



Plain Speaking, Nostalgia Style-General Powers of Appointment circa 1986
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20th Anniversary of the 1986 Act

It's been twenty years since the Tax Reform Act of 1986 introduced us to the wonderful world of reduced itemized deductions, the "bubble" in marginal tax rates as Congress discovered phase-outs, passive activities and all the other wondrous changes it brought to us. While it turns out that CPAs in tax practice were not put out of a job by that law, it brought a significant change to tax practice.

The Tax Court, apparently caught up in the nostalgia, this week issued its opinion in the case of *Estate of Gerson*, 127 TC No. 11 the Tax Court had to consider whether the IRS's regulations implementing a grandfathering provision in the 86 Act was a reasonable interpretation of the statute. The case generated a decision that included the main

opinion, a concurring opinion, and a set of dissents—and a pretty good chance that the Sixth Circuit Court of Appeals is going to end up putting its mark on the issue as well.

Trusts, the 1986 Act, and GST

Significant changes were made to the generation skipping transfer tax in the 1986 Tax Act. This led to one of what turned out to be a number of “grandfathering” provisions in that Act to grant relief to taxpayers who had implemented a plan under the old tax law that would now result in a very poor result under the new law. The provision in question exempted trusts that were irrevocable (and thus not able to be changed easily) on September 25, 1985 from the changes made to the GST in this act. That provision, found in §1433(b)(2)(A) which read

(2) Exceptions. - The amendments made by this subtitle shall not apply to -
(A) any generation-skipping transfer under a trust which was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added),

A feature often included in many trusts was to invest a third party (such as a surviving spouse) with a general power of appointment to designate individuals that would receive the trust corpus on the holder’s death. The IRS took the position after the passage of the 1986 Act when dealing with trusts where such a power was held that the power invalidated the grandfathering clause noted above.

The IRS view was that Congress had intended the relief solely to avoid unfair results where taxpayers had no real ability to avoid the GST tax if it was applied to the trust, even though the actions that had created the skip took place at a time when the law did not impose such dire consequences. When a person held a general power of appointment that allowed him/her to change the beneficiaries, the IRS argued they clearly had the ability to avoid the “bad result” that Congress was attempting to insulate the trusts against.

The Circuits Speak Prior to the Final Regulations

The Tax Court, in the initial case it heard to deal with this issue, *Peterson Marital Trust v. Commissioner*, 102 T.C. 790 (1994), *affd.* 78 F.3d 795 (2d Cir. 1996), they agreed with the IRS’s view on this matter. The court noted:

Mrs. Peterson, as the holder of a testamentary general power of appointment, maintained effective control over the disposition of the property in the Marital Trust until her death in 1987. Had she chosen to do so, Mrs. Peterson could have exercised the general power of appointment to cause the trust property to be distributed to persons other than the Grandchildren's Trusts, thereby avoiding a generation-skipping transfer. Accordingly, as of the September 25, 1985,

grandfather date, the corpus of the trust was not irrevocably required to be distributed to the Grandchildren's Trusts.

The Second Circuit Court of Appeals agreed with the Tax Court on this matter.

However, in two future cases the IRS would not find such a receptive audience for its view. In reversing a U.S. District Court holding in the case of *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999) the Eighth Circuit held:

Trust A, having been created by Mr. Simpson's will in 1966, was of course irrevocable on September 25, 1985. Was the transfer made by Mrs. Simpson a transfer 'under' this trust? We do not see how an affirmative answer can be avoided. The power of appointment that made the transfer possible was created by the trust. Language has to mean something, and the argument that this particular transfer was not 'under' trust A is simply untenable.

The Ninth Circuit also decided that the language Congress had passed made it clear that a transfer under a general power of appointment did not negate grandfather treatment for a pre-September 25, 1985 trust. In the case of *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002) the Ninth Circuit indicated also that the language of TRA 86 §1433(b)(2)(A) meant that a general power of appointment did not bring a trust outside of grandfather protection.

The IRS had issued revised final regulations between the date of the *Simpson* and *Bachler* cases to address the objections raised in *Simpson*. The Ninth Circuit specifically chose not to rule on the validity of those regulations since they were issued after the date of the transfer that took place in *Bachler*.

