Power to Replace a Trustee Can Produce Adverse Tax Results

The power to replace a corporate trustee, when held by a trust beneficiary, may cause the trust property to be includable in the beneficiary's estate. This article analyzes the law on this issue and suggests drafting ideas.

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Many estate plans contain long-term trusts in which an independent trustee, such as a bank or trust company, plays a pivotal role. Over the course of any trust administration, however, the relationship between trust beneficiary and trustee, for a variety of reasons, may become strained or unworkable. The trustee may exercise more control or make decisions contrary to family desires, or may simply not perform satisfactorily. Accordingly, many testators prefer to establish a mechanism, in the event of a falling out between trustee and beneficiaries, for the appointment of a replacement trustee thought to be more compatible with the family.

From a tax perspective, the appointment of an independent trustee allows trust principal distributions to be made without being restricted by an "ascertainable standard" under Section 2041(b)(1)(A). Access to trust principal may be granted to a beneficiary via a right of withdrawal relating to the beneficiary's "health, education, support, or maintenance" pursuant to Section 2041(b)(1)(A), regardless of whether there is an independent trustee. Where the testa-tor is content with such an ascertainable standard for trust principal distributions, there is no need for an independent trustee. But where the testator wishes that access to trust principal not be limited by an ascertainable standard (e.g., where the testator may wish to authorize a principal distribution for "comfort," "welfare," "care," or "general happiness"),' a trust beneficiary cannot be granted the right of withdrawal without the trust principal being subject to estate tax upon the beneficiary's death under Section 2041(a).

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IRS Rulings

Revenue Ruling *79-353 and* Letter Ruling *8916032*. In *Rev. Rul. 79-353,*[2] the IRS announced the position that a decedent-grantor's retention of the right to remove a corporate trustee, without cause, and to appoint another corporate trustee results in the powers of the trustee being attributed to the grantor for estate tax purposes. If possession of those trustee powers would cause the property to be includable in the grantor's estate under Section 2036(a)(2) or 2038(a)(1), *Rev. Rul.* 79-353 held that those powers would be attributed to the grantor, even though the grantor could not appoint himself as successor trustee, and that the property would be included in the grantor's estate.

When issued, *Rev. Rul.* 79-353 created quite a stir.' Previously, it had been generally accepted that if the grantor simply retained the power to remove a trustee, particularly a corporate trustee, and replace the removed trustee with a corporate or otherwise independent trustee (not himself), no adverse tax consequences would result.' As a result of the concerns generated by *Rev. Rul.* 79-353, the IRS subsequently restricted its application to trusts that were established or that became irrevocable after 10/28/79, the publication date of the Ruling.'

Revenue Ruling 79-353 does not deal with Section 2041 powers of appointment. In *Ltr. Rul.* 8916032, however, the IRS extended the holding of *Rev. Rul.* 79-353 to cover a situation in which a beneficiary, other than the settlor, has the power to. remove and replace the corporate trustee and the trustee is empowered to make principal distributions to satisfy a legal obligation of the beneficiary holding the trustee replacement power.

Letter Ruling 8916032 discusses several matters involving trusts created by a husband and wife for the benefit of themselves and their issue. The estate tax holding addressing the trustee replacement power involves a trust called the Family Trust at a time after the husband's death when a corporate trustee is sole trustee as to property contributed by the husband. The wife is to receive all the net income for her life, but principal distributions may be made to issue in the discretion of the corporate trustee under a nonascertainable standard. The trust instrument provides that the surviving spouse and the grantors' children (including guardians of any minor children) may, by majority vote, remove the corporate trustee and designate another corporate trustee.

The ruling concludes that if, by reason of voting power held by the surviving spouse in her own right and as guardian of her minor children, the surviving spouse has the right to remove the corporate trustee and replace it with another, the discretionary authority of the trustee to make principal distributions will be attributed to the surviving spouse. Because the trustee's powers include discretion to make principal distributions to the surviving spouse's children, including minor children whom she has an obligation to support, the ruling holds that the right to remove the trustee is a general power of appointment under Section 2041. As a result, estate tax is triggered in the surviving spouse's estate.

The IRS has ruled that a beneficiary's right to remove a trustee may be a general power of appointment.

