

## Private Letter Rulings 201310002-201310006 (March 8, 2013)

**Favorable “DING Trust” Letter Rulings; Confirmation of IRS’s Position That Settlor’s Retention of Testamentary Power of Appointment Does Not Necessarily Cause Full Transfer to Trust to be Incomplete Gift**

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## Synopsis

“Delaware Incomplete Non-Grantor” Trusts (commonly referred to as “DING Trusts”) are trusts used to avoid state income tax by having the trust situated in a jurisdiction that will not tax the accumulated income and capital gains in a non-grantor trust. (However, the state income tax savings will have to be balanced against the higher federal income tax rates and the 3.8% Medicare tax that applies to undistributed trust income over the low threshold of \$11,950 if the settlor would not have been subject to those taxes if the trust had not been created.) No DING Trust rulings have been issued for five years. The status of DING trust rulings has been in doubt for several reasons, but apparently the IRS is now comfortable issuing rulings, at least with for trusts structured like the one in PLRs 201310002-201310006. While these identical rulings are favorable, they do confirm the position suggested in CCA 201208026 that a settlor’s retention of a testamentary power of appointment over a trust does not render the full transfer to the trust as an incomplete gift.

The rulings all involve identical fact situations. Grantor created an irrevocable trust of which Grantor and his issue were discretionary beneficiaries. There was a corporate trustee, who was required to distribute income or principal at the direction of a distribution committee or principal upon direction from Grantor. The distribution committee consists of Grantor and each of his four sons. There must always be at least two “eligible Individuals” serving as distribution committee members. Three alternative methods are provided for distribution directions: (1) *Grantor consent power*-distribute income or principal upon direction of a majority of the distribution committee members with the written consent of Grantor; (2) *Unanimous member power*-distribute income or principal upon direction by all distribution committee members other than Grantor; and (3) *Grantor’s sole power*-distribute principal to any of Grantor’s issue (not to Grantor, and not income) upon direction from Grantor as Grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

The IRS gave four favorable rulings. (1) The trust is not a grantor trust. (2) The transfer to the trust is an incomplete gift by Grantor (for various reasons listed in the ruling). (3) A direction by distribution committee members to make distributions to Grantor is not a completed gift by the committee members (because it is merely treated as a return of Grantor’s property). (4) A direction by distribution committee members to make distributions to persons other than Grantor is not a completed gift by the committee members because the distribution power is held jointly by persons having interests that are adverse to each other.

The IRS did not explain its reasoning in any depth with respect to various issues. For example, the IRS did provide any explanation at all as how it resolved questions that it had raised in a release in 2007 about how Revenue Rulings 76-503 and 77-158 might apply to these types of trusts. Accordingly, persons creating DING Trusts will likely want to obtain their own private letter rulings before making any significant transfers to the trusts.

## Background

“Delaware Incomplete Non-Grantor” Trusts are trusts used to avoid state income tax by having the trust situated in a jurisdiction that will not tax the accumulated and capital gains income in a non-grantor trust. (Income of a grantor trust would presumably be subject to tax in the state of the grantor’s residence.) The trust is merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 40% rate) to have an argument of avoiding state income taxes at a much lower rate.

The DING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor's lifetime. The grantor retains a testamentary limited power of appointment. Various rulings have ruled that the transfer to the trust is an incomplete gift for gift tax purposes, and some have also ruled that the distribution committee members do not have gift tax consequences. E.g., PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005.

No DING Trust rulings have been issued for five years. The status of DING Trust rulings has been in doubt for several reasons.

