IRC 2036- A Refresher

Take-Away: IRC 2036, one of the *string provisions* of the Tax Code, is something of a stealth provision that can trip up a sound estate plan. The scope of IRC 2036 is surprisingly broad, and it can lead to unexpected estate tax liability in not-so-obvious situations.

Background: IRC 2036 generally provides that if a transferor *retains* the power to possess or control the beneficial enjoyment, e.g., income from or use of an asset gifted into a trust, upon the death of the transferor that transferred interest will be included in the transferor's gross estate at its *date of death* value. This is the result even if the transfer was a completed gift to an irrevocable trust and the transferred interest had a lower value at the time of transfer, which is usually why the interest was initially transferred to the trust, to remove the asset and its future appreciation from the transferor's taxable estate.

IRC 2036: IRC 2036 is very broad in its coverage. The Regulations that interpret this Tax Code section are even broader in their sweep leading to estate inclusion. This Tax Code section provides (with *my* emphasis):

(a) The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth, by trust or otherwise,) under which he, the transferor, has retained for his life or for any period not ascertainable without reference to his death or any period which does not in fact end before his death- (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or income therefrom.

Regulations: The Regulations that interpret IRC 2036 note that it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, having an adverse interest, (ii) in what capacity the power was exercisable by the transferor or by another person or persons in conjunction with the transferor, and (iii) whether the exercise of the power was subject to a contingency beyond the transferor's control that did not occur before his death. [Regulation 20.2036-1(b)(3).] All of which loosely translated means that the IRS will be taking a close look at all lifetime transfers to 'reel back' the transferred asset(s) into the transferor's taxable estate if there is any semblance of a retained interest in the transferred asset.

Possession or Enjoyment-A Present Economic Benefit: IRC 2036(a)(1) is not dependent upon the existence of a *legally enforceable right* retained by the decedent. Instead, it applies a facts and circumstances 'test' that focuses on whether the decedent-transferor has retained a *substantially present economic benefit in the sense of benefiting or having the right to benefit from the property or income from the property,* or the trust to which the property was transferred.

Implied Understanding: IRC 2036 is often where the claim of an implied understanding appears. If the transferor does not have access to sufficient assets, after the transfer, e.g., assets held outside of the trust that was funded, to pay for his/her own living expenses, the IRS will claim that there was an implied understanding that the transferor could have access to the use of, or income from, the assets that he/she transferred. As a result, the implied understanding is inferred from the facts and circumstances that the decedent continued to indirectly have access to the transferred asset or its income for his/her own support and thus continued to have continued enjoyment of the asset or its income. *Estate of Albert Strangi, Tax Court Memo 2003-145, Tax Court Memo 2007-107* is a classic example of where most of the transferor's assets were given to a family limited partnership such that the only way he could continue to pay his bills was through the limited partnership that he allegedly did not control, but his children did.

Alone or in Conjunction With: Different from IRC 2036(a)(1), IRC 2036(a)(2) applies *only if* it can be established that the decedent-transferor had a *legally enforceable right recognized under applicable state law* to designate who would enjoy the property or the income from the transferred property (or the trust to which the property was transferred) *exercisable either alone or in conjunction with any other person.* Accordingly, requiring the consent of a non-adverse party, such as an independent trustee, will not prevent the application of IRC 2036(a)(2) if the decedent-transferor could have participated in exercising the 'designation right.' Courts have, however, recognized that this 'designation right' is not regarded as legally enforceable if it is sufficiently constrained by state law, such as by fiduciary duties. In sum, to prevent the application of IRC 2036(a)(2) the decedent's estate will have to show that the decedent did not have a legally enforceable designation right, or if the decedent did possess such a right, it was not freely exercisable because the right was limited by state fiduciary duties. [*United States v. Byrum, 408 U.S. 125 (1972).*]

Fiduciary Duty: In the *Estate of Nancy Powell, v. Commissioner, 148 Tax Court, 392 (2017)* fiduciary duties were found to be illusory and ineffective to protect against IRC 2036(a)(2), where a family member who was a general partner of a family limited partnership also was an attorney-in-fact acting under a general durable power of attorney given by the decedent. The Court found that the fiduciary duties, as a general partner, were illusory because they conflicted with the family member's duties to act in the decedent's best interests under the general durable power of attorney and because such fiduciary duties were nearly entirely owed to the decedent as the 99% owner of the partnership. Consequently, holding the transferor's durable power of attorney triggered IRC 2036(a)(2)'s acting 'in conjunction with' trap to cause estate inclusion (along with, admitted, many other 'bad' death-bed facts.)

Protective Steps: To protect assets of an LLC or a trust from the IRS's 2036 arguments, careful steps should be taken to avoid how it could be applied to a decedent's estate. If an LLC interest is transferred to a trust, often the case when the IRS asserts estate inclusion, consider the following:

1. Any LLC Operating Agreement or trust instrument should clearly demonstrate in their respective provisions that the settlor-transferor did not *retain,* directly or indirectly, any IRC 2036 rights or control over the LLC or the trust, or their assets or income. The Operating Agreement and trust instrument should be consistent in their terms regarding the transferor/settlor's lack of any retained control, directly or indirectly.

2. At all times there should be well-documented activities of the trust's administration that are consistent with the trust agreement, and of property management of the LLC in accordance with its Operating Agreement. The obvious goal is to avoid any appearance of an undisclosed 'implied agreement or understanding' with the transferor that he/she will benefit from the transferred assets.

3. If an LLC is involved, the managers of the LLC should have clearly defined duties and carry them out in accordance with the terms of the LLC's Operating Agreement, including provisions of the Agreement that establish a manager's clear fiduciary duties.

4. If the transferor continues to have some ownership interest in an LLC, or he/she serves as its manager, the Operating Agreement should prohibit the transferor from participating in any decisions that relate to the determination of allocations of income to or among the LLC members, the timing or amount of distributions from the LLC, the dissolution of the LLC, and in some cases transfers of interests in the LLC, or any amendment to the LLC Operating Agreement. The transferor continuing as the LLC manager in effect waives a red flag in front of the IRS.

5. A trustee who has authority to vote on decisions of the LLC that relate to the above-described decisions should not also serve as the personal attorney-in-fact of the settlor of the trust, since that will invoke the 'in conjunction with' trap of IRC 2036(a)(2).

Protecting against the imposition of federal estate tax under IRC 2036 can be challenging in a structure that involves a trust holding ownership interest in an LLC, particularly if the settlor also has some ownership of the LLC or decision-making power over it.

Conclusion: There has been a growing number and evolving estate inclusion cases by the Tax Court in recent years, where there is either an implied understanding for the transferor to have access to the transferred property or a right to control the enjoyment of its income. The *Powell* decision is an example of just how far the Tax Court will go to find IRC 2036 applicable. Executing an LLC Operating Agreement one day, executing a Trust instrument the next day, promptly transferring the LLC interests to the Trust the following day, and then returning to 'business as usual' the next without planning to provide proper attention to the administration of the LLC and the trust is when many estates run afoul of IRC 2036.

If you would like to read additional missives, click here.