NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report Responding to IR-2007-127, Request for Comments Regarding General Powers of Appointment Under IRC Section 2514

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Report No. 1134

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I. INTRODUCTION

This report[1] (the **"Report"**) responds to the request of the Internal Revenue Service (the "**Service**") Office of the Chief Counsel in IR-2007-127 (the "**Request**") for comments regarding whether the conclusion reached in several private letter rulings (the "**PLRs**")[2] that certain individuals with discretionary powers to distribute trust income and principal (including to themselves) do not possess general powers of appointment is consistent with prior published Revenue Rulings.[3] The Request also indicates that it has been suggested that the nature of the underlying transfer to the trust as an incomplete gift affects the analysis. The Request invites suggestions for a substantially similar trust structure that would achieve the intended income, gift and estate tax objectives of the trust structure described in the PLRs.

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[1] The principal drafters of this report were Jeffrey N. Schwartz and Robert W. Weaver. Substantial contributions were made by Patrick C. Gallagher and Carlyn S. McCaffrey. Helpful comments were received from Mitchell Gans, Dana Mark, David S. Miller, Bich-Nga Nguyen, Donald Schapiro, Michael L. Schler and David Stoll.

[2] *See, e.g.,* Priv. Ltr. Rul. 200502014 (Sept. 17, 2004), Priv. Ltr. Rul. 200612002 (Nov. 23, 2005), Priv. Ltr. Rul. 200637025 (June 5, 2005), Priv. Ltr. Rul. 200647001 (Aug. 7, 2006), Priv. Ltr. Rul. 200715005 (Jan. 3, 2007) and Priv. Ltr. Rul. 200731019 (May 1, 2007).

[3] Rev. Rul. 76-503, 1976-2 C.B. 275, and Rev. Rul. 77-158, 1977-1 C.B. 285.

This Report concludes that the holding in the PLRs that the individuals referred to above do not possess general powers of appointment within the meaning of section 2514[4] because they have substantial adverse interests to each other, within the meaning of section 2514(c)(3)(B), is inconsistent with the Service's prior Revenue Rulings. Nevertheless one could reasonably conclude that the retained dominion and control that causes the underlying transfer to the trust described in the PLRs (the "**Trust**") to be an incomplete gift should also cause the relevant powers to be treated as powers that are exercisable by the holder only with the consent of the creator of the power for purposes of section 2514(c)(3)(A) and therefore constitute powers other than general powers of appointment.

In reaching its conclusions, the Report considers whether the classification of powers as general powers of appointment might impact upon the incomplete gift conclusion in the PLRs, and whether the corresponding analysis set forth in the Report may in turn affect the income tax conclusion set forth in the PLRs. In this regard, the Report concludes that the initial transfer to the trust is an incomplete gift, whether or not the persons described in the PLRs possess general powers of appointment, but questions whether one of the effectively retained powers supporting incomplete gift treatment may be categorized as a presently exercisable power of disposition which, contrary to the conclusion in the PLRs, would cause the Trust to be treated as a so-called "grantor trust" under section

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[4] Unless otherwise indicated, "section" references are to the Internal Revenue Code of 1986, as amended.

674. The consequences of grantor trust treatment are that the creator and funder of the trust, pursuant to section 671, would be treated as owning the trust property and would be required to include in computing his or her taxable income and credits all of the income, deductions and credits of the trust.[5]

The Report also considers a modified structure analyzed in a private letter ruling made publicly available after the issuance of the Request (the "**Alternative Structure PLR**").[6] The Report concludes that, although the relevant individuals described in the Alternative Structure PLR do not possess general powers of appointment, this structure may raise an additional income tax issue.