- a. *Gift tax consequences for distribution committee members.* IR-2007-127 (July 9, 2007) announced that the IRS was reconsidering its position in these rulings with respect to the gift tax consequences of trust committee members. The IRS expressed concern that the prior letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158. The IRS announcement says that those Revenue Rulings indicate that “because the committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust corpus.” The ABA Real Property Trusts and Estate Law Section submitted comments to the IRS on September 26, 2007. The letter was prepared by prominent members of the estate planning bar, including Jonathan Blattmachr, Prof. Mitchell Gans, Carlyn McCaffrey, Diana Zeydel, and others. The letter concludes that the DING PLRs are not inconsistent with Rev. Ruls. 76-503 and 77-158 (or 79-63). The letter points out various distinctions, and that the co-powerholders in the DING rulings situations have considerably more adversity to each other than the co-powerholders in the revenue rulings. It also points out that the regulation at issue does not necessarily require succession to a power on the powerholder's death to create adversity; it merely gives that as an additional way that a co-holder of a power can be deemed to be adverse if his only interest in the trust is as a co-holder of a power. In addition, it reasons that no one can have a general power of appointment over property the transfer of which is incomplete (addressing a revenue ruling, a case and several PLRs that might arguably be inconsistent with that proposition). As a corollary to this argument, the letter states that if the original donor has not made a gift to a beneficiary, the beneficiary should not be able to make a gift back to the donor by agreeing to a distribution to the grantor.
- b. *Incomplete gift treatment for grantor.* CCA 201208026 concluded that retained testamentary powers of appointment over a trust under which the grantors were not beneficiaries cause the *remainder interest* to be an incomplete gift, but concluded that the testamentary powers of appointment relate only to the remainder interest. During the grantors' lifetimes, they had no ability to keep the trustee from making distributions among the potential trust beneficiaries — which might potentially include all of the trust assets. Therefore, the CCA reasoned that the gift was complete as to the “beneficial term interest” that existed before the grantors' deaths — but was an incomplete gift as to the remainder interest. (Reg. §25.2511-2(b) states that if the donor is the discretionary income beneficiary, a retained testamentary power of appointment causes the transfer to the trust to be an incomplete gift.) The issue then became to determine the relative values of the term interest (a completed gift) and the remainder interest (an incomplete gift). The CCA reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to “applicable family members”) was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest was the full value transferred to the

trust. CCA 201208026 raised concerns that merely reserving a testamentary limited power of appointment in the grantor may be insufficient by itself to cause the transfer to a DING trust to be an incomplete gift by the grantor.

### Private Letter Rulings 201310002-201310006 Analysis

PLRs 201310002-201310006, issued March 8, 2013, address the grantor trust and gift tax issues for DING trusts.

The trusts are believed to be Nevada DING trusts (though the rulings do not state explicitly that they are Nevada trusts) Based on local law limitations, it is clear that this cannot be a Delaware trust, as discussed in paragraph b.(1) below regarding Grantor's sole power over principal.

The rulings all involve identical fact situations, and the rulings are identical (except that PLR 201310003 inadvertently [apparently] deleted a phrase in the paragraph about Grantor's Consent Power in the discussion of Rulings 2 and 3).

- a. *Basic Facts.* Grantor created an irrevocable trust of which Grantor and his issue were discretionary beneficiaries. There was a corporate trustee, who was required to distribute income or principal at the direction of a distribution committee or principal upon direction from Grantor. The distribution committee consists of Grantor and each of his four sons. Three alternative methods are provided for distribution directions: (1) *Grantor consent power*-distribute income or principal upon direction of a majority of the distribution committee members with the written consent of Grantor; (2) *Unanimous member power*-distribute income or principal upon direction by all distribution committee members other than Grantor; and (3) *Grantor's sole power*-distribute principal to any of Grantor's issue (not to Grantor, and not income) upon direction from Grantor as Grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

There must always be two "eligible Individuals" (defined) serving as distribution committee members. "A vacancy on the Distribution Committee" must be filled by the eldest of Grantor's adult issue other than then serving members of the committee (with alternate successors if there are no such surviving adult issue). (The rulings do not clarify whether this is interpreted to mean that a vacancy occurs when any member ceases to serve or only when there are less than two members serving. Some commentators say that a distribution committee member is not replaced unless there is only one remaining committee member, and that this provision may be important in resolving the IRS's concern that prior DING rulings may be inconsistent with Rev. Ruls. 76-503 and 77-158. Under this reasoning, it is not clear whether the distribution committee members would have a general power of appointment once the committee has been reduced to only two individuals. *See Bill Lipkind on PLR 201310002: DING Redux*, Leimberg Est. Pl. Email Newsletter #2076 (March 12, 2013).) The distribution committee ceases to exist upon Grantor's death.

There is a decanting power, authorizing the distribution committee to distribute assets to qualified trusts. Grantor has a testamentary power of appointment to appoint the assets to any persons or entities other than Grantor's estate, creditors, or creditors of the estate. In default of exercise of the power appointment, the assets will pass to the issue of Grantor's deceased father.

b. *Rulings.* The IRS gave four important rulings.

- (1) *Non-Grantor Trust.* The trust is not a grantor trust. Without any explanatory analysis, the ruling merely concludes that §§673, 674, 676, and 677 do not apply. Whether §675 applies is a question of fact to be determined when federal income tax returns of the parties are filed. Section 678 does not apply because no beneficiary can unilaterally vest trust income or corpus in himself.

