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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2944

Date:	**14-Mar-22**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Austin Bramwell and Jessica Soojian on the IRS's Alarming New Linked Attribution Theory - And What To Do About It**

“Although Tax Court awarded the taxpayer a victory in Estate of Levine, its reasoning handed the IRS a heretofore unidentified and potentially potent weapon. The IRS argued in Levine that the decedent, merely by appointing the same individual as both her attorney-in-fact and as the independent fiduciary of an irrevocable trust intended to pass outside of her estate, retained de facto a taxable power over the trust property. Although the Court might have been expected to make short work of the IRS’s argument, it instead rejected it only after engaging in a fact-sensitive inquiry into the extent of the fiduciary’s obligations. In an otherwise similar case but involving different a set of fiduciary duties, Levine implies, the Court may hold for the IRS. Thanks to Levine, all wealthy individuals should consider steps to neutralize a novel threat to their estate plans. We call that threat the theory of linked attribution.”

Austin Bramwell and **Jessica Soojian** provide members with timely and important commentary that examines the fallout from *Estate of Levine* and what they refer to as the theory of “linked attribution.”

Austin Bramwell is a partner in the **Trusts & Estates Group of Milbank LLP** and an Adjunct Professor of Law at New York University School of Law. The views expressed herein are his own.

Jessica D. Soojian is a partner in the **Trusts & Estates Group of Milbank LLP.** The views expressed herein are her own.

Here is their commentary:

EXECUTIVE SUMMARY:

Although Tax Court awarded the taxpayer a victory in *Estate of Levine*, its reasoning handed the IRS a heretofore unidentified and potentially potent weapon. The IRS argued in *Levine* that the decedent, merely by appointing the same individual as both her attorney-in-fact and as the independent fiduciary of an irrevocable trust intended to pass outside of her estate, retained *de facto* a taxable power over the trust property. Although the Court might have been expected to make short work of the IRS's argument, it instead rejected it only after engaging in a fact-sensitive inquiry into the extent of the fiduciary's obligations. In an otherwise similar case but involving different a set of fiduciary duties, *Levine* implies, the Court may hold for the IRS. Thanks to *Levine*, all wealthy individuals should consider steps to neutralize a novel threat to their estate plans. We call that threat the theory of linked attribution.

FACTS:

Suppose that a wealthy patriarch, in an effort to reduce his estate tax burden, creates an irrevocable "dynasty" trust for his descendants. By funding the trust, he hopes to use up his gift and GST tax exemption amounts, and also to fix value today so that future appreciation can pass free of estate tax at death. Accordingly, he retains none of the powers described in sections 2036, 2038, or 2042 of the Internal Revenue Code that can cause property transferred during lifetime to be included in his gross estate at death. In fact, he is so cautious that he retains no powers over the trust whatsoever, not even to make investment decisions or to appoint (or remove) trustees. He instead appoints an independent trustee to administer the trust, who conscientiously carries out all of the duties of a trustee.

Under these circumstances, the trust should be invulnerable to estate tax, right? Not so fast. According to *Estate of Levine v. Comm'r*, 158 T.C. 2 (2022), the analysis does not necessarily end there. For suppose, in addition, that the grantor-patriarch has appointed the same individual as both his attorney-in-fact and as the independent trustee of the dynasty trust. In that case, as in *Levine*, the IRS may argue that the patriarch has retained or possessed, after all, a taxable power under section 2036 or 2038. The taxable power exists, the IRS may argue, because the independent trustee's powers must be attributed back to the grantor through the trustee's dual service as grantor's attorney-in-fact.

Unfortunately, the Tax Court in *Levine* gave this "linked" attribution theory a surprisingly respectful hearing. The theory did not simply fail because the grantor did not personally retain or possess a taxable power, whether through an attorney-in-fact or otherwise. Rather, Judge Holmes only rejected linked attribution because he found, under the particular facts and circumstances, that the independent trustee's fiduciary duties were sufficiently rigorous to prevent the decedent from being deemed to have a taxable power.

The Tax Court's opinion thus leaves open the possibility that under a *different* set of circumstances, the linked attribution theory will prevail and cause trust assets that otherwise would be shielded from estate tax to be included in a decedent's gross estate.

