter a trust does not render a gift incomplete, if the power is exercisable only in conjunction with a person having a substantial adverse interest in the trust. Thus, by analogy, since the grantor's spouse, as remainderman, would be adversely effected by distributions to the grantor, the spouse's veto power should render the gift incomplete.

In response to this argument the court stated:

> [T]he grantor's spouse may qualify as an adverse party, if he or she possesses a direct legal or equitable interest in the trust property. Yet, while this may be true for gift tax purposes, it does not necessarily follow that the concept is relevant in determining the rights of creditors under state law respecting assets placed in a discretionary trust for the settlor's own benefit. In the latter case, the principal concern is not whether a completed gift has occurred, but rather whether a transfer in trust will be permitted to shield the grantor's assets from the claims of present or future creditors. In that context we think the veto power held by the grantor's spouse would be ineffective to shelter the discretionary trust assets from such claims,... .

Outwin v. Commissioner, 76 T.C. at 166-167.

Thus, the court concluded that in the context of whether the trust assets should be shielded from creditors, a spousal veto power would not be effective to prevent application of the general rule contained in the Restatement, and followed in

Massachusetts, applicable to discretionary trusts.[2]

In the instant case, as was the case in Outwin, California law (discussed below) evidences a strong public policy "against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors." Accordingly, we believe that, as was the case in Outwin, the Decedent retained dominion and control over the trust corpus, because he retained the power to relegate his creditors to the trusts for settlement of claims. Therefore, the transfers to the trusts were incomplete gifts when the trusts were created, and the trusts corpora are includible in the Decedent's gross estate under § 2036(a)(1) and § 2038. Rev. Rul. 76-103, supra; Estate of Paxton v. Commissioner, supra. Further, as the court concluded in Outwin, the Decedent's spouse's veto power would not be effective to shelter discretionary trust assets from creditors' claims, in view of California public policy as evidenced by statutory and case law to subject such trusts to creditors' claims.[3]

The estate argues that Outwin, Estate of Paxton, and Rev.

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[2] At the conference, the estate contended that, in this case, Decedent did request distributions and Spouse actually exercised her veto power. We do not believe the Tax Court's analysis in Outwin would change depending on whether or not the veto power was exercised. Rather, the court was enunciating a specific proposition that an exception to § 156(2) in the case of a veto power could lead to abuse in a particular case, and therefore should be rejected in all cases, whether or not the spouses are in fact alter egos of one another or whether or not the veto power is ever exercised. Clearly, in Outwin, the gift, determined by the court to be incomplete at the time the trust was established, would not become complete (or recharacterized as initially complete) because, at some future date, the grantor's spouse exercises the veto power.

[3] We note that the instant case also presents a reciprocal veto power situation similar to that presented in Outwin. In the instant case, the Decedent was the trustee of Spouse's trusts until her death. Thus, he effectively held a veto power over distributions from Spouse's trusts during the same period Spouse held a veto power with respect to distributions from Decedent's trusts.

Rul 76-103 are distinguishable because, under California law, the law applicable in the instant case, the Decedent's creditors could not reach the trust assets.

We do not agree. First we note that the California Probate Code adopted the rule of Restatement (Second) of Trusts § 156(2), cited by the court in Outwin. Section 15304 of the California Probate Code provides,

> "If the settlor is the beneficiary of a trust created by the settlor and the trust instrument ...gives the trustee discretion to determine the amount of income or principal or both to be paid to or for the benefit of the settlor, a transferee or creditor of the settlor, may reach the maximum amount that the trustee could pay to or for the benefit of the settlor under the trust instrument"[4]

Further, California courts have repeatedly acknowledged the general principle that "one cannot by any disposition of his own property...put the same or the income thereof beyond the reach of creditors, so long as he himself retains the right to receive and use it." McColgan v. Magee, 155 P. 995 (Cal Sup. Ct. 1916). See also, Nelson v. California Trust Co., 202 P.2d 1021 (Cal Sup. Ct. 1949) ("It's against public policy to permit a man to tie up his property in such a way that he can enjoy it but prevent his creditors from reaching it..."); In re Phillips, 206 BR 196 (1997).