Section 674(a) provides that a grantor is treated as the owner of any portion of a trust for which the beneficial enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, *without the approval or consent of any adverse party*. Similarly, §§676(a) and 677(a) provides that a grantor is treated as the owner of a trust subject to certain other powers that can be exercised without the approval of an adverse party. Section 672(a) provides that for purposes of the grantor trust rules, the term “adverse party” means any person 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. With respect to the grantor consent power and unanimous member power, distributions can be made only with the consent of an adverse party. (The rulings do not specifically reason that the distribution committee members are adverse to the grantor for this income tax purpose, but that must be the basis of the rulings’ conclusion. Observe that the rulings conclude that the distribution committee members are NOT adverse to Grantor for gift tax purposes, as discussed in the discussion below regarding the impact of Grantor’s consent power on the issue of whether the transfer to the trusts is an incomplete gift by Grantor.)

With respect to the “Grantor’s sole power” alternative, the grantor has the power to distribute principal (*not income*) in a nonfiduciary capacity (the nonfiduciary capacity element is important as a basis for finding that the transfer to the trust is not a completed gift by Grantor, as explained below), §674(b)(5)(A) has an exception for the power to distribute corpus that is limited by reasonably definite standard.

- (2) *Incomplete Gift by Grantor.* The rulings give four reasons that Grantor does not make a completed gift upon creation of the trust.
- *Grantor’s consent power.* Under Reg. §25.2511-2(b) a gift is complete if the donor “has so part with dominion and control as to leave him in no power to change its disposition.” Grantor’s consent power is deemed to be such a power over disposition (which makes the gift incomplete), because a donor is considered as having a power exercisable in conjunction with someone else as long as the other person does not have a substantial adverse interest in the disposition of the transferred property. Reg. § 25.2511-2(e). The rulings conclude that the other distribution committee members do not have interests adverse to Grantor for this purpose. Reg. §25.2511-2(e) does not define “substantial adverse interest,” but Reg. §25.2514-3(b)(2) states that a “taker in default of appointment under a power has an interest which is adverse to an exercise of the power.” The ruling gives no explanation as to why the four sons are not deemed to be “takers in default” if a distribution is not made. (Perhaps it is because of Grantor’s retained testamentary limited power of appointment, so that none of the four sons could be assured of receiving any undistributed trust assets, but the rulings do not discuss that reasoning.) The next two sentences of Reg. §25.2514-3(b)(2) state:

“A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor’s death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate.”

Rather than treating this as merely a possible method of showing adversity, the rulings reason that continued holding of the power after the “possessor’s death is a *prerequisite* to showing adversity by the coholder of a power:

“Under §25.2514-3(b)(2), a coholder of a power is *only considered as having an adverse interest* where he may possess the power after the possessor’s death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. In this case, the Distribution Committee ceases to exist upon Grantor’s death. Accordingly, the Distribution Committee members do not have interests adverse to Grantor under §25.2514-3(b)(2) and for purposes of §25.2511-2(e).” (Emphasis added).

The comments submitted to the IRS by the ABA Real Property Trusts and Estate Law Section on September 26, 2007 take the position that the regulation does not necessarily require succession to a power on the power holder’s death to create adversity, but merely gives that as an additional way that a coholder of the power can be deemed to be adverse if his only interest in the trust is as a coholder of the power.

In any event, the rulings conclude that Grantor’s consent power (i.e., the ability to join with the other distribution committee members in making distributions by consenting to distributions that a majority of the distribution committee members want to make) “causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes.”

- *Grantor’s sole power over principal.* Grantor’s sole power to make distributions (for health, maintenance, support or education) causes the transfer property to the trust to be “wholly incomplete” for federal gift tax purposes. The rulings do not specifically discuss how this provision cause the transfer to be “wholly incomplete” even though it is only a power over principal and not income. The rulings do not discuss regulations providing that a transfer will not be incomplete for gift tax purposes if the donor has a power to change beneficial interest but the power is held in a fiduciary capacity and is subject to a “fixed and ascertainable standard.” Reg. §§25.2511-2(c) & 25.2511-2(g). In this situation, however, Grantor’s authority to direct distributions was held in a nonfiduciary capacity. Interestingly, the IRS treats whether a grantor holds a substitution power in a nonfiduciary capacity for purposes of §675(4)(C) as a question of fact to be determined in each year for income tax purposes. The IRS gave no analysis of whether Grantor actually held the power in a nonfiduciary capacity as a factual matter.