COMMENT:

De Facto Powers: A Brief History

Before *Levine*, one could be forgiven for thinking that the law was well-settled on whether a decedent can retain a taxable power *de facto*. After all, in *Byrum v. U.S.*, 408 U.S. 125 (1972), the Supreme Court held that the term "right," for purposes of section 2036(a)(2), "connotes an ascertainable and legally enforceable power." Despite that construction, the IRS attempted for many years to advance the theory that a decedent's ability to influence a trustee, such as through a power to remove and replace, could cause the trustee's powers to be attributed back to the decedent. The IRS's *de facto* powers theory was decisively rejected by the Tax Court in *Estate of Wall v. Comm'r*, 101 T.C. 300 (1993), which, applying the *Byrum* construction of "right," refused to accept the IRS's "underlying assumption . . that even a corporate trustee will be compelled to follow the bidding of a settlor who has the power to remove the trustee." On the contrary, the Tax Court wrote in *Wall*, "the trustee is accountable only to the beneficiaries, not to the settlor, and any right of action for breach of fiduciary duty lies in the beneficiaries, not in the settlor." Thus, the mere potential for the grantor to influence the trustee does not amount to an "ascertainable and legally enforceable power" as required by *Byrum*.

Conceding defeat, the IRS went on to issue Rev. Rul. 95-58. Although the revenue ruling does not officially abandon the theory of *de facto* powers, the ruling provides a safe harbor where *de facto* powers will not be considered to exist, despite a retained power to remove and replace a corporate trustee. The theory of *de facto* or attributed powers has since then essentially laid dormant.[i]

The IRS's Linked Attribution Theory in *Levine*

In *Levine*, the IRS first attempted to argue that the decedent died holding a taxable power *de jure*. In the particular context of the case, which involved a complicated generational-split dollar life insurance scheme, this means that the IRS's primary argument was that the decedent had a right, under default state contract law, to force an accelerated payment of life insurance cash surrender values to the decedent. That argument failed to persuade the Tax Court, which held instead that the decedent did not retain or possess a right to immediate payment but rather a mere power to persuade the holder of the policies to accelerate payment, which was insufficient to trigger inclusion under section 2036 or 2038.

That left the IRS to argue, as a fallback, for a revival of the long dormant theory of *de facto* attribution. According to the IRS, even if the decedent did *not* retain the legal right under the split-dollar arrangement to payment of the cash surrender value, the decedent should still be *deemed* to have retained the right as a practical matter. As the Tax Court assured the IRS in response to its argument, "we will look carefully to the particular circumstances of this transaction to see whether, as a practical matter on the facts of this case, Levine kept a right to the cash surrender values of the policies bought by the Insurance Trust."

In advancing its new attribution theory, the IRS could not simply relitigate its losses in *Wall* or *Byrum*. Instead, the IRS sought to distract from *Wall* and point to the peculiar circumstances in *Levine* that the same individual, one Robert Larson, served as both the decedent's attorney-in-fact and as a fiduciary of the irrevocable trust whose interests in the life insurance policies the taxpayer argued should be excluded from the gross estate. As the Tax Court described the IRS's position, this meant that the decedent "through her attorneys-in-fact . . had the power to surrender the policies at any time for their cash-surrender values."

The "Correct" Response to Linked Attribution

Relying on *Wall* and general principles of principal and agent relationships, the Tax Court should have made short work of the IRS's attribution argument. An attorney-in-fact, as the Court observed, stands in the shoes of the principal. That is, an attorney-in-fact who is duly authorized can take any action that the principal could. Conversely, an attorney-in-fact cannot assume rights or powers that the principal does not herself possess. As the taxpayer in *Levine* correctly observed in his reply brief, "the attorney-in-fact could not take any action under the 1996 Power of Attorney which the Decedent could not take herself." The decedent, as the Tax Court agreed, had no power to surrender the life insurance policies, and therefore, neither could any attorney-in-fact.

To overcome those weaknesses, the IRS devised a linked theory of attribution. According to this theory, Mr. Larson, as fiduciary of the irrevocable trust, owned the life insurance policies. He also, as attorney-in-fact, was answerable to the decedent. Thus, suggested the IRS, the decedent could, as a practical matter, influence Mr. Larson's decisions as a fiduciary of the trust. Mr. Larson's power as fiduciary of the trust, therefore, should be attributed to the decedent.