IRS arguments

The proposition that the power to distribute trust property in discharge of a decedent's legal obligation is the equivalent of a general power of appointment seems correct.' Accordingly, if a trust beneficiary has the power to remove the trustee and appoint himself as trustee and, as trustee, has the power to make distributions to his minor children, the trust property is includable in the beneficiary's estate to the extent that the fund could have satisfied his obligation. This presumably means that the entire trust property is subject to estate tax.' The power to make distributions in discharge of a beneficiary's legal obligation of support is akin to a power to make distributions for the beneficiary's benefit, and that power, coupled with the power in the beneficiary to substitute himself as trustee, constitutes a general power of appointment in accordance with Reg. 20.2041-1(b)(1).

Where the trustee replacement power is circumscribed, however, to permit the beneficiary to substitute another (but not himself) as trustee, it should not follow that inclusion in the beneficiary's estate under Section 2041 is triggered. Case law does not not support the proposition that a beneficiary's power to remove a trustee, without cause, and to appoint another, causes Section 2041 inclusion. In *First National Bank of Denver,'* both the district court and the Tenth Circuit found that no general power of appointment was held by a beneficiary who possessed a power to remove a corporate trustee and appoint another because the power did not include the power to appoint himself as successor trustee.

Letter Ruling 8916032 cites no support for an expansion of *Rev. Rul.* 79-353 from retained interest (Sections 2036 and 2038) cases to power of appointment (Section 2041) cases. In fact, a close reading of *Ltr. Rul.* 8916032 discloses that it does not expressly rely on *Rev. Rul.* 79-353 for its holding with respect to Section 2041. Nonetheless, the position taken in the letter ruling appears to be based on the same logic; that is, that the beneficiary could appoint a trustee after first ascertaining that the trustee would follow his instructions and that if the trustee should fail to do so, the beneficiary would simply appoint another (and another) until he got his wishes. This suggests that the fiduciary duties of a trustee are to be disregarded—a position that ignores the legal obligations of a trustee under trust law to the creator and beneficiaries.

Revenue Ruling 79-353 primarily relies on *Corning,'* a 1955 income tax case. That reliance appears to be misplaced in light of *Byrum,*[70] a 1972 Supreme Court case dealing with the estate tax treatment of trustee replacement powers retained by a decedent-grantor. Although *Byrum* was partially overturned by the enactment of Section 2036(b), that legislation should not affect tax treatment of the trustee replacement power under that case. In recognizing the sanctity of a trustee's fiduciary obligations, the *Byrum* Court declared that it would have been futile for the decedent-grantor to remove one corporate trustee with whom there might be disagreement, because a ". . . successor trustee would succeed to the rights of the one removed."

The estate tax holding addressing the trustee replacement power in *Ltr. Rul.* 8916032 is unsupportable under present law. That holding is of significant concern because its logical extension is that a trustee replacement power, granted to a beneficiary who may receive trust principal through the trustee's exercise of discretionary authority under a nonascertainable standard,

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Citations

1 See *Estate of Vissering,* 96 TC No. 33; *Estate of Little,* 87 TC 599 (1986); *Whelan,* 81-1 USTC 113,393, 46 AFTR2d 80-6227 (DC Calif., 1980). See also Reg. 20.2041-1(c)(2) and Corbett, "Judicially Determined Ascertainable Standards Formulated Under §S2036, 2038 and 2041," 15 *Tax Mgmt.* (BNA) 198 (11/8/90).

2 1979-2 CB 325, as modified by *Rev. Rul.* 81-51.

3 See, e.g., Barr, Berall, and Ross, *Drafting trustee-removal power to avoid the adverse consequences of* Rev. Rul. 79-353, 10 EP 30 (1983); Roth, Weinberg, and Cummins, "Retained Power to Substitute Corporate Trustees: Is Revenue Ruling 79-353 Correct?" 119 *Tr. & Est.* 42 (April 1980); Blattmachr, "Controversy Surrounds IRS Ruling on Removal of Corporate Trustee," *Nat'l L.J.,* p. 18 (1/21/80).

4 See Heckerling, "Tax Aspects of Power to Remove, Substitute and Appoint Trustees," *8 Real Prop., Prob. & Tr. J.* 545 (1973).

5 *Rev. Rul.* 81-51, 1981-1 CB 458.

