

Estate & Succession Planning Corner

By *Lawrence I. Richman*

The IRS Reconsiders Its Rulings on Incomplete Gift Nongrantor Trusts



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In IR 2007-127, the IRS announced it was reconsidering the ruling position it had taken in a series of private letter rulings,¹ which concluded that the nongrantor beneficiary/members of trust distribution committees do not possess a general power of appointment by reason of their joint distribution power. The announcement is important because it represents a broadside attack on the critical path taken by practitioners in structuring irrevocable trusts, which are incomplete gifts on the part of the trust's grantor, to be recognized as separate taxpayers for income tax purposes.

We initially reviewed the structure in my March–April 2006 column entitled *How to Structure an Incomplete Gift in Trust So That the Trust is NOT a Grantor Trust*.² In that column we examined the ruling position of the IRS. In those rulings, a grantor established an irrevocable trust for the benefit of the grantor and certain designated individuals. Distributions could be made to one or more of the grantor and the designated individuals by a Distribution or Appointment Committee. That committee consists of either two of the designated individual beneficiaries or one of the designated individual beneficiaries and the grantor. If a member of the Distribution or Appointment Committee is unable or unwilling to serve, another designated individual beneficiary is named to the Distribution or Appointment Committee, so that there is always a successor member acting and more than one member of such committee is acting at all times. In order to support the fact that the Grantor's gift is not complete upon formation of the irrevocable trust, the grantor retains a testamentary limited power of appointment.



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The income and gift tax consequences of an irrevocable trust structured along these lines was recently discussed in LTR 200729025.³ In that private letter ruling, the Distribution Committee was labeled the Power of Appointment Committee. It consisted of three of the five current beneficiaries of the trust: namely, the Grantor's sister, said sister's daughter and said sister's stepdaughter. The other two current beneficiaries of the trust were the grantor and the grantor's spouse. The provisions regarding the Power of Appointment Committee provided that at all times its members were to include at least two persons who are beneficiaries of the trust and that neither the Grantor nor the Grantor's spouse (or any future spouse of the Grantor) were to be members of said committee. If one of the three designated members of the Power of Appointment Committee were to predecease the Grantor, then the Grantor's eldest living descendant who also was a beneficiary of the Trust was designated a successor member of the Power of Appointment Committee.

In LTR 200729025, the IRS cited the statutory provisions of the grantor trust rules under Code Secs. 673, 674, 676 and 677 regarding adverse parties and concluded that none of the circumstances or administrative controls that would cause the Grantor to be treated as the owner of the trust for income tax purposes was present. On the gift tax issue, the IRS concluded that the grantor's retention of a testamentary limited power of appointment caused the grantor's gift to be incomplete upon the creation of the trust. The IRS then considered whether the members of the Power of Appointment Committee (who had the right to effect distributions to any one or more of themselves) possess a taxable general power of appointment. It considered the provisions of Code Sec. 2514(c)(3)(B), which provides that a power is not a taxable general power of appointment if the power cannot be exercised by its possessor except in conjunction with a person having a substantial interest in the property that is adverse to the exercise of the power in favor of the possessor.

Significantly, the private letter ruling cites the provisions of Code Sec. 2514(c)(3)(B), which provides that a person is deemed to have a substantial adverse interest to the exercise of the possessor's power if after

the death of the possessor such person may possess a power of appointment over the same property. Of equal importance is the ruling's citation to Reg. §25.2514-3(b)(2), which provides that a co-holder of a power of appointment does not have an adverse interest simply on account of the co-holder's status as a joint possessor of a power of appointment and as a permissible appointee unless the co-holder permissible appointee will possess the power after the possessor's death and at that time may exercise it in favor of himself, his estate, his creditors or the creditors of his estate.

In concluding that the members of the Power of Appointment Committee do not have a taxable general power of appointment and will not be treated as making a taxable gift if Trust income or corpus is distributed to the Grantor by them, the ruling ignores the fact that under the Trust structure posited there cannot be a situation in which any one member

(the surviving co-holder in the regulation) will ever have a taxable general power of appointment. The ruling cites the Code provision and the regulation that implicitly require that ultimately a co-holder be economically benefited in order for adversity to exist under Code Sec. 2514.

Indeed, in its July 9, 2007 release, the IRS noted this apparent inconsistency and also cited its ruling position in Rev. Rul. 76-503⁴ and Rev. Rul. 77-158.⁵ The critical element in those revenue rulings, which caused the IRS to rule that the powers held by those who controlled the distributions of the trust were taxable general powers of appointment, was that the trust distribution committee members were replaced should they resign or die. In Rev. Rul. 76-503, three cousins were co-trustees and beneficiaries of a trust established by their respective parents. Each co-trustee was authorized to name a successor to themselves if they died or resigned. The ruling was issued to address the question of what portion of the trust, if any, was includible under Code Sec. 2041 in the estate of one of the co-trustees upon the death of such co-trustee.