Finally, the Report briefly explores potential implications under section 2518 (dealing with qualified disclaimers) of a conclusion by the Service, which we believe would be potentially problematic and anomalous, that, although the initial transfer to the Trust is an incomplete gift, the relevant powers are nevertheless general powers of appointment. In this regard, the Report briefly discusses a possible modification to the Trust that might permit Trust property to be returned to the creator of the Trust through the use of qualified disclaimers. This modification would not affect the income tax analysis set forth in the PLRs, which analysis, as indicated above, we believe may merit further consideration in light of the incomplete gift analysis set forth in the Report.

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[5] Trusts treated as owned by their settlors pursuant to section 671 are referred to in this Report as "grantor trusts."

[6] Priv. Ltr. Rul. 200729025 (April 10, 2007).

II. OVERVIEW OF TRUST STRUCTURE

A. Typical Dispositive Provisions

As indicated in the Request, the PLRs involve a trust structure under which current trust distributions may be made by the members of a distribution committee (the "**Committee Members**") consisting of at least two trust beneficiaries other than the creator of the trust (the "**Settlor**"). The Committee Members acting unanimously (this power is referred to in this report as the "**Committee Distribution Power**"), and any single Committee Member acting with the consent of the Settlor (this power is referred to in this report as the "**Settlor Consent Distribution Power**"), may distribute all of the trust property among a class of beneficiaries that includes, among others, themselves and the Settlor.

In each PLR a Committee Member who resigns or dies is replaced as a Committee Member by another individual beneficiary of the trust, typically pursuant to a provision in the trust instrument providing for named individuals or the eldest living descendant of the Settlor who is not already acting as a Committee Member to become a Committee Member. The Alternative Structure PLR analyzes a modified structure in which there are initially three Committee Members and, after the first member resigns or dies, there must thereafter be two Committee Members acting at all times.

In all of the structures, the Settlor retains the power by the Settlor's will to appoint the trust property as constituted at the Settlor's death to anyone excluding the Settlor, the Settlor's estate, the Settlor's creditors or the creditors of the Settlor's estate. If the Settlor does not exercise this testamentary power, the trust

property passes to designated takers in default who may or may not include Committee Members.

B. Intended Tax Results

The trusts at issue in the PLRs and the Alternative Structure PLR were structured with the intention of achieving the following results: (i) the initial gift by the Settlor is an incomplete gift for federal gift tax purposes, (ii) the trust is respected as a taxpayer separate from the Settlor for federal income tax purposes, *i.e.* it is not a grantor trust, and (iii) the Settlor may receive future trust distributions without such distributions being treated as taxable gifts by one or more of the Committee Members. Under these circumstances, it is anticipated that the Settlor may (x) fund the trust without incurring any current federal gift tax,[7] (y) have no liability for the payment of income tax on the trust's ordinary income and capital gains,[8] and (z) retain the possibility of receiving future trust distributions.[9]

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[7] If distributed from the trust during the Settlor's lifetime to a recipient other than the Settlor, the Settlor would at that point part with sufficient dominion and control over the distributed property to be treated for federal gift tax purposes as having made a completed gift of the distributed property. In addition, upon the death of the Settlor, any property remaining in the trust would be subject to U.S. federal estate tax as part of the Settlor's gross estate.

[8] The trust would be subject to federal income tax on its accumulated ordinary income and capital gains in accordance with the normal rules under subchapter J of the Code.

[9] In many jurisdictions, the Settlor's ability to receive trust distributions might enable the Settlor's creditors to reach the trust property and thereby cause the trust to be treated as a grantor trust for federal income tax purposes. The ability of the Settlor's creditors to reach trust assets could cause the Trust to be treated as a grantor trust under section 676 or 677. There is no discussion of this issue in the PLRs, presumably because additional facts or representations were submitted or because the relevant income tax rulings were limited to a conclusion that "an examination of the trust" revealed none of the circumstances that would cause the Settlor to be treated as the owner of any portion of the trust. The ability of the Settlor's creditors to reach the trust property would depend upon applicable local law, as opposed to the express terms of the trust instrument. A discussion of this issue is beyond the scope of the Report.

