

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **201208026**

Release Date: 2/24/2012

CC:PSI:04:DSRyan
POSTF-120621-11

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 2511.04-00, 2503.03-00

date: SEPTEMBER 28, 2011

to: Frances F. Regan
Area Counsel (CC:SB:1)

Mary P. Hamilton
Senior Attorney (CC:SB:1:BOS:2)

from: Curt G. Wilson
Associate Chief Counsel (CC:PSI)

subject:

This memorandum responds to your request for assistance. This document may not be used or cited as precedent.

LEGEND

Donor A =
Donor B =
Donors =
Trust =
Date =
Child A =
Child B =
State =
Other Forum Rules =
Other Forum =

Cite 1 =

Cite 2 =

Cite 3 =

Cite 4 =

Cite 5 =

Cite 6 =

ISSUES

1. Whether the Donors made completed gifts on transferring property to the Trust.
2. Whether annual exclusions are allowable under I.R.C. § 2503(b) for the withdrawal rights provided in the Trust.

CONCLUSIONS

1. On transferring the property to the Trust, the Donors made completed gifts of the beneficial term interests.
2. The withdrawal rights are unenforceable and illusory. No annual exclusion is allowable under I.R.C. § 2503(b) for the purported withdrawal rights.

FACTS

Donor A and Donor B (Donors) gratuitously transferred property to a trust (Trust) on Date and designated their adult child, Child A, as the sole trustee. The Trust beneficiaries are the Donors' children, other lineal descendants, and their spouses. The Trust will terminate when both Donors have died.

The Trust provisions

The Trust states that it is irrevocable, and that the Donors renounce any power to determine or control the beneficial enjoyment of Trust income or principal. However, the Trust provides the Donors with testamentary limited powers of appointment. If the Donors do not exercise their testamentary powers, the property remaining in the Trust at termination will be distributed to Child A and Child B.

The trustee, Child A, has absolute and unreviewable discretion in administering the Trust for the benefit of the Donors' children, other lineal descendants, and their spouses (beneficial term interests). Income and principal may be distributed at any time for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for any other purpose. Income and principal may also be distributed to a charitable organization.

Each beneficiary may withdraw an amount of property (based on the § 2503(b) annual exclusion amount) in any year in which a transfer is made to the Trust. However, this may be voided by the trustee for additions made to the Trust.

The Trust provides that the construction, validity, and administration of the Trust are to be determined by State law, but provision is made for Other Forum Rules. Specifically, all questions and disputes concerning the Trust must be submitted to the Other Forum that is charged with enforcing the Trust. A beneficiary filing or participating in a civil proceeding to enforce the Trust will be excluded from any further participation in the Trust.

LAW AND ANALYSIS

ISSUE 1:

The Donors' representative contends that, because the Donors retained testamentary limited powers of appointment over the Trust, they retained dominion and control over the transferred property. Therefore, they did not make any completed gifts.

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift by any individual. Under § 2502(c), the gift tax imposed under § 2501 is the liability of the donor.

Section 2511 provides that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-2(a) provides, in part, that the gift tax is an excise upon the donor's act of making the transfer and is measured by the value of the property passing from the donor.

Section 25.2511-2(b) provides, in part, that as to any property or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, the gift is complete.

Section 25.2511-2(b) further provides, in part, that, if upon a transfer of property the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

Section 25.2511-2(c) provides, in part, that a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves (unless the power is a fiduciary power limited by a fixed or ascertainable standard). The relinquishment or

termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply.

In Chanler v. Kelsey, 205 U.S. 466 (1907), the Supreme Court considered, in part, the legal interest that is subject to a testamentary power of appointment. In that case, a grantor created a trust providing a lifetime income interest for his daughter. The trust also provided the daughter with a testamentary limited power to appoint the trust property. If she failed to exercise the power when she died, the trust property was to be distributed to designated persons. The Court held that, for New York inheritance tax purposes, the daughter's execution of her testamentary power was considered "the source of title" to the remainder. As the holder of a testamentary power of appointment, she controlled the remainder passing at her death. See 205 U.S. at 474.

Though it predates the enactment of the gift tax, the Chanler opinion supports the proposition that a testamentary power of appointment relates to the remainder of a trust, not the preceding beneficial term interests. The testamentary power does not (and cannot) affect the trust beneficiaries' rights and interests in the property during the trust term. Rather, a trustee with complete discretion to distribute income and principal to the term beneficiaries may, in exercising his discretion, distribute some or all of the trust property during the trust term. The holder of a testamentary power has no authority to control or alter these distributions because his power relates only to the remainder, i.e., the property that will still be in the trust when the beneficial term interests are terminated. See Bowe-Parker, Page on the Law of Wills § 45.12 (1962). See also Bittker and Lokken, Federal Taxation of Income, Estate and Gifts ¶ 226.6.7 (2011); Howard M. Zaritsky, Tax Planning for Family Wealth Transfers (4th ed. 2011 Cum. Supp. No. 2) ¶ 3.03[1].

From the time the gift tax was enacted, taxpayers have contested the issue of when a donor parts with dominion and control so as to make a completed gift. For example, in Sanford's Estate v. Commissioner, 308 U.S. 39 (1939), the grantor, in 1913, transferred property to a trust for others. He reserved (i) a revocation power exercisable at any time during his life to retrieve the property and thereby terminate every beneficial interest; and (ii) a modification power exercisable at any time during his life to terminate or change every beneficial interest. In 1919, the grantor relinquished his revocation power, but he retained his modification power. In 1924, he relinquished his modification power. The Court held that notwithstanding the grantor's creation of the trust and relinquishment of his revocation power, he retained dominion and control over the disposition of the trust property until he renounced his power to modify the trust. Consequently, the grantor made a taxable gift in 1924 when he relinquished his modification power. See Burnett v. Guggenheim, 288 U.S. 280 (1933).

Following Sanford's Estate, the Supreme Court considered various situations in which a trust instrument purported to divest the respective grantor of all dominion and

control over property to the extent that the property could not be returned to the grantor except by reason of contingencies beyond his control. In these cases, the Court noted that the respective grantor lost all economic control upon making the transfer, which he would not regain unless certain contingencies occurred. The Court concluded that the respective gifts were complete except for the value of the retained rights. Smith v. Shaughnessy, 318 U.S. 176 (1943); Robinette v. Helvering, 318 U.S. 184 (1943); Estate of Kolb v. Commissioner, 5 T.C. 588 (1945). See § 25.2511-2(c).

Consistent with Chanler v. Kelsey, the Service has maintained in litigation that a power holder's testamentary limited power of appointment relates only to the remainder of the respective trust. See Poinier v. Commissioner, 858 F.2d 917 (3d Cir. 1988) (testamentary power holder's renunciation of her power relates to the remainder), aff'g 86 T.C. 478 (1986). See also Robinson v. Commissioner, 675 F.2d 774 (5th Cir. 1982) (grantor's power to change the beneficiaries who would receive trust property when her lifetime income interest terminated constituted a gift of the remainder), aff'g 75 T.C. 346 (1980). See Smith v. Shaughnessy, supra (right to receive income during the trust term and testamentary power to appoint the remainder are separate and severable interests).

In the case at hand, when each Donor transferred property to the Trust on Date, he or she retained a testamentary limited power to appoint so much of it as would still be in the Trust at his or her death.¹ The Trust emphasizes that the Donors do not retain any powers or rights to affect the beneficial term interests of their children, other issue, and their spouses (and charities) during the Trust term. With respect to those interests, the Donors fully divested themselves of dominion and control of the property when they transferred the property to the Trust on Date. Indeed, during the period extending from the creation of the Trust until the Donors' deaths, the trustee, Child A, has sole and unquestionable discretion to distribute income and principal to the beneficial term interests. He may even terminate the Trust by distributing all of the property.

Accordingly, for gift tax purposes, the Donors' transfers to the Trust constituted a completed gift of the beneficial term interests. The Donors' testamentary limited powers of appointment relate only to the Trust remainder. Their relinquishment of their testamentary powers during the Trust term would affect only the ultimate disposition of the remainder and, as such, would constitute a transfer of the remainder. Bittker and Lokken, Federal Taxation of Income, Estates and Gifts ¶ 126.6.7 (2011).

¹ We note that the Trust has conflicting provisions. In one provision, the Donors emphatically renounce any power to determine or control the beneficial enjoyment of the Trust, but other provisions state that the Donors have testamentary limited powers of appointment. Under State law, generally, if two provisions conflict and cannot be reconciled, the latter provision is considered to indicate the grantor's subsequent intention, and that provision prevails. That is the rule unless the general scope of the trust leads to a contrary conclusion. Cite 1. We believe that the highest court of State would conclude that the Donors intended to retain the testamentary limited powers and, thus, did so.

