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Letter Ruling on Constructive Trust Add Omits Key Questions

by Russell A. Willis III

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In this article, Willis argues that a recent private letter ruling signals that the IRS will make only a cursory inquiry into a transaction in which there are opportunities for manipulation.

Friday mornings I like to fire up the French press and sit down to browse the week's release of private letter rulings. To each his own, I can hear you saying.

Many requests for rulings concern section 9100 relief for late elections, and some are "comfort" rulings regarding transactions for which the tax consequences are reasonably clear. There is a sprinkling of chief counsel memos advising examiners to take some position in pending audits, often with the analyses of litigation hazards redacted.

But sometimes there is a letter ruling in which it seems more is going on than immediately meets the eye. The pieces do not quite fit. Maybe a key fact is left unstated, or maybe the facts as presented raise issues that are unaddressed, which might negate some or all of the benefit of the favorable ruling.

Sometimes what is stated or omitted suggests an interesting back story. A case in point is LTR 201735005.

What the Ruling Says

The ruling seems straightforward enough. A settlor created an irrevocable trust for his daughter and her descendants, funded entirely with closely held stock. The trust was created before September 25, 1985, so it is grandfathered to be exempt from the generation-skipping transfer tax, unless there are actual or constructive additions after that date.[1]

That, of course, is what the ruling is about. Something happened that required an adjustment between the trust and the daughter, and the question was whether the IRS might treat the event as a constructive addition.

So, what exactly happened? The corporate trustee sold the stock and "erroneously" reported the gain as a passthrough item on the Form K-1 issued to the daughter. She "mistakenly" paid income taxes, both federal and state, on the reported gain.[2]

At some point, the trustee acknowledged its "error" and reimbursed the daughter some portion of the taxes she had paid. When the trustee later sought court approval of an "intermediate" accounting, the daughter objected, claiming she was still owed reimbursement for state taxes she had paid, plus interest, and her lawyers' fees for pursuing the objection. The court agreed, after first finding that the statute of limitations on the daughter's claims had not yet run.

The daughter — or was it the trustee? — sought a letter ruling that her "inadvertent" payment of taxes on gains that were properly taxable to the trust:

1. was not a constructive addition to the trust;
2. was not a taxable gift to the trust remaindermen; and

[1] Reg. section 26.2601-1(b)(1).

[2] The quotation marks are intended to highlight that the IRS seems to have accepted these characterizations of the transaction — the trustee made an "error," on which the daughter "mistakenly" relied in reporting her individual income tax liabilities – without inquiry.

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3. would not cause any portion of the trust to be includible in her gross estate under section 2036(a); also
4. that the reimbursement to her, with interest, and the payment of her lawyers' fees, would not cause any portion of the trust to lose its grandfathered, exempt status.[3]

And the IRS granted favorable rulings, emphasizing that these were premised on a finding that the daughter had not waived her right of recovery.

Straightforward, no? But a close reading of the ruling discloses several apparent anomalies.

Was the K-1 'Erroneous'?

Whoever requested the ruling took the trouble to say that the closely held stock was in an S corporation and that the trust was a qualified subchapter S trust (QSST) under section 1361(d)(3).

But in the next sentence, we learn that the trustee was required to accumulate income until the daughter attained a specified age. This would have disqualified the trust as a QSST — even if, as appears to be the case, the daughter was a minor when the trust was created and the specified age was the age of majority — unless income was in fact distributed, perhaps to a custodial account, which is not mentioned in the ruling and would be contrary to an instruction to accumulate.

On the other hand, if the trust was a QSST, it would have been treated as a "grantor" trust under section 1361(d)(1)(A), and it might not have been a "mistake" for the daughter to pay tax on realized gains — unless the sale of the stock itself terminated the QSST status of the trust.

And that is what reg. section 1.1361-1(j)(8), finalized in 1995, says:

> An income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST.

But that is a flat reversal of the position the IRS had taken about three years earlier in Rev. Rul. 92-84, 1992-2 C.B. 216.[4]

T.D. 8600, which promulgated the final regulation, obsoleted the revenue ruling as of July 21, 1995. If a QSST had sold all or part of its S corporation stock in a tax year that was still open on that date, the trustee and the beneficiary were given a choice of which way they wanted to treat the transaction, provided they took consistent reporting positions with one another.