C. Attractiveness

This type of trust might be attractive to individuals residing in states that impose significant state-level income taxes such as, for example, New York. An individual residing in such a state might be motivated to reduce state-level income taxes and could do so, for example, by making a current gift of appreciated property to a child residing in a state which imposes lower or no income tax, but might be reluctant to do so because of the gift tax that would be imposed on such a gift and his or her inability to access the transferred funds in the future. Such an individual might be interested in potentially reducing state-level income taxes by transferring appreciated property to a trust that (i) is a non-grantor trust that is not subject to state-level income tax (or is subject to state income tax at a lower rate than would be imposed by the state in which the taxpayer resides),[10] (ii) results in a completed, taxable gift only when property is distributed to third-party beneficiaries, (iii) includes a mechanism that enables the creator of the trust to obtain distributions of trust property so long as the creator is able to obtain the consent of one of two or more family members, all without reduction for, or using credits against, gift tax, and (iv) bifurcates between two or more family members authority to make distributions to persons other than the creator of the trust, thereby decreasing the risk of family members making a distribution contrary to the wishes of the creator of the trust.

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[10] For example, a non-grantor trust created by a New York resident that has a sole Delaware trustee, holds only intangible personal property, has no New York source income, and has no Delaware beneficiaries generally is not subject to either Delaware or New York income tax.

III. ANALYSIS OF TRUST STRUCTURE IN PLRs

The PLRs reach the following conclusions with respect to the trust structures described above:[11]

1. The Settlor's initial transfer to the Trust is an incomplete gift for federal gift tax purposes;

2. Based on the facts and representations submitted by the taxpayer requesting the ruling, nothing in the trust agreement indicates that the trust would be treated as a "grantor trust" for federal income tax purposes under any of Sections 673, 674, 675 and 676; and

3. The Committee Members do not possess general powers of appointment within the meaning of Section 2514 because they have substantial adverse interests to each other and, therefore, distributions made by the Committee Members to the Settlor will not be taxable gifts by the Committee Members.

If the Service reversed the third conclusion of the PLRs, the attractiveness of the structure at issue in the PLRs would be significantly diminished even if the first and second conclusions remained unaltered because of the potential estate and gift tax consequences to the Committee Members of holding general powers of appointment.[12] For example, even if an initial transfer to the trust were treated as an incomplete gift by the Settlor until property was actually distributed from

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[11] The Alternative Structure PLR reaches the same conclusions with respect to the structure described therein.

[12] The extent to which the third conclusion may have influenced the other conclusions is unclear.

the trust, a subsequent distribution to the Settlor by a Committee Member who was deemed to possess a general power of appointment over the trust property could nonetheless be a taxable gift from the Settlor to the Committee Member and a further taxable gift from the Committee Member to the Settlor. In addition, the estate of a Committee Member who at death is treated as possessing a general power of appointment over all or a portion of the trust property would be subject to estate tax on the value of such property at the Committee Member's death.[13]

IV. GENERAL POWER OF APPOINTMENT CONCLUSION QUESTIONED IN LIGHT OF PRIOR REVENUE RULINGS

The PLRs conclude that the Committee Members do not possess general powers of appointment over the trust property because the Committee Members have substantial adverse interests to each other. The Request questions this conclusion in light of Rev. Rul. 76-503, 1976-2 CB 275, and Rev. Rul. 77-158, 1977-1 C.B. 285.

A. Relevance of Substantial Adverse Interest

Section 2514, governing the federal gift tax consequences of the exercise or release of a general power of appointment, provides, in part, as follows:

> "(b) POWERS CREATED AFTER OCTOBER 21, 1942. – The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.
>
> (c) DEFINITION OF GENERAL, POWER OF APPOINTMENT. – For purposes of this section, the term 'general power of appointment' means a power which is exercisable in favor of the individual possessing the power (hereinafter in this subsection referred to as the 'possessor'), his estate, his creditors, or the creditors of his estate; except that–

[13] See section 2041.