The estate argues that these cases are not factually identical to the instant case since most cases involve a situation where the settlor retained a right to trust income. Nonetheless § 15304 of the Probate Code and the general principles espoused by the case law above, evidence a strong public policy according creditors' rights against self-settled discretionary trusts.

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[4] We note that the statute applies if the trustee has the "discretion" to determine distributions. The Restatement rule uses the term "uncontrolled discretion".

The estate cites DiMaria v. Bank of California National Ass'n, 46 Cal. Rptr 924 (1965). In DiMaria, the settlor created an irrevocable trust in 1969 and transferred most of her assets to the trust. The trust provided for the distribution of the entire net income to the settlor during her lifetime with the remainder to her adult children. The trustee had the power to distribute to settlor so much of the principal as the trustee deemed advisable if in the trustee's discretion, the trust income together with settlor's other income was insufficient to provide for settlor's reasonable support, medical care and comfort. The case arose when a creditor of settlor attempted to levy against the corpus of the trust. Upon the trustee's refusal of the levy, the creditor filed the action.

The court concluded that the trustee did not have the "absolute discretion" to distribute corpus, but rather, was limited to making invasions pursuant to the specified standard. Accordingly, unlike the situation presented in Ware v. Gulda (the Massachusetts case cited in Outwin), the creditors could not reach the entire trust corpus, but were limited to the portion subject to the trustee's discretionary invasion power (the additional corpus required for the settlor's support.)

The estate argues that, in the instant case, the trustees power to distribute corpus is not uncontrolled, but, as was the case in DiMaria, is limited, because in this case, Spouse had to consent to distributions to Decedent. Accordingly, no portion of the trusts could be distributed in the trustees' discretion and therefore, the creditors cannot reach the trust corpus.

However, in DiMaria, the trustee's power to distribute corpus was limited as to amount and circumstances, based on a definite standard. Thus, the trustee did not have unlimited discretion to make distributions. In the instant case, the terms of the trust expressly grant the trustee the "absolute and uncontrolled" discretion to distribute any portion of the trust corpus to the Decedent, and thus the trust is within the purview of § 156(2) of the Restatement (Second). The only question is whether the Spouse's veto power is the kind of limitation on the trustee's discretion that would cause the trust to not be subject to §156(2) (or the California Probate Code and case law). In Outwin the Tax Court, as discussed above, found that such a technique would not be effective to avoid creditor protection afforded under case and statutory law and public policy.

The estate also relies on Estate of German v. Commissioner, 7 Cl Ct. 641 (1985), a case similar to Outwin, where the decedent created six irrevocable trusts in 1969, and granted the trustees (the decedent's children) discretionary authority to distribute trust income and corpus to the decedent provided the remaindermen (decedent's children) consented. The court found that the few Maryland cases on the issue tended to indicate that a discretionary trust where the remainder passes to persons other than the decedent's estate on termination could not be reached by creditors. In rejecting the Tax Court's analysis in Outwin regarding the spousal veto power, the Court of Claims noted that Maryland courts do not assume that a wife would be deemed the husband's alter ego for purposes of insulating property from the settlor's creditors. Accordingly, the court concluded that creditors could not attach the trust property where the property could be distributed to the grantor only with the consent of the trust remaindermen. Therefore, the trust corpus was not includible in the decedent's gross estate.

Estate of German involved consideration of Maryland law that is not consistent with California law on the subject of creditors' rights vis-a-vis discretionary trusts. Further, as discussed above (footnote 2), the Outwin court, in discussing why the spousal veto power was not effective to avoid the rule of the Restatement (Second), § 156(2) was not advocating that a state court should assume that spouses are the alter egos of one another, but rather, was enunciating a general proposition regarding a spousal veto power exception to § 156(2). Accordingly, we do not believe that Estate of German supports the estate's position in this case.