When Did the Transaction Occur?

There are three possibilities — again, assuming the trust somehow qualified as a QSST. First, the transaction occurred after July 21, 1995, in which case reporting the gain as a passthrough was indeed "erroneous." Second, the transaction occurred on or after October 5, 1992, the date the revenue ruling was published, but on or before July 21, 1995, in which case the reporting would not have been "erroneous," but the parties could have amended their returns. It is possible they missed the opportunity. Third, the transaction occurred before October 5, 1992, in which case one might argue the revenue ruling nonetheless described the law as it then applied, and the reporting would not have been "erroneous."

Missing from the narrative, incidentally, is whether the trustee in fact distributed the gain element of the sale proceeds. Presumably it did not, because the text of the ruling suggests the trustee did not have discretion to distribute principal to the daughter after she attained majority. But even if the trustee did distribute proceeds, that would not have carried the gain out to the daughter as part of distributable net income unless the distribution met the requirements of reg. section 1.643(a)-3(b), or its predecessor if the

[3]When the ruling was requested, the trustee had not yet made payment to the daughter under the court order. But the text of the letter ruling does not suggest the court order was conditioned on a favorable ruling — and why should it have been?

[4]The "holding" portion of Rev. Rul. 92-84 reads, in full:

> If a "qualified subchapter S trust" (QSST) sells all or part of its stock in an S corporation, the beneficiary rather than the trust is the taxpayer who recognizes gain or loss on the sale of the stock, even if under local trust law gain or loss on the sale is allocable to corpus rather than to income.

Interestingly, paragraph (j)(8) was added to the final regulation in response to comments received concerning the revenue ruling, well outside the stated period for public comment on the notice of proposed rulemaking, which had been published nearly 10 years previously.

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transaction occurred before January 2, 2004, the effective date of the current reg.

But I digress.

The date of the ruling request was November 19, 2016.[5] So your first instinct might be to say, "Well then, the transaction must have occurred fairly recently." But there are some indications to the contrary.

Occam's Razor

One supposes, for example, that the transaction occurred more than three years before the trustee made a partial reimbursement of the daughter's "mistaken" tax payment. Otherwise, the parties could simply have filed amended returns — the daughter claiming a refund and the trust making a late payment, with penalties and interest.[6]

However, the economics of the transaction would be better for all concerned — except possibly the remaindermen — if it were instead handled the way it actually was: The daughter gets interest from the date of her "mistaken" tax payment, possibly at a higher rate than the IRS would have paid, and the trustee does not incur late payment penalties. The parties might have agreed to defer reimbursement of state taxes to lay the groundwork for requesting the ruling by creating a nominal controversy to be resolved by the state court.

There is at least an argument to be made, albeit weak, that interest paid to the daughter is deductible by the trust (in effect, she made a loan to the trust that allowed it to hold its investment positions). Certainly, her lawyers' fees are deductible, at least to the extent they can be said to have benefited the trust.[7]

Because of the mismatch between net fiduciary accounting income and distributable net income, some or all of the interest and fees would be chargeable to principal under state law, while the deductions would reduce the taxable component of income distributions to the daughter.

Was the Daughter 'Mistaken' in Paying the Tax?

Let us suppose the transaction occurred more recently than July 21, 1995, the effective date of reg. section 1.1361-1(j)(8). Keep it simple. Under what circumstances might the daughter have "mistakenly" paid tax on a capital gain from which she received no proceeds?

Certainly, she would have become used to seeing a mismatch between the actual distributions to her of net fiduciary accounting income and the amounts reflected on the Forms K-1, which, because this was a QSST, would have been coming directly from the Form 1120S returns for the S corporation.

If we take the text of the letter ruling at face value, the trust was initially funded entirely with stock in the S corporation, and, at least during the daughter's majority, it distributed income currently. Therefore, unless the corporation itself made distributions to the trust in excess of accumulated adjustments, which the trustee could then reinvest, there would likely be not much else in trust corpus apart from the S corporation stock itself.

The sale of this stock, then, would have been a rather significant event. Possibly, the daughter and her advisers would have consulted with the trustee concerning the transaction. In any event, it is difficult to imagine she had no idea what was happening.