(1) [provisions relating to powers of appointment subject to ascertainable standards]

(2) [provisions relating to powers of appointment created on or before October 21, 1942]

(3) In the case of a power of appointment created after October 21, 1942, which is exercisable by the possessor only in conjunction with another person–

> (A) **if the power is not exercisable by the possessor except in conjunction with the creator of the power–such power shall not be deemed a general power of appointment;**
>
> (B) **if the power is not exercisable by the possessor except 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–such power shall not be deemed a general power of appointment.** For the purposes of this subparagraph a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the possessor's power;
>
> (C) if (after the application of subparagraphs (A) and (B)) the power is a general power of appointment and is exercisable in favor of such other person–such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the possessor) in favor of whom such power is exercisable.

For purposes of subparagraphs (B) and (C), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate."

(Emphasis added.)

The Settlor Consent Distribution Power is a power that may only be exercised with the consent of the creator of the power and therefore, by reason of the application of section 2514(c)(3)(A), is not a general power of appointment.

The Committee Distribution Power, however, would in the first instance appear to fall within the definition of a general power of appointment unless that power is exercisable by a Committee Member only with the consent of another Committee Member having a substantial interest in the trust which is adverse to the exercise of the Committee Distribution Power, within the meaning of section 2514(c)(3)(B). Moreover, if the Committee Distribution Power constitutes a general power of appointment, a distribution to the Settlor pursuant to the Settlor Consent Distribution Power could, with respect to the distributed property, potentially be deemed a release of the Committee Distribution Power by the consenting Committee Member or, if the Committee Distribution Power were a "presently exercisable" general power of appointment, would constitute an exercise of the Committee Distribution Power.[14] In either case, the transfer to the Settlor would be subject to federal gift tax.

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[14] Under Treas. Reg. § 25.2514-1(d), if the holder of a presently exercisable general power of appointment and of a nongeneral power of appointment over the same property exercises the nongeneral power, the exercise of the nongeneral power constitutes an exercise of the general power to the extent that there is a decrease in the amount of property subject to the general power. The regulations contain the following example: "[A]ssume A has a noncumulative annual power to withdraw the greater of $5,000 or 5 percent of the value of a trust having a value of $300,000 and a lifetime nongeneral power to appoint all or a portion of the trust corpus to A's child or grandchildren. If A exercises the nongeneral power by appointing $150,000 to A's child, the exercise of the nongeneral power is treated as the exercise of the general power to the extent of $7,500 (maximum exercise of general power before the exercise of the nongeneral power, 5 [percent] of $300,000 or $15,000, less maximum exercise of the general power after the exercise of the nongeneral power, 5 [percent] of $150,000 or $7,500)." Treas. Reg. § 25.2514-1(d).

B. Meaning of Substantial Adverse Interest

Treas. Reg. §§ 25.2514-3(b)(2) and (3) explain, in part, that

"(2)....[a]n interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in §25.2512-5 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in §25.2512-1. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. **A co-holder 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 co-holder 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. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons 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.**

* * *

(3) A power which is exercisable only in conjunction with another person, and which after application of the rules set forth in subparagraphs (1) and (2) of this paragraph, constitutes a general power of appointment, will be treated as though the holders of the power who are permissible appointees of the property were joint owners of property subject to the power. The possessor, under this rule, will be treated as possessed of a general power of appointment over an aliquot share of the property to be determined with reference to the number of joint holders, including the possessor, who (or whose estates or creditors) are permissible appointees. **Thus, for example, if X, Y, and Z hold an unlimited power jointly to appoint among a group of persons, including themselves, but on the death of X the power does not pass to Y and Z jointly, then Y and Z are not considered to have interests adverse to the exercise of the power in favor of X. In this case, X is considered to possess a general power of appointment as to one-third of the property subject to the power."**

(Emphasis added)

C. Identification of Relevant Substantial Adverse Interest

Neither the Request nor the PLRs specifically identify the substantial interest in the Trust of one Committee Member which is adverse to the exercise of the Committee Distribution Power by another Committee Member.