6 See *Rev. Rul.* 79-154, 1979-1 CB 301.

7 *Self,* 142 F. Supp. 939, 55-2 USTC 111,613, 49 AFTR 1913 (Ct. Cls., 1956).

8 42 AFTR2d 78-6466 (DC Colo., 1978), *affd* 648 F.2d 1286, 81-1 USTC 113,408, 47 AFTR2d 81-1644 (CA-10, 1981).

9 24 TC 907 (1955), *affd per curiam* 239 F.2d *646,* 57-1 USTC 19214, 50 AFTR 1201 (CA-6, 1956).

10 408 U.S. 125, 72-2 USTC 112,859, 30 AFTR2d 72-5811 (S. Ct., 1972). See Scroggin and Petmecky, "Is the Power to Change Trustees a General Power of Appointment? A Review of PLR 8916032," *67 Taxes* 520 (August 1989); Covey, "The *Byrum* Case and Closely-Held Stock: An Analysis," *3 Tax Advisor* 644 (1972).

11 93 TC 171 (1989), *aff'd* 918 F.2d 1263, 90-2 USTC 160,049, 66 AFTR2d 90-6038 (CA-6, 1990). *Cf. Ltr. Rul.* 8922003.

12 Section 2041(b)(1)(A). See *Ltr. Rul.* 8922062.

13 *Rev. Rul.* 79-154, *supra* note 6.

14 See *Upjohn,* 72-2 USTC 112,888, 30 AFTR2d 72-5918 (DC Mich., 1972).

15 Reg. 20.2041-3(c). See also *Rev. Rul.* 76-503, 1976-2 CB 275; *Ltr. Rul.* 9030032.

16 395 U.S. 316, 69-1 USTC 112,609, 23 AFTR2d 69-1954 (S.Ct., 1969). See also *Estate of Bischoff,* 69 TC 32 (1977); *Estate of Levy,* TCM 1983-453.

17 But see Pennell, "Estate Planning: Drafting and Tax Considerations in Employing Individual Trustees," 60 *N.C.L. Rev. 799* (1982).

18 See Adams and Abendroth, "The Unexpected Consequences of Powers of Withdrawal," 129 *Tr. & Est.* 41 (August 1990); Scroggin and Petmecky, *supra* note 10.

19 See Reg. 20.2041-3(d)(1).

may subject the trust principal to estate tax at the beneficiary's death. Assuming that, in accordance with Reg. 20.2041-1(b)(1), a beneficiary may not appoint himself as replacement trustee, a beneficiary's trustee replacement power should not under any circumstances cause trust property to be included in the beneficiary's gross estate under Section 2041. Otherwise, serious fiduciary obligations are incorrectly trivialized and ignored. Section 2041 should not be extended beyond the Regulations and interpreted to convert a hypothetical opportunity for wrongful transfer of property into a general power of appointment.

Curiously, the position of *Ltr. Rul.* 8916023 does not comport with other recent positions taken by the IRS. In *Estate of Headrick,"* the Tax Court and the Sixth Circuit held that the decedent's life insurance trust was not subject to estate tax, even though the decedent retained the power to replace the corporate trustee with another. There is no indication that the IRS argued that that power caused estate tax inclusion, and the opinion does not address the issue. In *Ltr. Rul.* 9036048, the IRS ruled that where a trustee having an obligation to support his children may appoint a special trustee empowered to make principal distributions to the .children-that could.discharge such support obligation, the trust principal is not subject to estate tax under Section 2041.

In *Ltr. Rul.* 9113026, however, a trust beneficiary was eligible to receive principal distributions in the trustee's discretion under a nonascertainable standard and had the power to replace the trustee with another without cause. The IRS concluded that the trust principal was not subject to inclusion in the beneficiary's estate under Section 2041 because the trust became irrevocable in 1976 and was protected under the grandfathering rule applicable to *Rev. Rul.* 79-353, discussed above. The implication of *Ltr. Rul.* 9113026 is that, if the trust had become irrevocable after the grandfather date, there would have been a 2041 issue.

