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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
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Date:  
August 27, 2001

Legend

Trust =

Grantor =

This responds to a letter dated November 13, 2000, and subsequent correspondence, submitted on behalf of X, requesting rulings on the proper tax treatment of the income of an irrevocable trust ("Trust") under section 671 of the Internal Revenue Code and the federal gift tax consequences of contributions to the Trust.

Facts

Grantor proposes to establish an irrevocable Trust which will be funded by inter vivos and testamentary transfers. The Trust provides for one trustee (Trustee) and two members of a Distribution Committee. Article 1.1 provides that during the lifetime of the Grantor ("Initial Term"), the Trustee shall have no power or authority to make any distribution of net income or principal of the trust estate, to, or for the benefit of, any trust beneficiary at any time when any person is serving as a member of the Distribution Committee unless the distribution is made at the direction of the Distribution Committee. Distributions may be made to the Grantor, the Grantor's Spouse or any of the descendants of the Grantor's parents.

Article 3.6 provides that the initial members of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). At all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). During the Initial Term, the Distribution Committee shall direct the Trustee with regard to (i) all discretionary distributions from the Trust estate to beneficiaries, and (ii) certain of the Trustee's powers. The Trustee is authorized and directed to follow the direction of the Distribution Committee. All rights and powers conferred on the Distribution Committee shall be exercisable only by unanimous action

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of all members of the Distribution Committee except that any member of the Distribution Committee acting alone may direct the Trustee to make one or more distributions upon obtaining the Grantor's prior written consent to each such distribution and filing such consent with the Trustee.

The Trust lasts during the lifetime of the Grantor. Under Article 1.2, upon the death of the Grantor, income and principal of the Trust estate, as it is then constituted shall be transferred, conveyed and paid over to such person or persons then eligible to receive distributions out of the Trust estate, other than the Grantor, as the Grantor appoints by the Grantor's will. To the extent all, or any portion of the income and principal of the Trust estate is not so effectively appointed, such income and principal shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for each child of the Grantor who is then living, and one such share for the collective descendants who are then living of any child of the Grantor who is not then living. From each such share so set aside for the collective descendants who are then living of any child of the Grantor who is not then living there shall be set aside per stirpital parts for such descendants. If no descendant of the Grantor is living at the death of the Grantor, the income and principal of the Trust, to the extent not effectively appointed, shall be distributed, free from Trust, to the then living descendants per stirpes, of the Grantor's parents.

Article 1.3 provides that the Grantor may, at any time during the Grantor's life release the Grantor's right to receive discretionary distributions of income and principal from the trust estate, the right to consent to distributions as described in Article 3.6, and/or the power of appointment described in Article 1.2, and may limit the persons or entities in whose favor the power of appointment described in Article 1.2 may be exercised. Article 1.3 further provides that notwithstanding any of the foregoing or any other provision of this Agreement, the Grantor shall have no power or authority to change the class of persons eligible to receive distributions during the Initial Term (except to cause the Grantor personally to be excluded from the class by releasing the Grantor's own right to be eligible to receive such distributions.)

## Law and Analysis

### Issue 1

Section 671 provides the general rule that in cases where the grantor or another person is regarded as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or such other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits against the tax of an individual.

Section 672(a) defines adverse party as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or

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nonexercise of the power which he possesses respecting the trust.

Section 673 through 678 set forth the conditions under which a grantor or other persons will be treated as the owner of a trust and taxed on the trust income.

Section 673 provides generally that the grantor of a trust shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent of the value of such portion.

Section 674 provides generally that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 675 provides generally that the grantor shall be treated as the owner of any portion of a trust in respect of which the grantor or a nonadverse party has certain administrative powers. The administrative powers enumerated in section 675(1) and (2) are the powers exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, to deal with or dispose of the trust corpus or income for less than adequate consideration and to borrow the trust corpus or income without adequate interest or security unless authorized to make loans to any person without regard to interest or security.

Section 675(3) provides that under certain circumstances the grantor shall be treated as the owner of any portion of a trust where the grantor has borrowed trust corpus or income.

Section 675(4) provides that the grantor shall be treated as the owner of a portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

Section 676(a) provides that the grantor shall be treated as the owner of any portion of a trust, where at any time the power to revert in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not treated as such owner under section 674, whose income, without the approval or consent of any adverse party, or both, may be distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

Section 678(a)(1) provides a general rule that a person other than a grantor shall

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be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.

Because of the discretion of the Distribution Committee, acting together, or singly with the consent of the Grantor, to make distributions from income and/or corpus to one or more of the beneficiaries which includes the members of the Distribution Committee, the members of the Distribution Committee have a substantial beneficial interest in both the income and corpus portions of the Trust. Any distribution that the Grantor wishes to make from assets contributed to the Trust by that Grantor, could be made only if one of the members of the Distribution Committee agrees. Since each of the two Distribution Committee members is a potential recipient of Trust distributions, a consent to a distribution could adversely affect that individual's beneficial interest in the Trust. Thus, with respect to the Grantor, both of the members of the Distribution Committee are adverse parties within the meaning of section 672(a).

The requirement in Article 3.6 that the initial members, and any current or successor member of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate and that at all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of Trust estate, ensures that the Grantor will not be able to act independently of an adverse party. The restrictions on the powers of the Trustee preclude the Trustee from independently controlling distributions or making loans without the consent of an adverse party.