A Committee Member has the following interests in the Trust:

1. As a co-holder of the power and potential distributee of trust property pursuant to the exercise of the Committee Distribution Power;

2. As a co-holder of the power and potential distributee of trust property pursuant to the exercise of the Settlor Consent Distribution Power;

3. As a potential appointee of trust property on the death of the Settlor pursuant to the Settlor's exercise of the Settlor's retained testamentary power of appointment; and

4. In some but not all of the PLRs, as a taker in default of the exercise of the Settlor's retained testamentary power of appointment.

As indicated by the above quoted provisions of Treas. Reg. §§ 25.2514-3(b)(2) and (3), the interest of one Committee Member as a co-holder of the power and potential distributee of trust property under the Committee Distribution Power is not adverse to the exercise of the Committee Distribution Power by another Committee Member since, on the death or resignation of one Committee Member, the power does not pass to the remaining Committee Member but instead passes to a successor Committee Member.[15]

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[15] The rationale for this rule is discussed below.

Similarly, neither a Committee Member's interest as a potential appointee of trust property on the death of the Settlor pursuant to the Settlor's exercise of his retained testamentary power, nor, in those PLRs where it is present, a Committee Member's interest as a taker in default, would constitute a substantial interest in the trust which is adverse to the exercise of the Committee Distribution Power by another Committee Member.[16]

Therefore, the only remaining interest of a Committee Member which could be found to be adverse to the exercise of the Committee Distribution Power by another Committee Member is the interest of a Committee Member as a co-holder and potential distributee under the Settlor Consent Distribution Power.

D. Relevance of Revenue Rulings Mentioned in the Request

As indicated above, the Request questions the general power of appointment conclusions in the PLRs in light of Rev. Rul. 76-503, which effectively explains the rationale behind Treas. Reg. §§ 25.2514-3(b)(2) and (3), and Rev. Rul. 77-158, which applies the same reasoning to powers exercisable by majority, rather than unanimous, consent.

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[16] *See* Rev. Rul. 79-63, 1979-1 CB 302 (co-trustee who had to consent to the decedent's exercise of his power to direct distributions of trust property during the decedent's lifetime, and who was also a taker in default of the trust property if the decedent failed to exercise the power, did not have a substantial interest adverse to consenting to exercise of the decedent's lifetime power by reason of being a taker in default of decedent's testamentary power) and Treas. Reg. § 25.2514-3(b)(2)(An interest will be treated as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 25.2512-5 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 25.2512-1. Because the interest of a potential appointee under a testamentary power such as the one retained by the Settlors in the PLRs cannot be actuarially determined, it would have to be valued under the willing-buyer, willing-seller test. Under that test, such an interest, one that is exercisable entirely in the discretion of a third-party and which provides the potential recipient with no enhanced bargaining or other powers, would presumably have only nominal value). It may also be argued that the possibility of being an appointee of trust property under such a power is not technically an "interest" in the trust.

Rev. Rul. 76-503 describes a situation in which three siblings transferred their interests in a family business to a trust for the benefit of their descendants. Each sibling-grantor designated one of the sibling's adult children as one of the three trustees of the trusts. The trustees were empowered to manage the trust assets in their complete discretion and to distribute trust property to whomever they selected, including themselves, in such proportions, at such times, and for such purposes as they saw fit. Each trustee was also able to designate one of the trustee's relatives to serve as a successor trustee in the event of the trustee's death or resignation. In the absence of such a designation, the oldest adult living descendant of the deceased or resigned trustee who was willing to serve as the new trustee was to become the successor trustee.