Drafting methods

Several drafting methods can be used to (1) avoid any potential danger that the IRS may seek to impose estate tax on account of trustee replacement powers and at the same time (2) allow significant flexibility in arrangements for replacement of a trustee. Three primary methods are available:

1. The use of an ascertainable standard.
2. The designation of an independent or disinterested person to accomplish trustee replacement.
3. The grant of certain kinds of joint powers to beneficiaries.

Use of ascertainable standard. In *Ltr. Rul.* 8916032, the Family Trust included a provision that authorized the corporate trustee to distribute principal to the surviving spouse for "health, support, maintenance and education." The ruling makes it clear that attribution of the trustee's discretionary powers to the beneficiary holding the removal power is not troublesome when those powers are limited by a fixed and ascertainable standard.[12]

Care must be taken that the power to distribute trust principal is limited by an ascertainable standard. While a trustee may distribute principal pursuant to an ascertainable standard to himself and certain others, a distribution under the same standard to someone to whom the trustee. owes. a.legal obligation of support probably will have adverse tax consequences. The rationale is that an ability to discharge a legal obligation is treated as a power to distribute property to the power-holder or to his creditors, and therefore is a general power of appointment.[13] But while *Ltr. Rul.* 9036048 confirms this position, *Ltr. Rul.* 9043052 states somewhat in passing the position that, even if a parent was serving as trustee, there would be no includability in the parent's estate under Section 2041 if the power to distribute principal to a child to whom the parent owed a support obligation was subject to an ascertainable standard. Another way to avoid the difficulties that may result from distributions in discharge of a beneficiary's support obligation is to include a provision, sometimes referred to as an *Upjohn*[14] clause, prohibiting any distributions that would discharge the support obligations of a beneficiary.

Independent power-holder. Where a testator wishes to grant a broad principal invasion power that is not limited by an ascertainable standard, a trustee replacement power can be granted without risk of estate tax by designating an independent person (e.g., a brother, sister, other relative, or close friend) who is em-powered to replace the trustee. This may be a practical solution where that person is reluctant or unwilling to serve as trustee but is willing to assume responsibility for trustee replacement:

Use of an ascertainable standard, independent power-holder, or joint power arrangement may avoid unfavorable tax risks.

In *Ltr. Rul.* 8916032, the power-holder was a beneficiary. The rationale in that ruling, however, suggests that its holding could be applied to a trust in which the power-holder does not hold a beneficial interest. The taint under *Ltr. Rul.* 8916032 *is* that the discretionary principal invasion may be exercised by the trustee to discharge an obligation of support of the power-holder. Would the IRS view the power to substitute a replacement trustee differently if the power-holder were not a trust beneficiary? For example, if a parent creates a sprinkling trust for a child and grandchildren, and if the child's spouse, who has an obligation of support to the grandchildren, is granted a trustee replacement power, there would appear to be some risk that the trust property could be included in the estate of the child's spouse.

Jointly held powers. Properly structured, jointly held powers to replace a trustee can safely be used even in conjunction with broad (nonascertainable) authority to make principal distributions. In *Ltr. Rul.* 8916032, the mechanism for removal of the independent trustee was by majority vote of the surviving spouse (who had a life income estate) and children (all of whom, except the surviving spouse, could receive discretionary principal distributions under a nonascertainable standard). The tax problem under the ruling arose because a discretionary principal distribution to a minor child could discharge the surviving spouse's obligation of support, and the surviving spouse, in her own right and as guardian of her children, might find herself in a position to exercise the trustee replacement power. The ruling expressly states, however; that the joint power would not trigger adverse tax consequences if, when the settlor died, the survivor did not possess a majority of the votes (individually or as one or more of the guardians) to effect trustee replacement, because each child's beneficial interest in the trust would be regarded as adverse to the surviving spouse's interest.[15] From a drafting perspective, it follows that the tax treatment of the trustee replacement power in *Ltr. Rul.* 8916032 would have been different if the trust instrument had provided that a minor child's vote could be exercised only by a guardian who had no obligation to support that child (i.e., someone other than the surviving spouse).