Instead, we are in accord with the Outwin decision. In reaching its conclusion that the creditors of the grantor could reach the assets of the grantor's trusts and that, therefore, the transfer to the trusts was an incomplete gift, the Outwin court stated, "Although the transfers in trust in these cases are not subject to gift tax, the settlor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the settlor's gross estate under §§ 2036(a)(1) or 2038(a)(1)." Outwin v. Commissioner, 76 T.C. at 168, fn. 5. Subsequently, the court specifically reached this conclusion under § 2036(a)(1) in Estate of Paxton v. Commissioner, supra.

The estate argues, in the alternative, that if creditors could reach the trust property, the doctrines of "marshaling", and "equitable subrogation," would place the ultimate burden of paying any creditors on the decedent, or his estate.

"Marshaling" is an equitable doctrine "aimed at consolidating claims in such a way as to maximize the satisfaction of creditors and others with interests in the property." Section 3433 of the California Civil Code provides as follows:

Sec. 3433 Marshaling Assets.

> RELATIVE RIGHTS OF DIFFERENT CREDITORS. Where a creditor is entitled to resort to each of several funds for the satisfaction of his claim, and another person has an interest in, or is entitled as a creditor to resort to some, but not all of them, the latter may require the former to seek satisfaction from those funds to which the latter has no such claim, so far as it can be done without impairing the right of the former to complete satisfaction, and without doing injustice to third persons.

Thus, according to the estate, the trustees would have a "fiduciary obligation to invoke this rule in the event of any attempt by Decedent’s creditors to reach the trust assets," preventing those creditors from executing upon those assets "so long as Decedent had individual assets sufficient to satisfy his creditors’ claims."[5]

The estate also argues that the trustee would be required to seek restitution of any funds paid to creditors pursuant to the doctrine of equitable subrogation, a doctrine "broad enough to include every instance in which one person, not acting as a mere volunteer or intruder, pays a debt for which another is primarily liable, and which in equity and good conscience should have been discharged by the latter." Estate of Kemmerrer, 251 P.2d 345, 347 (1952); 50 Am. Jur., Subrogation; § 7.

Numerous cases have addressed creditors’ rights with respect to discretionary trusts in the context of gift and estate taxation. We have found no court opinion that has ever raised marshaling or equitable subrogation as a basis for its conclusion regarding completion of the gift, or inclusion in the gross estate. See, e.g., Commissioner v. Vander Weele, supra; Estate of Paxton v. Commissioner, supra; Outwin v. Commissioner, supra; Paolozzi v. Commissioner, supra.

The doctrine of marshaling is an equitable doctrine most commonly invoked to prevent a junior lienholder with a security interest in a single property from forfeiting his interest in the property to a senior lienholder with a security interest not only in that property, but also in at least one other property of the

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[5] Restatement (Second) of Trusts, §147, comment c, indicates that this procedure may apply in the case of a beneficiary’s interest in a trust.

debtor. See 53 Am. Jur. 2d, Marshaling § 1. As a general rule, the doctrine must be raised by the party claiming entitlement to marshaling and will only apply in the discretion of the court. 53 Am Jur. 2d, Marshaling § 30.

Equitable subrogation is also an equitable principle pursuant to which a party (who is not a volunteer but has a direct interest in discharge of a debt) that satisfies another's debts is allowed to recover from the party primarily liable for the obligation. In re Air Crash Disaster, 86 F3d 498, 549 (6th Cir. 1996). The purpose of equitable subrogation "is to place charge where it ought to rest, by compelling payment of a debt by the person who ought in equity to pay it." Medica, Inc. v. Atlantic Mutual Insurance Company, 566 N.W. 2d 74,77 (1997).