The question analyzed in Rev. Rul. 76-503 is whether any amount of the trust is includible in the estate of a deceased trustee (**"D"**) under section 2041 (the estate tax counterpart to section 2514) as the value of property subject to a general power of appointment. In analyzing this issue, the Revenue Ruling, after quoting the applicable regulations under section 2041 (which are substantially the same as the above quoted provisions of Treas. Reg. §§ 25.2514-3(b)(2) and (3)), explains as follows:

> "In the above-quoted portion of section 20.2041- 3(c)(2) of the regulations, the example provided describes Y and Z as having substantial interests, in the property subject to the jointly held power of appointment, that are adverse to exercise of the power in favor of the decedent X because the power will pass to Y and Z upon the death of X. In such a situation, Y and Z will be able to exercise, by themselves, the power in their own favor after the death of X, so it is in their economic interest to refuse to agree to exercise the power in favor of X during X's lifetime. Their ability to benefit themselves is thus enlarged by the death of X. In such circumstances, the Code and regulations (quoted above) provide that

the potential survivors of the decedent hold an interest and that it is adverse to the exercise of the power in favor of the decedent.

Where, however, as in the example in section 20.2041-3(c)(3) of the regulations, the surviving coholders of the power do not receive, at the death of the decedent, the entire power of appointment between themselves but must continue to share the power with the decedent's replacement, they would not necessarily be in a better economic position after the decedent's death than they are before the death. In such a situation, the fact that the coholders may survive the decedent does not mean that they stand to profit by refusing to exercise the power in favor of the decedent during the decedent's lifetime. Therefore, the coholders of the power do not have an interest that is adverse to exercise of the power in favor of the decedent for purposes of section 2041(b)(1)(c)(ii) of the Code.

If the coholders of the power, who must share their power with the decedent's replacement upon the death or resignation of the decedent, have no interest in the subject property other than as coholders of, and permissible appointees under, the power, those facts alone cannot support the conclusion that they hold adverse interests. As a result, the decedent's power meets the definition of a 'general power of appointment' because the coholders of the power in actuality have no substantial interest in the subject property, which is adverse to the exercise of the power in favor of the decedent.

If the coholders of the decedent's general power of appointment are, along with the decedent, permissible appointees of the subject property, the amount includible in the decedent's gross estate is the value of the subject property divided by the total number of holders of the power who are also permissible appointees, pursuant to section 2041(b)(1)(C)(iii) of the Code and section 20.2041-3(c)(3) of the regulations, quoted above.

Accordingly, in the instant case, one third of the value of the trust (as of the date of death of D or appropriate alternate valuation date) is includible in the gross estate of D under section 2041 of the Code as property subject to a general power of appointment."

Rev. Rul. 77-158 involved a similar fact pattern, except that the three trustees could act by majority vote to make trust distributions and, therefore, any two of the trustees acting together could distribute to themselves all of the trust property in equal shares. As in Rev. Rul. 76-503, since each trustee's power passed to a successor trustee, a trustee has no reasonable expectation of improving

his economic position by refusing to consent to a distribution to another trustee/beneficiary. The Service concluded that each of the trustees had a general power of appointment over one-third of the trust.

The effective rationale behind the conclusion in Rev. Rul. 77-158 is that, although any two of the trustees could distribute the entire trust to themselves, effectively cutting out the third, no individual trustee could assume that he would be one of the two that shares in the distribution or that his position would otherwise improve when a current trustee is replaced by a successor trustee. Under these circumstances, Rev. Rul. 77-158 concludes that none of the trustees is adverse to the exercise of the joint distribution power in a manner which the divides the property among the trustees in three equal shares. Accordingly, a trustee is held to possess a general power of appointment over one-third of the trust property.

E. Application of Rev. Rul. 77-158 to the PLRs

Under the trust structure set forth in PLRs, and assuming for purposes of comparison a two member distribution committee, a Committee Member's powers and interests under a combination of the Committee Distribution Power and the Settlor Consent Distribution Power (together the "**Combined Distribution Power**") are effectively the same as the powers and interests of a trustee of the trust described in Rev. Rul. 77-158. Under these circumstances, it is difficult to conclude than that the interests of one Committee Member under the Settlor Consent Distribution Power are substantial interests adverse to the exercise of the Committee Distribution Power.

