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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2-PLR-124396-02

Date:

August 14, 2002

Trust =

A =

Trustee =

Dear :

This letter responds to a letter April 25, 2002, and subsequent correspondence, submitted on behalf of Trust, requesting rulings on the proper tax treatment of the income of an irrevocable trust ("Trust") under § 671 of the Internal Revenue Code and the federal gift tax consequences of contributions to Trust .

The information submitted states that A proposes to establish Trust, an irrevocable trust, which will be funded with intervivos transfers. The initial trustee will be Trustee.

FACTS

Article Second, paragraph 2.1 of Trust, provides that during A's lifetime, Trustee will pay over or apply the net income and principal thereof to such extent (if any), including the whole thereof, and in such amounts and proportions, including all to one to the exclusion of the others, and at such times or times and in such manner or manners as the Distribution Committee, in its exercise of sole and absolute discretion, shall determine, to or for the benefit of such one or more of (i) the descendants of A's parents as shall be living at the time of such payment or application; and (ii) any organization described in § 501(c)(3) of the Internal Revenue Code, or any successor thereto. Any net income not so paid over or applied (which may be the whole of such

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income) shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed of as a part thereof.

Article Second, paragraph 2.2 of Trust, provides that the Distribution Committee shall direct Trust with regard to all discretionary distributions of net income and principal from the trust estate to the beneficiaries, and the Trustee shall make no distribution other than as directed by the Distribution Committee.

Article Second, paragraph 2.3 of Trust, provides that the Distribution Committee shall have the sole and absolute authority to exercise any discretion over payments, distributions, applications, uses or accumulations of trust income or principal to or for the benefit of the beneficiaries.

Article Second, paragraph 2.4 of Trust, provides that the initial members of the Distribution Committee will be A's brother and sister. At all times during A's lifetime, the Distribution Committee will be composed of two beneficiaries of Trust, other than A.

Article Second, paragraph 2.5 of Trust, provides that all rights and powers conferred on the Distribution Committee shall be exercisable only by the unanimous consent of all members of the Distribution Committee, except that either member of the Distribution Committee, acting alone, may direct Trustee to make one or more distributions upon obtaining A's prior written consent to each such distribution.

Article Second, paragraph 2.6 of Trust, provides that during A's lifetime, A may at any time release her testamentary power of appointment. A may, at any time during her life, limit the person or entities in whose favor said power of appointment may be exercised.

Article Third of Trust provides that upon the death of A, the income and principal of the Trust shall be transferred, conveyed and paid over to such person or persons (other than A, her estate, her creditors and the creditors of her estate) to such extent, in such amount or proportions, and in such lawful interests or estates, whether absolute or in trust as A may appoint by her will by specific reference to this power and, to the extent not so effectually appointed, shall be divided into per stirpital shares for the descendants of A.

LAW and ANALYSIS

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

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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 party having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

Sections 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 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 § 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 revest 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 § 674, whose income,

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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 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.

Due to the discretion of the Distribution Committee, acting together, or singly with the consent of A, 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 the corpus portions of Trust. Any distribution that A wishes to make from assets contributed to Trust by A, 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 Trust. Thus with respect to A, both of the members of the Distribution Committee are adverse parties within the meaning of § 672(a).

The requirement in Article Second, paragraph 2.4 of Trust that at all times during A's lifetime, the Distribution Committee will be composed of two beneficiaries of Trust, who are either descendants of A's parents, other than A, or an organization described in § 501(c)(3), ensures that A will not be able to act independently of an adverse party.

A does not have a reversionary interest in excess of five percent in any portion of Trust. Accordingly, § 673 does not apply to treat A as the owner of any portion of Trust. Because control over the beneficial enjoyment of, and any distributions of, income and corpus is exercisable by A only with the consent of a Distribution Committee member, who is an adverse party, A will not be treated as the owner of any portion of Trust under § 674 or § 677. Trust does not authorize any of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of A under § 675. Section 676 does not apply to A because A cannot revest title in A in any portion of 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 Trust in that person.

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

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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.

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 the estate.

Section 25.2511-2(c) provides 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 interest 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 (the statute being confined to transfers by living donors), is regarded as the event which completes the gift and causes the gift tax to apply. See also § 25.2514-3(c)(1). The receipt of income or other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the “calendar period” (as defined in § 25.2502-1(c)(1)).

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 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.

In the present case, A proposes to make inter vivos transfers of property to an irrevocable Trust. Under Trust, A possesses a limited testamentary power to appoint Trust principal (and accumulated income) to persons other than A, her creditors, her estate, or the creditors of her estate. By reason of A's limited power of appointment, A will have the power to change the beneficiaries of Trust. Therefore, for purposes of the gift tax, A will continue to possess dominion and control over the property transferred to Trust and the inter vivos transfers of property to Trust will not be completed gifts. Section 25.2511-2(c). However, when the Distribution Committee distributes Trust property to a beneficiary other than the A or if, during her lifetime, A releases her testamentary power to appoint the Trust property, the gifts will be complete. Section 25.2511-2(f).

CONCLUSION

Accordingly, based on the representations made and the information submitted, we conclude that so long as the Distribution Committee is serving, A will not be treated as the owner pursuant to § 671 of any portion of Trust under §§ 673, 674, 675, 676, 677, and 678. Additionally, we conclude that the inter vivos transfers of property by A to Trust will not be completed gifts for purposes of § 2501 until the Distribution Committee or a member of the Distribution Committee acting with the consent of A distributes Trust property to a Trust beneficiary, other than A or if, during her lifetime, A releases her testamentary power to appoint the Trust property.

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 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 Trust or the death of A.

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

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

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Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to A.

Sincerely yours,

CAROLYN HINCHMAN GRAY
Senior Legal Counsel, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes