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Answers to Questions Frequently Asked of the Advanced Markets Team

What is the effect of Section 2511(c) on Transfers to Trusts in 2010?

Background and Purpose of Section 2511(c)

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 added a new provision to the Internal Revenue Code, Section 2511(c), effective in 2010 only. This provision has raised many questions from commentators on its gift tax implications and effect. The specific language of Section 2511(c) states that: *“Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned [grantor trust] by the donor or the donor’s spouse”*.... It is generally believed that the purpose of this new Code section was to prevent taxpayers from shifting taxable income away while avoiding gift tax due to an incomplete gift to a non-grantor trust.

The original wording of Section 2511(c) applied to “transfers of property by gift under section 2503,” but was later amended to “transfer of property by gift” for clarification purposes. The result of the clarification, as articulated in a technical explanation memo by the Joint Committee on Taxation, is that the gift tax annual exclusion and marital and charitable deductions may apply to such transfers. Section 2511(c) will sunset on December 31, 2010, unless Congress acts to extend this provision before that date.

General Application of Section 2511(c)

Under Section 2511(c), all transfers made in 2010 to non-grantor trusts will be considered completed gifts, regardless of whether under pre-2010 rules such transfers would have been considered incomplete gifts or non-transfers for gift tax purposes. Here is an illustration that demonstrates how 2511(c) can apply:

Transfer of Property to Non-Grantor Trust

In 2010, Taxpayer transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as Taxpayer may decide. Under pre-2010 rules (See Treas. Reg § 25.2511-2(c)), the transfer of the remainder interest in the trust would not be treated as a completed gift. Under the current version of Section 2511(c), however, the entire value of the property will be treated as being transferred by gift.

Transfers to Wholly Owned Grantor Trusts in 2010

Unfortunately there is very little clarification and as yet no regulations to explain the application of Section 2511(c) to transfers to wholly owned grantor trusts in 2010. The technical explanation memo issued by the Joint Committee on Taxation only clarifies the effect of 2511(c) with respect to transfers to non-grantor trusts and does not address the effect of Section 2511(c) on wholly owned grantor trusts. As a result, there is much confusion surrounding the interpretation of 2511(c) as it applies to a transfer in trust that is treated as wholly owned by the donor or the donor’s spouse under the grantor trust rules of the Internal Revenue Code.

Below are two possible interpretations of Section 2511(c) as it applies to grantor trusts and commentary regarding such interpretations:

1. Section 2511(c) not applicable to transfers to grantor trusts

One possible interpretation of 2511(c) is that the language of this subsection may only be applicable to transfers to non-grantor trusts. If this interpretation is correct, then arguably transfers to grantor trusts in 2010 will need to be analyzed in the same manner as they would have been prior to the applicability of 2511(c). Consequently, transfers to wholly owned grantor trusts in 2010 may still be on the hook for gift tax if the transfer in trust would be considered a completed gift.

This interpretation of 2511(c) is bolstered by Congress' clear intent not to abolish the gift tax in 2010 despite the repeal of the estate and GST tax. If the language of 2511(c) was interpreted in a manner that allowed a Grantor to make a completed transfer of property to a grantor trust in 2010 without liability for gift tax, the assets transferred could potentially escape gift and estate tax and be a windfall for the taxpayer.

2. Transfers to grantor trusts are excluded from gift tax at time of transfer under Section 2511(c)

A second possible interpretation of Section 2511(c) is that a transfer to a grantor trust in 2010 will not be treated as a completed gift at the time of the transfer (and thus not taxable), regardless of whether it is a present interest gift. This interpretation appears to be risky and is not free from doubt because 2511(c) is silent regarding transfers to grantor trusts. As a matter of semantics, the statement that a transfer in trust is treated as a taxable gift "unless" the trust is a grantor trust is equivalent to a statement that if the trust is not a grantor trust, then the transfer is treated as a gift.

Transfer to trust is a taxable gift unless trust is a grantor trust = If trust is not a grantor trust then transfer is a taxable gift

This language, however, could be interpreted to mean that a transfer to a donor's wholly owned grantor trust will not be treated as a gift even though such transfer otherwise may have been treated as a gift under traditional principles. This interpretation of Section 2511(c) could have two different types of gift tax implications, as described below.

a. Transfer escapes gift tax altogether

One view based on the second possible interpretation is that the Grantor may receive a windfall by transferring property to a grantor trust in 2010, allowing the transfer to escape gift taxation altogether (i.e., presently and in the future). Under this viewpoint, it is not clear how basis in the property transferred would be determined because the transfer would not be treated as a transfer by gift (where the donee would take the donor's basis in the property) and would not qualify as a transfer by sale (where the purchaser's basis in the property would be the amount paid in consideration).

b. Transfer is a complete and taxable gift when trust becomes a non-grantor trust

Another view is that a transfer to a grantor trust will avoid gift tax at the time of the initial transfer but will be treated as a taxable gift when the trust is no longer defective for income-tax purposes (i.e. the trust becomes a non-grantor trust), which may occur during the Grantor's life or upon his death. This viewpoint appears to be more in line with the presumed purpose of Section 2511(c), which was to prevent a Grantor from being able to shift income away from him while avoiding the gift tax, because it would seemingly unify the gift and income tax rules concerning Grantor trust status and transfers to trusts. Consequently, a transfer to a grantor trust in 2010 would be treated as an incomplete gift because the donor would be deemed to have retained an interest in the trust under Sections 671–679. At such time when the trust is no longer considered a grantor trust under Sections 671–679, the donor would no longer retain an interest in the trust and a completed gift will be made at that time.

It is not clear under this analysis, however, whether a grantor trust that becomes a non-grantor trust due to the death of the Grantor will be includible in the donor's gross estate after 2010 when it is presumed that an estate tax will exist, or how transfers made in 2010 to grantor trusts will be treated if Section 2511(c) is retroactively repealed. Unfortunately, until further clarification or regulations are issued by the IRS, the applicability of 2511(c) to transfers to grantor trusts is an issue without a definitive answer.

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