We believe that there is no certainty that a court would apply either doctrine in the present case. Since the decedent, within the trustees discretion, could have received up to all of the income and corpus of the trust, it is questionable whether it would be inequitable to charge the trust with the decedent's debts. Indeed, the trust's liability under state law is based, in the first instance, on equitable principles. Thus, it seems questionable whether these doctrines could be invoked in the context of a self-settled discretionary trust.

More significantly, application of §§2036 and 2038 is dependent on whether the grantor has retained the legal right to secure the economic benefits of the trust by relegating creditors to the property. The courts' decisions in Vander Weele, Estate of Paxton, and Paolozzi and Outwin (and Rev. Rul. 76-103) rest on the determination that the decedent/donor retained the legal power to, in effect, spend the trust income and corpus. The efficacy of marshaling and equitable subrogation in shielding a trust from invasion to satisfy the decedent/donor's debts and thus, the determination of whether a gift is complete or incomplete, or whether trust corpus is included or excluded from the gross estate, would be dependent on the fluctuating state of the decedent/donor's individual finances on a day to day basis. If the decedent/donor's debts exceeded his or her assets, then marshaling and subrogation would not shield the trust assets from invasion. Clearly, the courts (and Rev. Rul. 76-103) focused on the decedent/donor's continuing legal power to relegate creditors to the trust and rejected any such analysis of the day to exposure of the trust depending on the individual's financial situation. Cf.: Estate of Rosenblatt v. Commissioner, 633 F.2d 176 (10th Cir. 1980); Estate of Alperstein v. Commissioner, 613 F.2d 1213 (2nd Cir. 1979); Revenue Ruling 75-351, 1975-2 C.B. 369.

The estate cites Autin v. Commissioner, 109 F.3d 231 (5th Cir. 1997), rev'g, 102 T.C. 768 (1996). In Autin, the taxpayer formed a closely-held corporation in 1974, and had 51% of the shares issued in his name. At the same time, the taxpayer signed a "counterletter" stating that the shares were held by taxpayer for the account of his son and "that in truth and fact [the taxpayer] has no ownership interest in the [corporation]." Id. at 233. The taxpayer did not change the record ownership of the shares into his son's name until 1988. The issue before the court was when the gift of the shares was a completed gift for federal gift tax purposes.

The government argued, in part, that because under state law the counterletter was not effective against "third persons in good faith" the grantor could pledge the shares to a creditor, or sell the shares to a good faith purchaser, and therefore, the gift was not complete until record ownership was changed. However, the court found that, under applicable state law, the counterletter vested ownership of the stock in the son and that therefore, upon the taxpayer's execution of the counterletter, he had no power to adversely affect the rights of his son. Assuming the taxpayer's creditor to whom the shares had been pledged could reach the shares, the taxpayer would be subject to suit by his son and therefore the taxpayer could not legally divest his son of the value of the shares.

The estate argues that, as was the case in Autin, in view of the principles of equitable subrogation and marshaling, the Decedent's gift was complete when the trust was created. However, in the situation hypothesized in Autin, the taxpayer pledges the donee's property as collateral, and the donee's right to seek reimbursement from the taxpayer, if the creditor seizes the property, is clear. However, as discussed above, it is questionable whether the trustee would have a similar rights in the context of a self-settled discretionary trust, such as the one presented here. Further, as discussed above, the efficacy of marshaling and equitable subrogation in shielding the trust assets from creditor's claims is dependent on the day to day financial status of the Decedent. Sections 2511, 2036 and 2038 apply in the context of a self-settled discretionary trust based on the settlor's continuing legal power to relegate creditors to the trust property, irrespective of the day to day financial status of the settlor.

In conclusion, we believe the California statutory and case law provide ample basis for concluding that there is a strong public policy in California to allow creditors of the grantor of a discretionary trust such as the trusts considered herein, to reach the assets of the trust in satisfaction of claims. Accordingly, we believe, as was the case in Outwin, that the decedent's creditors could reach the trust under California law. The Decedent's seven irrevocable trusts are includible in Decedent's gross estate.