The problem with this linked attribution theory is that it is foreclosed by the Tax Court's own decision in *Wall*. In *Wall*, the decedent could have attempted to influence the trustee through a power of appointment, but had no legal right to force the trustee to exercise its powers in particular way. Indeed, the trustee's duties were owed not the decedent but to the beneficiaries of the trust. Likewise, the decedent in *Levine* could have attempted to influence the trust fiduciaries, but she had no legal right to force them to act. The *de facto* theory should have failed summarily in *Levine* just as it had in *Wall* and for the same reason: the decedent did not possess the powers in question, which in any event were required to be exercised for the benefit of beneficiaries other than the decedent.

The Tax Court's Actual Response

While the Tax Court held for the taxpayer, the IRS's argument went further than one might have expected. *Wall*, the controlling case, is not cited in the *Levine* decision at all. Instead, the Tax Court went on to compare Mr. Larson's fiduciary duties to the alleged duties of the decedents in family limited partnership cases, notably, *Estate of Strangi*, T.C. Memo 2003-145, and *Estate of Powell*, 148 T.C. 18 (2017). The duties owed by the decedents in *Strangi* and *Powell*, Judge Holmes reasoned, were only weak (if not illusory) constraints, whereas Mr. Larson's duties to the trust beneficiaries, including contingent remaindermen, were real and serious. Consequently, the Court held, Mr. Larson's powers as trust fiduciary could not be attributed to the decedent.

While Judge Holmes ultimately reached the correct result, his reasoning is a muddle that gives undeserved vitality to the linked attribution theory. It is true that both *Wall* and *Strangi/Powell* addressed the extent and implications of a fiduciary's duties. But the contexts were very different. In *Wall*, the decedent did *not* hold legally enforceable and otherwise taxable power, yet the IRS attempted to *attribute* a power to the decedent, notwithstanding the existence of the powerholder's fiduciary duties; by contrast, in *Strangi* and *Powell*, the decedent *did* hold a legally enforceable power, which the taxpayer attempted (unsuccessfully) to negate by pointing the existence of a fiduciary constraint.

The *Levine* situation is essentially the same as the situation in *Wall*. Mrs. Levine, like decedent in *Wall*, could not compel the fiduciaries of an irrevocable trust to take a particular action, a conclusion bolstered by the reality that the fiduciaries' owed duties to others. *Strangi* or *Powell*, by contrast, involved decedents who died holding powers to control distributions from family partnerships. As the decedents in *Strangi* and *Powell* indisputably held those powers, their estates were left to argue that the powers were too attenuated by the force of fiduciary duties to be considered taxable.

The Tax Court's decision in *Levine* to distinguish *Strangi* and *Powell* rather than simply apply *Wall* makes a difference. In *Wall*, it was not even clear that the existence of fiduciary duties was necessary to its outcome. After all, under *Byrum*, gross estate inclusion under section 2036(a)(2) (and, by extension, section 2038) requires a legally enforceable power. That the trustee in *Wall* owed fiduciary duties to the beneficiaries merely reinforced the conclusion that the decedent did not effectively have the powers of the trustee *de facto*. Even if the duties were relaxed (or even negated altogether), it was still the case in *Wall* that the decedent simply did not legally hold any trustee powers. The existence of the trustee's fiduciary duties confirmed what was already, at least arguably, a foregone conclusion.

Strangi and *Powell*, by contrast, required a fact-specific inquiry into exactly how much of a constraint was imposed by a decedent's alleged fiduciary duties. As it happens, in those cases, the duties owed to other partners of a family limited partnership were not sufficiently rigorous to defeat the application section 2036(a)(2). *Levine* reached the opposite conclusion and held that Mr. Larson's fiduciary duties were, unlike the duties owed in *Strangi* and *Powell*, serious enough to defeat the IRS's attribution theory.

That was a good outcome for the taxpayer in *Levine*. For other taxpayers and their advisors, however, it is regrettable that *Strangi-Powell* analysis has now been imported into law of attributed powers. No longer is the mere existence of a fiduciary duty a decisive consideration that prevents attribution of a fiduciary's powers to the decedent. From now on, under *Levine*, the fiduciary's duties must be sufficiently rigorous.