In Rev. Rul. 77-158, since the three trustees could act by majority vote, a trustee ("**Trustee One**") could (i) join with a second trustee ("**Trustee Two**") to distribute all of the trust property among beneficiaries including themselves or (ii) join with the third trustee ("**Trustee Three**") to distribute all of the trust property among beneficiaries including themselves.

In the PLRs, there are effectively three persons, two Committee Members and the Settlor (each a "**Participant**") who may exercise the Combined Distribution Power by majority vote. A Participant ("**Participant One**") may (i) join with a second participant ("**Participant Two**") to distribute all of the trust property among beneficiaries including themselves or (ii) join with the third Participant ("**Participant Three**") to distribute all of the trust property among beneficiaries including themselves.

In Rev. Rul. 77-158, none of Trustee One, Trustee Two or Trustee Three had a reasonable expectation of improving that trustee's economic position by refusing to consent to a distribution of trust property in three equal shares because (i) each trustee's power passed to a successor trustee and (ii) although any two of the trustees could distribute all of the trust property to themselves, effectively cutting out the third, no individual trustee could assume that he or she would be one of the two that shares in the distribution.

In the PLRs, no Participant has a reasonable expectation of improving the Participant's economic position by refusing to consent to a distribution of trust property in three equal shares because (i) each Committee Member's power passes to a successor Committee Member, (ii) although there is no successor to

the Settlor, the Settlor possesses a testamentary power of appointment which, from the perspective of a Committee Member, is more limiting than the appointment of a "successor" Settlor since, upon death, the Settlor will be able to unilaterally control the disposition of the trust property, (iii) from the perspective of the Settlor, the testamentary power is the equivalent of a trustee's ability to appoint a successor trustee (since the testamentary power is a limited power that is not exercisable in favor of the Settlor and does not limit the ability of the other Participants immediately to exercise the Committee Distribution Power in favor of themselves), and (iv) although any two of the Participants could distribute the entire trust to themselves, effectively cutting out the third, no individual Participant can assume that he or she will be one of the two that shares in the distribution.

Under these circumstances, the clear implication of Rev. Rul. 77-158 is that the interest of one Committee Member as a co-holder and potential distributee under the Settlor Consent Distribution Power (analyzed above as being part of the Combined Distribution Power) is not an interest substantially adverse to the exercise of the Committee Distribution Power by another Committee Member. At most, the existence of the Settlor Consent Distribution Power affects whether a Committee Member should be treated as having a general power of appointment over one-half or one-third of the trust property, and not whether a Committee Member possesses a general power of appointment.

V. INCOMPLETE GIFT ANALYSIS

A. Status of Initial Transfer to Trust as Incomplete Gift

The Request indicates that it has been suggested that the facts present in the PLRs are distinguishable from those in Rev. Rul. 76-503 and Rev. Rul. 77-158 because, in the PLRs, the Settlor retains a testamentary limited power of appointment and therefore the Settlor's gift is incomplete. This formulation of the relevant inquiry may be based upon a potentially incorrect assumption that the Settlor's retention of the testamentary limited power of appointment is by itself sufficient to render the underlying gift incomplete, whether or not the Committee Distribution Power is classified as a general power of appointment.

For example, in concluding that the initial transfer is an incomplete gift, certain of the PLRs cite to a portion of Treas. Reg. § 25.2511-2(b) which provides in full as follows:

> "(b) As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers the property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor."

In the foregoing example where a donor transfers property in trust and retains a testamentary power of appointment, at no time prior to the donor's death is the donor's continued control over the trust property subject to the acquiescence of one or more persons who could otherwise distribute the trust property to themselves. In fact, in this example, all of the trust income was payable to the donor and the donor, through the exercise of the retained testamentary power of appointment, could at all times control the disposition of the balance of the trust property. Therefore, this example does not preclude the possibility that the granting of a presently exercisable general power of appointment over trust property could result in a completed gift of the underlying trust property, even with the donor's retention of a testamentary limited power of appointment.

