Luke James Skywalker Irrevocable Trust

Information for Tax Professionals

General Information

The trustee of the Luke James Skywalker Irrevocable Trust may distribute income to the grantor and other “lifetime beneficiaries,” but is not required to do so. Undistributed income is accumulated with principal. No principal may be distributed to the grantor, but may be distributed to the lifetime beneficiaries.

The grantor has not retained a testamentary power of appointment, so has no power to change the remainder beneficiaries of the trust.

Gift Taxes

In general, with limited exceptions, a gift tax return needs to be filed in years in which a donor makes any transfer by gift.[[1]](#footnote-1) However, gifts can be either complete or incomplete, and the gift tax only applies to completed gifts.[[2]](#footnote-2)

Even though the grantor did not reserve a power of appointment over the trust assets, other provisions of the trust could give the grantor some power to change the disposition of trust property such that transfers to the trust would be incomplete gifts for gift tax purposes.[[3]](#footnote-3) If so, then no gift tax return needs to be filed by virtue of those transfers.

However, if the grantor made other completed gifts during the calendar year, then a gift tax return is required for those other gifts, and the transfers to the trust should be disclosed on that return with adequate disclosure of why the gifts are incomplete.[[4]](#footnote-4)

On the other hand, there does not appear to be anything in the tax code or regulations that would prevent reporting the transfers to the trust as completed gifts on a gift tax return, even if they are incomplete gifts. Put differently, nothing in the code or regulations seems to require a donor to contend that a gift is incomplete, it merely requires the donor to provide evidence showing all relevant facts *if* the donor makes the contention:

“If a donor contends that his retained power over property renders the gift incomplete . . . , the transaction should be disclosed in the return . . . and evidence showing all relevant facts . . . shall be submitted with the return.”[[5]](#footnote-5) Arguably, this language is permissive—it doesn’t require the donor to make the contention that the gift is incomplete.

It could be advantageous to report the transfers to the trust as completed gifts, especially if the trustee anticipates making distributions in subsequent years that exceed the annual gift tax exclusion amount, as those distributions would otherwise complete the gift, giving rise to the requirement to file a return in each of those years.[[6]](#footnote-6) Note that the trust is not making the gift—the gift tax does not apply to trusts—rather the distribution from the trust completes the gift from the grantor to the beneficiary.[[7]](#footnote-7)

And even if the trustee anticipates that distributions in subsequent years will be limited to the annual exclusion amount, ongoing administration of the trust is complicated by the requirement to analyze distributions from the trust each year to determine if they qualify for the annual exclusion.

Therefore, filing a gift tax return for the initial transfers and claiming them as completed gifts (or, more accurately, *not* contending that they are incomplete gifts) eliminates the need for annual analysis of the trust distributions for gift tax purposes. Note that reporting transfers as completed gifts on a gift tax return does not foreclose inclusion of the assets in the transferor’s estate and claiming an adjusted basis at death. See *Basis Adjustment at Death*, below.

Finally, it’s worth noting that the transfers to the trust don’t qualify for the annual gift tax exclusion because they are gifts of a future interest in property.[[8]](#footnote-8)

Income Taxes, Generally

In general, the grantor trust rules determine whether the grantor is treated as the owner of the trust (or portion of the trust) for income tax purposes.[[9]](#footnote-9) And if so, then the grantor is taxed on the income, regardless of who receives it or whether it stays in the trust.[[10]](#footnote-10)

Grantor trust status can be caused by provisions of the trust regardless of circumstances, or by provisions of the trust in combination with circumstances, such as the relationship of the trustee to the grantor.

While the Luke James Skywalker Irrevocable Trust is not specifically designed as a grantor trust, neither is it specifically designed as a nongrantor trust. Therefore, the starting point for analysis of the income taxation for the trust is with the terms of the trust, making an informed judgment as to whether any of those provisions on their own or in combination with circumstances—such as the relationship of the trustee to the grantor—trigger any of the grantor trust rules.