Exactly what standard of rigor is required remains unclear. *Strangi*, *Powell*, and now *Levine* require that the fiduciary's duties not be "illusory." As *Strangi* shows, however, illusoriness is easier for the IRS to establish than the term may suggest. In *Strangi*, after all, the decedent did owe duties to family members, but those were not considered sufficient to prevent gross estate inclusion. *Levine* held that duties owed to grandchildren (as opposed to Mrs. Levine's children) were enough to cause the fiduciary's duties to be sufficient to prevent gross estate inclusion. Larson's duties to the grandchildren evidently proved decisive because they were beneficiaries of the irrevocable trust that held the life insurance, whereas funds paid over to the decedent would, under the decedent's will and revocable trust, pass exclusively to the decedent's children.

In many cases, however, the beneficiaries of a decedent's testamentary estate are identical or virtually identical to the beneficiaries of a decedent's dynasty trust. Indeed, some wills and revocable trusts provide that assets remaining at death be paid over to the decedent's dynasty trust created during lifetime, which arguably eliminates any conflict. It remains to be seen whether, in those circumstances, the fiduciary duties of a trustee who also served as the decedent's attorney-in-fact should be considered "illusory." For better or worse, the overly fine distinction that Judge Holmes draws between the fiduciary duties in *Levine* and the duties in *Strangi* suggest they would.

Significance of Standing on Both Sides of a Transaction

Some practitioners may take comfort from the fact that *Levine* involved a contractual arrangement between the decedent and the irrevocable trust. This circumstance inspired the IRS to devise the linked attribution theory, in an effort to persuade the Tax Court that the decedent could effectively unwind the arrangement at any time. Practitioners may conclude, therefore, that linked attribution is only a worry in cases where an irrevocable trust and the decedent enter into a contractual arrangement.

It may be naive, however, to assume that linked attribution will not sweep more broadly. While Judge Holmes's decision focuses on whether the parties involved stood on both sides of the transaction, the decision suggests that a linked attribution analysis may be required in other contexts. As noted, for example, Judge Holmes starts off by promising "to look carefully to the particular circumstances" to see whether the decedent retains a taxable right. As long as any decedent's circumstances include the appointment of the same person or persons as attorneys-in-fact and as trustees of a dynasty trust, a linked attribution inquiry may be a possibility. Cautious practitioners will attempt to negate linked attribution in all circumstances, not just where there is a contract between the decedent and an irrevocable trust.

What Planners Should Do

Whatever the future holds, *Levine*, for taxpayers, is a doctrinal setback, if not a weapon in the hands of the IRS. Taxpayers and their advisors need to take *Levine* into account when considering possible estate tax consequences. Below are some suggestions on how to proceed.

Avoid multiple fiduciary hats. It seems that the IRS will only invoke the theory of linked attribution if the same person is serving as both an individual's attorney-in-fact (or trustee of a revocable trust for such individual) and as trustee of an irrevocable trust designed to pass free of estate tax at such individual's death. Wherever possible, the safest course is to appoint different persons for each role. Alternatively, to the extent that there is partial overlap in these roles, the relevant documents should be drafted to permit an agent or trustee's recusal from decisions that may implicate the theory.

Welcome conflicts between fiduciary duties. Where there is full alignment in the appointment of attorneys-in-fact and the trustee of an irrevocable trust, the decedent's will and revocable trust should direct that the decedent's remaining assets pass to persons other than the beneficiaries of the irrevocable trust. At minimum, a residuary "pour-over" bequest directly to the irrevocable trust should be avoided. In addition, as in *Levine*, the decedent's remaining assets could pass outright to children or to generations other than the beneficiaries of the dynast trust. As a further alternative, the decedent could choose to give a share of the probate estate, such as 5%, to charity (or other individuals) rather than 100% in trust for the same beneficiaries as the dynasty trust.

Savings clauses. It is common for trust instruments to contain savings clauses that negate potentially taxable powers, and for powers of attorney to include modifications. Such clauses might be updated to address the possibility of linked attribution. In concept, they would provide that that certain powers be voided to the extent they are given to a fiduciary wearing dual hats.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell
Jessica Soojian

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CITES:

Byrum v. U.S., 408 U.S. 125 (1972); *Estate of Wall v. Comm'r*, 101 T.C. 300 (1993); *Estate of Strangi*, T.C. Memo 2003-145; *Estate of Powell*, 148 T.C. 18 (2017); *Estate of Levine v. Comm’r*, 158 T.C. 2 (2022); Rev. Rul. 95-58.

CITATIONS:

[i] *But see* Zeydel, Is Designating an Independent Trustee a Tax Panacea?, 43 *Estate Planning 3* (2016) (discussing the implications of the recent *Wyly* and *Webber* cases).

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