So when the Form K-1 arrived showing a passthrough of the gain on the sale of the stock, the daughter would have at least been aware that she was paying tax on a transaction from which she had seen none of the proceeds. Later, when she received only partial reimbursement from the trust of the taxes she had "mistakenly" paid, she should have been aware there was money left on the table.

The Long Game

To flip the previous question, under what circumstances might the parties have agreed that the gain should be passed through and the daughter should pay the tax? The most obvious scenario, of course, would be that neither the trustee nor the daughter's advisers were aware of

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[5]It does not appear that the IRS asked for additional information beyond the initial submission.

[6]*Compare* LTR 200340015, dealing with a rather similar situation.

[7]Reg. section 1.212-1(i). *See Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq.* 1968-2 C.B. 21. *See also* LTR 200033015 and LTR 201642027.

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reg. section 1.1361-1(j)(8) and instead thought something like Rev. Rul. 92-84 was the law.

But there is at least some possibility the parties may have engaged in a bit of tax rate arbitrage, only later realizing they might have inadvertently triggered a constructive addition. Or they could have been playing a long game, accepting the risk that there might be transfer tax consequences they could not undo with a letter ruling.

Suppose, for example, the daughter had offsetting losses. Again, the letter ruling does not address this possibility. She pays tax on only the net gain, while the trust would have paid tax on the entire gain, with the top marginal rate kicking in at a much lower threshold.

The parties wait for the limitations periods to close on both the trust return reporting the passthrough and the daughter's return reporting the gain. The trust then makes a partial reimbursement of what is likely the greater portion of the amount the daughter is out of pocket, and they work the rest out through a nonadversarial state court proceeding to which the IRS is, in effect, asked to defer.

This may be a longer game than most people are willing to play, but the amounts involved here may have been quite large.

Reality Check

The parties may have viewed the risk of transfer tax consequences as manageable.

If the daughter did make a constructive addition, the portion of the trust attributable to the pre-1985 transfer could be severed per section 2642(a)(3) and still have a zero inclusion ratio. The daughter would be treated as the transferor for generation-skipping transfer tax purposes of the portion attributable to the addition, which would have an inclusion ratio of one, in accordance with reg. section 26.2654-1(a)(2), unless she allocated some of her own exemption to the transfer.

If the constructive addition occurred after December 31, 2000, the allocation would be automatic unless she affirmatively elected out, under reg. section 26.2632-1(b)(2), or unless a non-skip person had a right to withdraw more than 25 percent of the trust corpus before attaining age 46, under section 2632(c)(3)(B)(i).

As it happens, the daughter herself had staged withdrawal rights. She could request distribution of one-quarter of trust principal when she attained a stated age and another one-third when she attained another stated age. The ages are redacted from the text as released. The remaining half was to be distributed at her death outright to her descendants, *per stirpes*, subject to a limited testamentary power in the daughter to reallocate the remainder among her descendants in some other proportions.

It does not appear, incidentally, that the daughter's limited power would allow her to appoint the remainder in further trust. But if it would, and if she were to exercise that power to postpone vesting of any part of the remainder beyond the common law perpetuities period or 90 years from the creation of the trust, this in itself would be treated as a constructive addition under reg. section 26.2601-1(b)(1)(v)(B).

Presumably, the daughter would choose to exercise her withdrawal rights as they arose because the alternative would be to create the very situation she or the trustee was trying to avoid here.

Because the portion of the trust attributable to a constructive addition would be includible in the daughter's gross estate under section 2036(a), exemption would not be automatically allocated until the close of the estate tax inclusion period, in accordance with section 2632(c)(4). This would give her some flexibility in making the election out.

And, of course, she could exercise her limited testamentary power to appoint the trust remainder among her descendants in a manner that vested the nonexempt portion of the trust in individuals who were non-skip persons as to her — that is, her own children. In some other case this might defeat to some extent the objective of keeping the entire trust out of the federal transfer tax regime until the expiration of whatever perpetuities period might apply. But here, if the text of the ruling accurately paraphrases the dispositive terms of the trust, there would be an outright distribution at the daughter's death in any event.

Still, the more efficient transfer tax plan would be to appoint the remainder at the daughter's death entirely to more remote descendants, keeping the trust entirely out of her children's estates.