Grantor’s sole power over principal in effect gives Grantor a lifetime power of appointment. CCA 201208026, discussed immediately below, held that a mere testamentary power of appointment caused the trust to be incomplete only as to the remainder interest. A lifetime power of appointment in effect would cause the transfer to be incomplete as to the term interest as well prior to the termination of the trust.

However, if including this provision is essential to cause incomplete gift treatment, the plan could not be used in states such as Delaware that do not permit the grantor to retain a lifetime power of appointment in order for a self-settled trust to be protected from claims of the grantor's creditors (and if the grantor's creditors can reach the trust, it would be a grantor trust). *See* Delaware Qualified Dispositions in Trust Act §§3570(11)b.2 & 3571.

- *Grantor's testamentary limited power of appointment.* The rulings reiterate the limitation under CCA 201208026 on incompleteness by retaining a testamentary limited power of appointment. The rulings state that the testamentary power of appointment causes "a retention of dominion and control over the remainder," and concludes that the retention of the testamentary power causes the transfer of property to the trust to be incomplete "with respect to the remainder" for federal gift tax purposes. Accordingly, retaining a testamentary limited power of appointment would not, under the reasoning of these rulings or CCA 201208026, cause a transfer to be incomplete as to the term interest prior to the termination of the trust.
  - *Unanimous member power does not remove Grantor's dominion and control.* Grantor retains dominion and control over the income and principal until the distribution committee members exercise their unanimous member power. Therefore the existence of the unanimous member power does not remove Grantor's ability to shift beneficial interests under the other two alternatives for giving distribution directions to the trustee (thereby causing the gift upon transfer property to the trust to be incomplete).
- (3) *No Completed Gift by Distribution Committee Members Upon Making Distribution to Grantor.* The rulings reason very simply that "[a]ny distribution from Trust to Grantor is merely a return of Grantor's property. Therefore, we conclude that any distribution of property by the Distribution Committee from Trust to Grantor will not be a completed gift subject to federal gift tax, by any member of the Distribution Committee." (This adopts the reasoning of the comments from the ABA Real Property Trusts and Estate Law Section submitted on September 26, 2007.)
- (4) *No Completed Gift by Distribution Committee Members Upon Making Distribution to Another Person Other Than Grantor.* The issue is whether distribution committee members have general powers of appointment; if so, the exercise or release of a general power of appointment is treated as a transfer by the individual possessing the power under §2514(b). The rulings conclude that the distribution committee members do not have general powers of appointment. Distribution committee members can participate in distribution decisions under the (1) Grantor's consent power, or (2) Unanimous member power.
- With respect to the Grantor's consent power, §2514(c)(3)(A) provides that if the power is exercisable only in conjunction with the creator of the power, it is not deemed a general power of appointment.
  - With respect to the unanimous member powers, §2514(c)(3)(B) provides that a power is not a general power of appointment if it can be exercised only "in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise of the power in favor of the possessor." The rulings rely on the statement in the regulations quoted above about the coholder of a power having an



adverse interest if the coholder may exercise the power after the possessor's death in favor of himself, his estate, his creditors, or the creditors of his estate. Reg. §25.2514-3(b)(2). That regulation goes on to provide an example:

“Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of person which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y.”

For example, under the facts of the rulings, if the distribution committee directs a distribution to Son 1, the sons are considered adverse to each other as to that decision, so the power to make a distribution, held jointly with the other sons, is not a general power of appointment. If a distribution committee member ceases to serve, the remaining distribution committee members continue to serve. Contrast the reasoning as to this issue with the reasoning regarding the issue of whether the “Grantor consent power” results in an incomplete gift by Grantor. For purposes of that issue, the sons were not considered to have an interest adverse to Grantor because their jointly held powers do not continue after Grantor's death. However, as to the interests of the sons among themselves, a son's jointly held power to make distributions does not cease to exist at the death of any of the other sons.

The IRS had expressed concern in IR-2007-127 that the prior favorable DING Trust letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 because those rulings suggest that because distribution committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust corpus. PLRs 201310002-201310006 do not give any indication whatsoever how the IRS resolved that issue, or whether particular attributes of the trusts involved in the rulings were central to the IRS's favorable ruling as to this power of appointment issue.

- (5) *Miscellaneous Observations.* The rulings make various miscellaneous observations in addition to the formal rulings described above. (a) The fair market value of the trust assets is includible in Grantor's gross estate for federal estate tax purposes. (b) Any distribution to any beneficiary other than Grantor will be a gift by Grantor for federal gift tax purposes. (c) The rulings specifically decline to express an opinion about the effect of the decanting authority to make distributions to other trusts.