ISSUE 2:

The Donors' representative contends that, if the Donors made completed gifts on Date, the gifts were of minority interests to the beneficiaries equal in value to their respective withdrawal rights (Crummey Powers). Therefore, the gift tax exclusions allowable under § 2503(b) effectively reduced the amount of taxable gifts to zero.

The withdrawal rights are not legally enforceable and thus are not present interests

Section 2503(a) provides, in part, that the term "taxable gifts" means the total amount of gifts made during the calendar year.

Section 2503(b) provides, in part, that in the case of gifts (other than gifts of future interests in property) made to any person during the calendar year, the first \$10,000 of such gifts to such person shall not, for purposes of § 2503(a), be included in the total amount of gifts made during such year.

Section 25.2503-3(a) provides, in part, that no part of the value of a gift of a future interest may be excluded in determining the total amount of gifts. An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property is a present interest in property.

To be a present interest, a withdrawal right must be legally enforceable. For example, if a trust provides for withdrawal rights, and the trustee refuses to comply with a beneficiary's withdrawal demand, the beneficiary must be able to go before a state court to enforce it. See Cristofani v. Commissioner, 97 T.C. 74 (1991); Restatement of the Law of Trusts § 197 (Nature of Remedies of Beneficiary); Bogert, Trusts and Trustees Vol. 41, § 861 (Remedies of the Beneficiary and Trustee).

As a matter of public policy, the federal courts are the proper venue for determining an individual's federal tax status, and the federal courts are not bound by the determinations of a private forum (such as Other Forum) concerning such status. Alford v. United States, 116 F.3d 334 (8th Cir. 1997). Likewise, as a matter of public policy, a State court will not take judicial notice of a private forum's (or group's or sect's) construction and determination of State law pertaining to a trust agreement, such as the Trust in this case. Cite 2. These determinations are strictly within the purview of the State courts. Cite 3; Cite 4.

Under State law, a trust clause may prohibit a beneficiary from seeking civil redress. Cite 5. Although the State legislature made a public policy decision to allow a beneficiary to make certain inquiries without fear of risking forfeiture, these "safe harbors" are not relevant here. Cite 6.

Under the terms of the Trust in this case, a beneficiary cannot enforce his withdrawal right in a State court. He may only press his demand before an Other Forum and be subject to the Other Forum's Rules. Notwithstanding any provisions in the Trust to the contrary, the Other Forum will not recognize State or federal law. If the beneficiary proceeds to a State court, his existing right to income and/or principal for his health, education, maintenance and support will immediately terminate. He will not receive any income or principal for his marriage, to buy a home or business, to enter a trade, or for any other purpose. He will not have withdrawal rights in the future, and his contingent inheritance rights will be extinguished. Thus, a beneficiary faces dire consequences if he seeks legal redress. As a practical matter, a beneficiary is foreclosed from enforcing his withdrawal right in a State court of law or equity.

Withdrawal rights such as these are not the legally enforceable rights necessary to constitute a present interest. Because the threat of severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory. Consequently, no annual exclusion under § 2503(b) is allowable for any of the withdrawal rights. See Rev. Rul. 85-24, 1985-1 C.B. 329; Rev. Rul. 81-7, 1981-1 C.B. 474.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is our belief that § 2702 applies in valuing the gifts in this case. Section 2702 provides special valuation rules with respect to transfers of interests in trusts. Generally, under § 2702(a)(2), the value of any retained interest which is not a qualified interest shall be treated as being zero. Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under § 25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors' gift is the full value of the transferred property.

If additions were made to the Trust, annual exclusions are not allowable for withdrawal rights relating to the additions because the trustee can void those rights after an addition is made. Section 25.2503-3(c), Example (1) and Example (3).

Please note, however, that our belief in this regard carries certain hazards to the extent further study is required. Should you wish to pursue this argument, please coordinate with the National Office.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Deborah S. Ryan at (202) 622-4045 if you have any further questions.

Sincerely,

Associate Chief Counsel
(Passthroughs & Special Industries)

By:

Leslie H. Finlow
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Passthroughs & Special Industries)