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If the transaction at issue here occurred after October 8, 1990, the effective date of section 2702, the gift tax value of the daughter's retained interest in a constructive addition would be zero. But as we have noted, it is not at all clear when the transaction occurred.

Did She Waive Her Right of Recovery?

The text of the letter ruling says the daughter "became aware" she had not been fully reimbursed when the trustee sent her a draft of "its first accounting." One imagines the trustee would have made its "first" accounting 30-odd years ago. But perhaps not, or perhaps the word "first" here refers to something else.

Nowhere in the text of the ruling is there any suggestion that this was a successor trustee. Quite the contrary: The placeholder "Trustee" — capitalized — is used throughout the ruling to refer to not only the trustee currently acting but also the initial trustee named in the trust document; thus presumably the same entity.

In any event, in ruling on the daughter's objections to what was apparently a different, later, "first intermediate" accounting, the state court found it necessary to determine that the statute had not yet run on her claims. So there had been at least some lapse of time.

As paraphrased in the text of the ruling, the applicable state statute would have barred the daughter's claims if she had failed to raise an objection within 30 months after the trustee sent her a financial report sufficiently disclosing the transaction that she "should have known of the potential claim or should have inquired into its existence."

But that statute by its terms would apply only if the trustee were making reports at least annually. So again, we are looking at several possible scenarios. One, the trustee was not making annual reports. Two, the trustee was making annual reports, but these somehow did not sufficiently disclose the transaction to put the daughter on notice of her claims. Or three, the transaction did in fact occur recently — although the fact that the state court found it necessary to decide the limitations question suggests that this latter scenario is somewhat less likely.

The accounting to which the daughter objected in state court was a "first intermediate accounting," covering a range of dates, possibly several years. What might have been the occasion for such an "intermediate" accounting is not indicated, but one plausible scenario is that the daughter had attained or was approaching an age at which the trust document provided her a power to withdraw a sizeable portion of the trust principal.

If, when the daughter exercised her withdrawal right, the trust were still holding mostly stock in the S corporation and she took shares as part of her distribution, the tax treatment of a later redemption of the stock held by the trust would be complicated by the attribution of her stock to the trust under section 318(a)(3)(B).

The text of the letter ruling does not preclude the possibility that the stock sale was in fact a redemption, which the parties might have wanted to get out of the way before the attribution rule made things more difficult. Again, the daughter and her advisers likely would have been involved in these conversations.

What About the State Court Proceeding?

Completely absent from the text of the ruling is any discussion of whether or why the state court proceeding should be seen as determinative of the tax consequences of this transaction under *Estate of Bosch*,[8] or under reg. section 26.2601-1(b)(4)(i)(B) if the court order incorporated a stipulation for settlement.

Was this in fact an adversarial proceeding? Did the trustee raise the limitations statute as a defense? Or waiver?[9] On what grounds, exactly, did the court find the statute was still open? If there was an arrangement along the lines of the "long game" described above, was this disclosed to the court? Were the remaindermen joined? And if so, were they represented by independent counsel? If the remainder interests were represented, did they take discovery on

[8] *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

[9] As noted, the IRS made clear that its favorable rulings were premised on a finding that the daughter "did not waive her right of recovery." It does not appear, however, that the trustee raised a defense of waiver in the state court proceeding or that the court ruled on the matter, separately from finding that the limitations statute had not run.

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correspondence between the trustee and the daughter or her advisers?

Even if the answers to all of these questions were "yes," it would seem the better practice for the IRS to go through this kind of analysis in the text of the ruling.

The ruling states as a fact that the daughter "did not waive her right to recovery," and while this seems a reasonable inference from the state court finding that the statute had not run, for clarity the ruling should state whether in treating this as a fact the IRS is deferring to the state court order, and if so, why deference is appropriate. If instead the statement the daughter "did not waive" is based entirely on the penalty of perjury statement under which the ruling request was submitted, the ruling ought to characterize this as a representation rather than as a fact.

Conclusion

A letter ruling is not precedent. I get that. But releasing these texts to the public has the effect of signaling what it is the IRS is willing to countenance. This ruling seems to signal that the IRS will make only a cursory inquiry into a transaction in which there are opportunities for manipulation. If in this instance the IRS did look into the questions raised here, the letter should have stated that and explained the basis of any factual determinations on which the favorable rulings depend.

And now my coffee has gone cold. ■

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