

Estate & Succession Planning Corner

By Lawrence I. Richman

The IRS Shifts Its Approach to Incomplete Gifts and the Annual Exclusion

Few aspects of gift planning are as important as whether a gift is complete or incomplete for transfer tax purposes and whether a gift qualifies for the annual exclusion.

Recently the IRS Chief Counsel Office issued ILM (Internal Legal Memorandum, sometimes also cited as a CCA) 201208026. The ILM addresses a situation in which two donors, presumably a husband and wife, established an irrevocable trust naming their adult child as the sole trustee. The beneficiaries of the irrevocable trust were the donors' children, grandchildren and other lineal descendants and their spouses. The trust terminates as a single trust when neither donor is living.

Although the trust agreement states that the trust is irrevocable, each donor apparently had a testamentary limited power of appointment (the scope of which is not mentioned in the ILM). If neither donor exercised such donor's retained testamentary limited power of appointment the trust is to terminate at the death of the second donor and is to be distributed to the child who is the Trustee and to another child (presumably one half to each).

While not discussed in the ILM, it would appear that the child who is both beneficiary and trustee possesses a general power of appointment. The ILM states that "The trustee, Child A, has absolute and unreviewable discretion in administering the Trust for the benefit of the Donors' children ... Income and principal may be distributed at any time for a beneficiary's health, education ... or for any other purpose."¹

The ILM also states that with respect to transfers made to the trust the beneficiaries may withdraw amounts transferred to the trust annually, based



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upon the current annual exclusion amount. Curiously, however, the beneficiary's right to withdraw the annual exclusion amount may be voided by the trustee, as opposed to the donors having the right to impose conditions on their gift or to determine who among the beneficiaries might exercise the rights of withdrawal.

Also significant is the fact that the trust apparently included arbitration and no-contest provisions; the ILM states that questions and disputes regarding the trust were subject to "Other Forum Rules" and that "a beneficiary filing or participating in a civil proceeding to enforce the Trust will be excluded from any further participation in the Trust."²

The issues addressed in the ILM were (1) whether the donors' retention of testamentary limited powers of appointment rendered their gifts to the trust incomplete and (2) whether the withdrawal rights of the beneficiaries were legally sufficient for purposes of the annual exclusion under Code Sec. 2053(b). The IRS Chief Counsel Office took the position that the donors' retention of limited powers of appointment in the instant situation, absent any other retained powers, did NOT cause the gifts to the trust to be incomplete. Accordingly, all transfers to the trust were completed gifts by the donors for gift tax purposes. Furthermore, no annual exclusion for gifts of a present interest would be allowed for the transfers because the withdrawal rights were determined not to be legally enforceable.

The conclusion that the donors' retention of a limited power of appointment did not cause the gift to be incomplete appears contrary to interpretations of Treasury Regulations and to previously issued private letter rulings. For example, in LTR 9021017, the IRS expressly stated "the retention of the [limited] power [of appointment] is sufficient, *in and of itself*, to render the transfer to the trust wholly incomplete for federal gift tax purposes."³ That private letter ruling was consistent with Reg. §25.2511-2(c) which states that "A gift is also 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 ..."⁴

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However, it should be noted that Reg. §25.2511-2(e), provides that a donor is only considered to have a power if the power is not exercisable in conjunction with any person having a substantial adverse interest. In the instant situation, the IRS could have taken the position that the rights of the donor's child trustee-beneficiary to distribute to himself the entire trust in such child's unreviewable discretion (*i.e.*, the child-trustee's general power of appointment) created a substantial adverse interest, which trumped the transfer tax significance of the donor's limited power of appointment.

Instead, the ILM relied on a 1907 Supreme Court decision⁵ to conclude that a testamentary power of appointment affects the remainder interest in a trust and not the beneficial term interest, thereby causing the term interest to be a completed gift. In

valuing the completed gift of the term interest, the IRS relied upon Code Sec. 2702. Since the donors had not retained a qualified interest under Code. Sec. 2702, the IRS concluded that the value of the donors' gift was the full value of the transferred property.

With respect to the inapplicability of the gift tax annual exclusion in the instant situation, the ILM reached its conclusion that the withdrawal rights were not legally enforceable because the trust precluded the beneficiaries from being able to go before a state court to enforce their rights of withdrawal. The ILM states: "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 a determination of a private forum (such as Other Forum) concerning such status."⁶ While perhaps overstating the inaccessibility of any redress in a state or federal court, the ILM accurately assesses the chilling effect of an *in terrorem* clause on a beneficiary's decision making process. "Because the threat of a severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory."⁷

Notwithstanding a certain amount of questionable reasoning, ILM 201208026 provides practitioners with important guidance relevant to today's planning.

- Going forward, practitioners should consider the advisability of including something more than the retention of a testamentary limited power of appointment in order to render a gift incomplete for federal transfer tax purposes. One suggestion is to include as an additional provision a power in the donors to veto trust distributions to beneficiaries, so as to demonstrate that the donors have retained an ability to shift benefits among beneficiaries during the term interest.
- Arbitration, mediation and no-contest clauses in trust documents may adversely affect the availability of present interest gift tax treatment. The IRS has provided a note of caution to practitioners regarding the potential adverse tax consequences to alternative dispute-resolution approaches.

Finally, the ILM is just that, an Internal Legal Memorandum. If the IRS formally adopts its approach it could have significant consequences going forward. In the interim, practitioners will need to stay tuned for further developments.

ENDNOTES

- ¹ CCA 201208026 (Sept. 28, 2011).
- ² *Id.*
- ³ LTR 9021017 (Feb. 22, 1990), brackets and emphasis added.
- ⁴ Reg. §25.2511-2(c).
- ⁵ *W.A. Chanler v. O. Kelsey*, SCt, 205 US 466, 27 SCt 550, 51 L.Ed. 552 (1907).
- ⁶ CCA 201208026 (Sept. 28, 2011).
- ⁷ *Id.*



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