An independent trustee is often appointed when, after the death of the surviving spouse, there is a continuing trust for lives of children. Generally, the trust property held in continuing trust is subject at a child's death to either generation-skipping transfer tax (GST) (assuming the trust property has not been allocated GST exemption under Section 2631) or estate tax (on account of a testamentary general power of appointment granted to a child to direct the disposition of a remainder interest in trust property). In such a case, there would typically not be any severe adverse tax consequence if an inadvertently over-broad trustee removal power were to subject the trust property to estate tax. On the other hand, where the trust is intended to be protected from future transfer tax through use of the $1 million GST exemption, it is essential that any power to replace a trustee not trigger estate tax at a child's death.

Often such a trust will direct payment of income equally to children, with each child's share to pass at his or her death to or for the benefit of the child's family. Where the trust instrument contains broad (nonascertainable) authority to make principal distributions to children, can a trustee replacement power be given to children without risk of estate tax? If each child's trust interest is structured as a separate share of a single trust for all purposes, the other children may not have a sufficient adverse interest under Reg. 20.2041-3(c) to prevent the risk of estate tax inclusion of a proportionate amount of the entire trust property under Section 2041(b)(1)(C)(iii). If, however, the children's separate interests are not disposed of as separate shares (e.g., where a principal distribution to any one child is charged to the entire trust rather than against that child's share), the children's respective interests as against each other arguably may be sufficiently adverse under Reg. 20.2041-3(c). On the other hand, the IRS might take the position that the children's interests are too remote as against each other. Alternatively, the IRS might attempt to extend the reciprocal trust doctrine under E*state of Grace*[16] to such an arrangement, al-though that doctrine has been limited to retained interest situations under case law."

Accordingly, the safest procedure may be to authorize grandchildren having contingent remainder interests to substitute trustees. In drafting such a provision, care should be taken in light of *Ltr. Rul.* 8916032 to prevent a minor grandchild's vote from being attributed (through guardian rights) to his or her parent. Suggested language for replacement of a corporate trustee appears in Exhibit I on this page.

The sample language limits the voting rights of minor children so as to minimize the need for court proceedings to secure appointment of an independent guardian, in that only a single vote by or on behalf of a child is required. Where appropriate, the trust instrument may be drafted to require super-majority vote or unanimous decision instead of majority vote. If the testator is concerned that trustee replacement occur only if there is family consensus, a provision requiring unanimous decision may be desirable.

A different situation is presented under a GST exemption trust providing for income and principal to be distributed among descendants under a broad (nonascertainable) authority for an extended period, which is often the maximum period under the rule against perpetuities. If a power to replace a trustee is granted to all descendants by unanimous decision, is there some risk that the IRS may assert Section 2041 includability?

An IRS challenge may be more likely if the trust instrument permits trustee replacement under circumstances that provide a greater op-

EXHIBIT I:

Replacement of Trustee

The corporate trustee of the trust created under Article xxx of this Will may be removed and a successor corporate trustee appointed, without cause and without court approval, by majority vote of those of my descendants who are not current income beneficiaries of that trust, subject to the following provisions of this paragraph. Any descendant who has not attained the age of majority (determined under the law of the state of that descendant's residence) shall not be eligible to participate in that vote unless such descendant is not a current income beneficiary of that trust and a guardian (or like representative) who does not have a legal obligation to support that descendant shall have been appointed by court order. For the purposes of any such vote, the vote of such a guardian on such a descendant's behalf shall be counted, but the existence of any other minor descendant for whom no such guardian is appointed shall not be taken into account, nor shall the existence of any adult descendant who is mentally incapacitated be taken into account. No corporate trustee shall be deemed to be removed from office under the foregoing provisions of this paragraph until a successor corporate trustee shall have accepted its appointment and commenced to serve as corporate trustee. Any vote pursuant to the foregoing provisions of this paragraph shall be by duly acknowledged written instrument.

portunity for improper influence over the trustee by the persons holding the removal power. This might be the case where there are no grandchildren born who might object to a trustee replacement that might be proposed by the testator's children.

Risk of IRS challenge is minimized, however, if the trustee replacement can be accomplished only with approval of at least one descendant in a younger generation who has an ancestor (e.g., parent, grandparent, or great-grandparent) who is a then living descendant of the testator. Such a younger-generation descendant's interest in the trust principal should be considered sufficiently adverse to his ancestor's under Reg. 20.2041-3(c), even though both individuals are current beneficiaries of the trust. The difference in the quality of their respective interests may be more substantial if such a younger-generation beneficiary is born after the testator's death (and cannot be a measuring life under the common law rule against perpetuities). Where the trust term is tied to the maximum period under the common law rule against perpetuities and the instrument directs, at trust termination, distribution to issue by representation, an after-born younger-generation descendant may ultimately become entitled to receive distribution when trust termination occurs. There would not seem to be any legitimate concern over an IRS challenge to a trustee removal power that requires approval of such a younger generation descendant, particularly one who is a potential remainderman upon trust termination.