Rev. Rul. 76-503 explains that the Code and Regulations provide that if three people jointly hold a power of appointment they are adverse to its exercise if upon the death of one of the co-holders

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the surviving co-holders will be able to exercise by themselves the power in their own favor. The IRS reasons that in such a circumstance it is in the economic interest of whoever will be the survivor or survivors not to exercise the power in favor of any other powerholder during their lifetime because, like in the television show, the last survivor wins. In Rev. Rul. 76-503, the IRS explains that if a powerholder is replaced upon ceasing to act, the fact that there is a replacement means that the other powerholders are not necessarily in a better position after the original powerholder ceases to act; simply put, there never is a winner in the “game” of survivor: no surviving powerholder takes all or stands to profit by refusing to make a distribution to a co-holder of the power. Accordingly, the IRS concluded in said revenue ruling that co-holders of a power of appointment who must continue to share their power with a replacement holder upon the death of a current holder lack a substantial interest in property that is adverse to the exercise of the power in favor of any other co-holder.

Given that a co-holder is a permissible appointee of the trust holder, the IRS ruled that upon the death of a co-holder of a power the portion of the trust estate includible in the decedent’s gross estate equals the fair market value of the trust estate as of the date of death divided by the number of co-holders of the power.

A year later, in Rev. Rul. 77-158,⁶ the IRS clarified the fact that whether the three co-trustees were required to vote unanimously (as in the 1976 ruling) or by majority vote (as in the 1977 ruling) in order to effect a distribution to the beneficiaries (including themselves) was irrelevant to its conclusion that unless a co-trustee powerholder is in a better economic position after the death of one of the co-trustee powerholders no substantial interest in the trust property exists that is adverse to its exercise in favor of a deceased co-trustee/co-powerholder and each of the co-trustees is deemed to possess a taxable general power of appointment.

The tension between these 1976 and 1977 revenue rulings and the many private letter rulings involving distribution committees issued during the past several years with the same non-taxable powerholder conclusion reflected in recent LTR 200729025 is apparent, and is the reason for the July 2007 release. In response to that release, the AICPA commented (1) that the private letter rulings involve the power of appointment gift tax rules under Code Sec. 2514

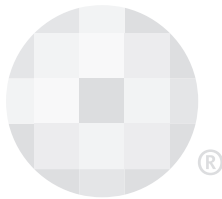
instead of the power of appointment estate tax rules under Code Sec. 2041 discussed in the revenue rulings and (2) that in the private letter rulings the grantor’s gifts were incomplete, whereas in the revenue rulings the trusts represented completed gifts. The AICPA concluded that given the different Code sections involved and the different facts, that it was not necessary to reconcile the private letter rulings and the revenue rulings.

As a matter of tax policy, however, neither the Code nor the Regulations preclude there being two transfer tax consequences flowing from a single event. In other words, if the revenue rulings apply to the Distribution Committees as described in the private letter rulings and the Distribution Committees were modified to bring them into compliance with the revenue rulings by not providing for successor members if a member of such committee was unable or unwilling to act, then, if such committees were to make a distribution to a beneficiary other than the grantor, that distribution would be a taxable release of the power of appointment by the members of the Distribution Committee (other than to the member of such committee who was the recipient of the distribution) and also would be deemed a gift by the grantor to the recipient of the distribution. If the grantor were the recipient of a distribution from the Distribution Committee, the IRS could take the position that even though the grantor had not made a gift to himself the members of the Distribution Committee had made a taxable gift to the grantor. The alternatives of keeping the Distribution Committee structure in place with successors as described in the private letter rulings or requiring that all distributions of the Distribution Committee be made pursuant to a strict or ascertainable standard under Code Sec. 2514(c)(1) may be a solution to the taxable power of appointment issue. However, if the rights and powers of the Distribution Committee are not deemed adverse to the Grantor, then the nongrantor trust status of the trust and its existence as a separate taxpayer apart from the Grantor is at risk.

By asking for comments on the gift tax consequences of trusts employing Distribution Committees in its July 9, 2007 news release, the IRS has placed taxpayers on notice of the serious tax issues that may not have been fully or properly considered in a series of recent private letter rulings approving nongrantor trust status for trusts employing a Distribution Committee structure when the grantor’s gift to the trust was incomplete for gift tax purposes.

ENDNOTES

- ¹ IRS News Release, IR-2007-127, Jul. 9, 2007. See, e.g., LTRs 200247013 (Aug. 14, 2002); 200502014 (Sept. 17, 2004); 200612002 (Nov. 23, 2005); 200637025 (June 5, 2005); 200647001 (Aug. 7, 2006); 200715005 (Jan. 3, 2007), 200729025 (Apr. 10, 2007) and 200731019 (May 1, 2007).
- ² Lawrence I. Richman, Estate & Succession Planning Corner, *How to Structure an Incomplete Gift in Trust So That the Trust is NOT a Grantor Trust*, J. PASSTHROUGH ENTITIES, Mar.-Apr. 2006, at 5.
- ³ LTR 200729025, Apr. 10, 2007.
- ⁴ Rev. Rul. 76-503, 1976-2 CB 275.
- ⁵ Rev. Rul. 77-97, 1977-1 CB 285.
- ⁶ Rev. Rul. 77-158, 1977-1 CB 285.



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