For example, because the Luke James Skywalker Irrevocable Trust allows the trustee to distribute income to the grantor, the trust might be a grantor trust as to that income, depending on whether the trustee is an adverse or nonadverse party.[[11]](#footnote-11) If the trustee is an adverse party, then the income interest does not cause grantor trust status; but if the trustee is the grantor or a nonadverse party, then you have grantor trust status. However, these provisions would only give us grantor trust status as to “income” that “may be distributed to the grantor.”[[12]](#footnote-12)

Because the Luke James Skywalker Irrevocable Trust relies on state law for capital gains allocation, if state law allows the trustee to allocate capital gains to income, these provisions would give us grantor trust status as to both ordinary income and capital gains if the trustee is the grantor or a nonadverse party.

Exclusion of Gain from Sale of Principal Residence

Under the tax code, $250,000 of gain from the sale of real property is excluded from gross income if the property was owned and used by the taxpayer as the taxpayer’s principal residence for 2 or more of the preceding 5 years.[[13]](#footnote-13) This is also true if a grantor trust owns the property and the taxpayer is treated as the owner of the trust under the grantor trust rules.[[14]](#footnote-14)

As discussed above, the Luke James Skywalker Irrevocable Trust could be a grantor trust. If so, the exclusion of gain remains available to the grantor.

Basis Adjustment at Death

In general, if property is included in a decedent’s gross estate, then its basis is adjusted to the date of death value.[[15]](#footnote-15) Note that reporting the initial transfers to the trust as completed gifts (see the discussion under *Gift Taxes*, above) does not foreclose estate inclusion.

For example, in CCM 201208026, the grantor retained a testamentary limited power of appointment, which causes estate inclusion.[[16]](#footnote-16) Yet the service concluded that the initial transfers to the trust were completed gifts. So in that case, you have both a completed gift and estate inclusion of the transferred assets. Further, the tax code makes it clear that a lifetime transfer could be both a completed gift and included in the transferor’s estate at death.[[17]](#footnote-17)

As it relates to the Luke James Skywalker Irrevocable Trust, the grantor has not retained a power of appointment, nor does the grantor have a right to the income of the trust, either of which would have caused estate inclusion.[[18]](#footnote-18) Therefore, as with the determination of grantor trust status, the starting point for analysis of estate inclusion and basis adjustment of the trust assets is with the terms of the trust, making an informed judgment as to whether any of those provisions cause estate inclusion.

If you have any questions regarding the tax implications or the filing of tax returns, please call upon us to help you.

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1. IRC 6019. IRC=Internal Revenue Code (Title 26 of the United States Code). [↑](#footnote-ref-1)
2. See, e.g., IRC 2702(a)(3)(B); TR 25.2511-1(c)(1), 25.2511-2(f). TR=Treasury Regulations (Title 26 of the Code of Federal Regulations). [↑](#footnote-ref-2)
3. TR 25.2511-2(b). [↑](#footnote-ref-3)
4. TR 25.6019-3(a). [↑](#footnote-ref-4)
5. TR 25.6019-3(a); see also TR 301.6501(c)-1(f)(5), which seems to permit reporting incomplete gifts as completed gifts: “For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as determined under section 6501(b).” [↑](#footnote-ref-5)
6. TR 25.2511-1(g)(1). [↑](#footnote-ref-6)
7. TR 25.6019-1(e), 25.2511-1(g)(1). [↑](#footnote-ref-7)
8. IRC 2503(b)(1). [↑](#footnote-ref-8)
9. IRC 671–679. [↑](#footnote-ref-9)
10. IRC 671. [↑](#footnote-ref-10)
11. IRC 677(a). [↑](#footnote-ref-11)
12. IRC 677(a)(1). [↑](#footnote-ref-12)
13. IRC 121(a), (b)(1). [↑](#footnote-ref-13)
14. TR 1.121-1(c)(3)(i). [↑](#footnote-ref-14)
15. IRC 1014(a)(1), (b)(9). [↑](#footnote-ref-15)
16. IRC 2038(a)(1). [↑](#footnote-ref-16)
17. See, e.g., IRC 2012(a): “If a tax on a gift has been paid under chapter 12 . . . and thereafter on the death of the donor any amount in respect of such gift is required to be included in the value of the gross estate of the decedent for purposes of this chapter, then there shall be credited against the tax imposed by section 2001 the amount of the tax paid on a gift under chapter 12 . . . .” [↑](#footnote-ref-17)
18. IRC 2038(a)(1), 2036(a)(1). [↑](#footnote-ref-18)