A testator's estate plan may set forth specific factors to be considered in determining whether to replace a trustee.

Other issues

Conditional removal power. Instead of an absolute power to replace an independent trustee, some commentators have suggested that the trust instrument might .be drafted to provide that the power arise only upon the occurrence of certain specified conditions or circumstances." Such conditions might include: inattentiveness to trust administration or gross negligence on the part of the trustee; the trustee's failure to comply with certain standards of con-duct or performance enumerated in the trust instrument (or state law); the trustee's failure to resign in the event of an irreconcilable conflict; or, in the case of a corporate trustee, the resignation or retirement of a particular bank officer in whom the testator has confidence. If the power to replace an independent trustee is exercisable only upon the occurrence of a contingency that does not occur during the decedent's lifetime, estate tax inclusion under Section 2041 is not triggered. If the condition occurs, how-ever, and the trustee replacement power be-comes presently exercisable, there is a risk that under the rationale of *Ltr. Rul.* 8916032, the IRS may attempt to impose estate tax.

It is difficult to extend that rationale to a conditional replacement power. If the circumstances justifying removal arise and the trustee is substituted, there is no basis for arguing that the power holder may improperly influence the independent trustee —at least not until the passage of some time during which circumstances may occur that give rise to another substitution right. Moreover, if the exercise of the replacement power is limited by a substantial period of time (e.g., once every ten years), the ability of its holder to influence the trustee is further diminished. Some implicit IRS recognition of this notion appears in *Ltr. Rul.* 9036048, which does not challenge a power to appoint a special trustee to make discretionary principal distributions.

Nonetheless, the IRS might assert that if circumstances giving rise to the exercise of such a limited replacement power occur, the trust principal is subject to estate tax. That concern would not be eliminated if the condition for trustee replacement occurs and then expires, because the IRS may argue that the expiration of the power triggers gift tax under Section 2514 or estate tax under Section 2041 via application of the retained interest provisions of Sections

2036 and 2038.[19] According to *Ltr. Rul.* 8916032, if the surviving spouse's power to exercise control over trust replacement terminates because she no longer controls the majority of votes needed to replace the trustee (as would be the case when some of the children attain the age of majority), that termination constitutes a lapse of a general power of appointment, triggering estate tax at her death.

Guidance by testator for removal. Where the testator desires to make an express statement of the circumstances under which a trustee may be removed, one approach is to provide guidance (albeit nonbinding) for the exercise of the power. This approach contemplates that an unconditional power to replace a trustee be granted to one or more persons, and that the removal power be structured to avoid risk of estate tax by using an ascertainable standard, independent power-holder, or joint power arrangement. The testator's estate plan might set forth specific factors to be considered in determining whether to replace a trustee, such as the following:

1. The investment performance of the trust assets, as compared with the major indices for investment performance for portfolios of marketable securities.
2. The overall financial stability of the corporate trustee, taking into account ratings of regulatory agencies.
4. The extent of continuity in trust officer personnel in the trust administration.
5. The extent to which the trustee has effectively responded to the beneficiaries' needs.
6. The extent to which any irreconcilable conflict or incompatibility has arisen between the trustee and the beneficiaries.

Central to any trustee replacement power is that the testator must have confidence in the person or persons to whom the replacement power is granted to exercise it only if and when appropriate. Although some testators may wish to impose legally binding limitations on the exercise of the power, the better practice is to place unrestricted reliance on the judgment of that person(s).

Conclusion

Trust property should not be subject to estate tax under Section 2041 on account of a beneficiary's trustee replacement power where that beneficiary cannot appoint himself as replacement trustee. Although estate planners can draft trustee replacement powers to avoid any risk of estate tax and generally provide for satisfactory means to accomplish trustee replacement, *Ltr. Rul.* 8916032is a potential pitfall.