The Grantor does not have a reversionary interest in excess of five percent in any portion of the Trust. Accordingly, section 673 does not apply to treat Grantor as owner of any portion of the Trust. Because control over the beneficial enjoyment of, and any distributions of, income and corpus is exercisable by the Grantor, only with the consent of a Distribution Committee member, who is an adverse party, Grantor will not be treated as the owner of any portion of the Trust under section 674 or section 677. The Trust agreement does not authorize any of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of the grantor under section 675. Section 676 does not apply to Grantor because Grantor cannot revest title in the Grantor in any portion of the Trust. Section 678 is not applicable since none of the trustees and no other person will have a power exercisable solely by that person to vest the corpus or income of the Trust in that person.

## Issue 2

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift.

Section 2511 provides that the gift tax shall apply whether the transfer is in trust

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or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, is deemed to be a transfer of property by the individual possessing the power for gift tax purposes. Section 2514(c) defines the term "general power of appointment" as a power which is exercisable in favor of the individual possessing the power (the possessor), his estate, his creditors, or the creditors of his estate. However, under section 2514(c)(1), a power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is not a general power of appointment.

Section 25.2514-1(c)(1) of the Gift Tax Regulations provides that a power of appointment is not a general power if by its terms it is exercisable only in favor of one or more designated persons or classes other than the possessor or his creditors, or the possessor's estate or the creditors of his estate.

Section 25.2511-2(c) provides that a gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title in himself or herself. 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 unless the power is a fiduciary power limited by a fixed or ascertainable standard.

Section 25.2511-2(f) provides that the relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by death of the donor, is regarded as the event which completes the gift and causes the gift tax to apply.

Section 25.2514-3(c)(1) provides that the general principles set forth in section 25.2511-2 for determining whether a donor of property (or of a property right or interest) has divested himself or herself of all or any portion of an interest therein to the extent necessary to effect a completed gift are applicable in determining whether the release or exercise of a power of appointment is subject to the gift tax. Thus, if a power of appointment is released so that thereafter the donor may still appoint among a limited class of persons not including himself or herself, the release does not effect a completed gift. Under these circumstances, the possessor of the power has retained the right to designate the ultimate beneficiaries of the property over which he or she holds the power. Since it is only the termination of such control which completes the gift under section 25.2511-2, the release is not subject to gift tax under section 2514.

In Estate of Sanford v. Commissioner, 308 U.S. 39 (1939), the taxpayer created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust

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in whole or in part, and to designate new beneficiaries other than himself. Six years later, in 1919, the taxpayer relinquished his power to revoke the trust. However, the taxpayer continued to retain his right to change the beneficiaries. In 1924, the taxpayer relinquished his right to change the beneficiaries.

In Estate of Sanford, the issue presented to the Court was whether the taxpayer's gift was complete upon i) his creation of the trust, ii) his relinquishment, in 1919, of the right of revocation, or iii) his later relinquishment, in 1924, of the right to change the beneficiaries. The Court held that a donor's gift is not complete, for purposes of the gift tax, when the donor has reserved the power to determine those others who would ultimately receive the property. Accordingly, the Court concluded that the taxpayer's gift was complete in 1924, when he relinquished his right to change the beneficiaries of the trust.

Thus, in Estate of Sanford, the Court inferentially found that, even though the taxpayer could not change the terms of the trust for his own benefit, the taxpayer nevertheless continued to possess dominion and control over the trust property by reason of his retained right to change the beneficiaries of the trust. See also, section 25.2511-2(c).

Under section 2514, only the exercise or release of a general power of appointment (rather than a limited power of appointment) is subject to gift tax. However, when a person transfers property and retains a limited power to appoint the property to others, the person's retention of the limited power of appointment is a retention of dominion and control over the transferred property, for purposes of the gift tax. Consequently, under those circumstances, the person's exercise or relinquishment of the limited power of appointment is subject to the gift tax under section 2511. Section 25.2511-2(f).

In the present case, Grantor proposes to irrevocably transfer property to the Trust. Grantor will retain a limited power to appoint Trust property (and accumulated income) to other family members. By reason of Grantor's limited power of appointment, Grantor will have the power to change the beneficiaries of Trust. Therefore, for purposes of the gift tax, Grantor will continue to possess dominion and control over the property transferred to Trust and the irrevocable transfer to Trust will not be a completed gift. Estate of Sanford v. Commissioner, supra; section 25.2511-2(f).

#### Conclusion

Accordingly, based on the representations made and the information submitted, we rule as follows:

1. So long as the Distribution Committee is serving, Grantor will not be treated as the owner pursuant to section 671, of any portion of the Trust under sections 673, 674, 675, 676, 677, and 678.

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2. Grantor's transfer to the Trust will not be a completed gift for purposes of section 2501.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including the federal tax consequences of the formation or operation of the Trust under the provisions of any other section of the Code. The rulings are subject to the condition that there are no changes in the applicable law prior to the date of the transfers to the Trust or the death of the Grantor.

A copy of this letter should be attached to the federal tax return of the Trust for the taxable year in which it is established. A copy is enclosed for that purpose.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,  
David R. Haglund  
Senior Technician Reviewer, Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure (2)  
copy of this letter  
copy for section 6110 purposes