Gerson Case

Revised Regulation §26.2601-1(b)(1)(i) provides

(i) IN GENERAL.

The provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. See paragraph (b)(1)(iv) of this section for rules for determining the portion of the trust that is subject to the provisions of chapter 13. *Further, the rule in the first sentence of this paragraph (b)(1)(i) does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985. See paragraph (b)(1)(v)(B) of this section regarding the treatment of the*

release, exercise, or lapse of a power of appointment that will result in a constructive addition to a trust. See section 26.2652-1(a) for the definition of a transferor.

In the Gerson case, the Tax Court now got to revisit the issue following the issuance of the final regulations and in light of the Eighth and Ninth Circuit's decisions that the plain language of the Act meant that the power of appointment didn't cause the grandfather to not apply to the transfer.

The majority of the Tax Court stuck by its initial decision. It again reasoned that

We also must not lose sight of the particular purpose of the statute. As the Second Circuit discussed in *Peterson Marital Trust v. Commissioner*, 78 F.3d at 801-802 n.6, the transitional rules set forth in section 1433(b)(2) are so-called grandfather provisions designed to protect taxpayers who, on the basis of pre-existing rules, made estate-planning arrangements from which they could not reasonably escape and which would otherwise generate GST tax liability. The generation-skipping transfers in the present case are not transfers the transitional rules were intended to protect. Mr. Gerson did not structure his irrevocable trust in a manner that tied the hands of his heirs, nor was decedent required to make the disputed generation-skipping transfers. To the contrary, Mr. Gerson gave the decedent the flexibility to transfer trust property to anyone of her choosing. Decedent, who was aware or should have been aware of the regulation in dispute, nevertheless exercised her general power of appointment to effect a generation-skipping transfer.

And finally the majority went on to find

Considering all the factors discussed above, we hold section 26.2601-1(b)(1)(i), GST Tax Regs., is a reasonable and valid interpretation of the plain language of TRA 1986 section 1433(b)(2)(A). The regulation harmonizes with the plain language of the statute, its origin, and its purpose. *Natl. Muffler Dealers Association v. United States*, 440 U.S. at 477. Accordingly, we sustain respondent's determination that decedent's transfer to her grandchildren was subject to GST tax.

Judge Swift in his concurring opinion writes that the majority was too "circumspect" in discussing problems with the Eighth and Ninth Circuit's opinion, stating that those courts made serious mistakes in handling the cases in question.

Judge Laro wrote a dissent that four other judges of the Tax Court joined in where he criticizes the Tax Court's holding, noting:

The conclusion in the Court's opinion is predicated on its finding that respondent's interpretation is "a reasonable * * * interpretation of the plain language" of TRA 1986 section 1433(b)(2)(A), as opposed to a finding, which the Court's opinion does not make, that respondent's interpretation represents the plain reading of TRA 1986 section 1433(b)(2)(A). To my mind, an unambiguous statute has only a

single plain reading, see *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001), and any other reading is *ultra vires* even if it is "reasonable".² Such is especially so where, as here, respondent's interpretation was previously rejected by a judicial tribunal in favor of the plain reading application of that section.

What Now?

This particular case would be appealed to the Sixth Circuit, which has not ruled on the matter. Therefore it seems likely that the case will go before that Circuit as the taxpayer asks for a reversal since the dollar amount involved (\$1,144,465) is clearly enough to justify spending the money to fight through the appeal. We will find if the Sixth Circuit makes the "score" 2 to 2 or whether it throws in with the Eighth and Ninth to leave the Second Circuit standing alone as seeing this interpretation as reasonable among the appellate courts that have considered the issue.

But what if you have a client that has this issue? What advice can be given? At this point, most likely clients would have to be counseled that allowing assets to go to the skip generation risks a significant tax, but if it turns out that the regulation is eventually held to be invalid they will be missing a significant estate planning opportunity if they don't take advantage of this option. What you can really hope for is that the client doesn't die before the courts finally resolve this issue.