For example, Priv. Ltr. Rul. 9109027 (Nov. 30, 1990), involves a trust that became irrevocable upon funding, but with respect to which the Settlor retained the right to income for ten years and a testamentary power of appointment exercisable if the Settlor's death occurred within ten years after the trust's creation. If the Settlor was alive at the end of ten years, the trust property was to be paid to a child of the Settlor. The ruling concludes that the Settlor's gift to the trust was a completed gift despite the retention of the testamentary power of appointment because his ability to exercise the power was subject to a contingency beyond his control, his death before a particular date. Similarly, in the PLRs, the Settlor's ability to exercise his testamentary power of appointment over the trust property is subject to a contingency beyond his control, the decision

by Committee Members not to distribute trust property to themselves or to others before the death of the Settlor.[17]

Nevertheless, even if one were to conclude that the grant of the Committee Distribution Power to a single individual might constitute a completed gift of the underlying trust property despite the Settlor's retention of a testamentary limited power of appointment, that conclusion would not lead to the further conclusion that the grant of the Committee Distribution Power to two or more Committee Members should constitute a completed gift.

As indicated above, the rationale underlying the treatment of the Combined Distribution Power as a general power of appointment under Rev. Rul. 76-503 and Rev. Rul. 77-158 is that each Committee Member and the Settlor, acting in their own economic self-interests, will agree to distribute the trust property to themselves in equal one-third shares. However, until such time as

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[17] *See also* Stephens, Maxfield, Lind, Calfee & Smith, Federal Estate and Gift Taxation (WG&L) at 10.01[9] ("A similar problem arises if the donor creates a trust with a right in donor to designate beneficiaries of income or corpus but, in addition, gives some third party a general power of appointment over the trust property. Under the Sanford principle [Estate of Sanford v. Commissioner, 308 U.S. 39 (1939)], there is no gift to those to whom the donor may direct payments because, pro tempore, the donor has obviously retained control. If, under local law, the donor may still effect distributions to beneficiaries free and clear of the third party's power, the donor has made gifts to no one, for the donor still controls the entire trust property; but any distribution pursuant to the donor's designation constitutes a gift by the donor. Reg. § 25.2511-2(f). On the other hand, if, under local law, a donor can and does give another a general power of appointment over property that takes precedence over any interest in or control over the property by the donor, the donor has made a completed gift of the entire property. The only obstacle to this conclusion is the settled property law and tax law principle that a power is not an interest in property. How then can the donor be said to have transferred "property" by creation of the power? The answer is that the effect of the transaction is a complete shift of dominion and control over property actually owned by the donor to the one to whom the power is given, and it is immaterial that the shift in actual ownership is couched in terms of a gift of the power. See Cerf v. Comm'r, 141 F2d 564 (3d Cir. 1940). Cf. Reg. § 25.2514-1(b)(2), indicating correctly that if a life beneficiary of a trust, who has also a non-general power of appointment, exercises the power in favor of permissible appointees, the life beneficiary has made an actual transfer of the income interest, not dependent on tax rules regarding the exercise of powers.")

that agreement is reached and the trust property is distributed from the trust, the Settlor is free to alter the disposition among the Committee Members by, for example, deciding to act other than in the Settlor's economic self-interest and to give all of the trust property to one of the Committee Members.[18] Under these circumstances, the Settlor has not parted with dominion and control over the trust property until such time as there is an actual exercise of the Combined Distribution Power in favor of a beneficiary other than the Settlor, even if the Committee Distribution Power is classified as a general power of appointment. Until that point in time, the Settlor has never parted with the effective power to control the disposition of the trust property among multiple trust beneficiaries and therefore there is no completed gift.

B. Potential Income Tax Implications

In addition to buttressing the incomplete gift analysis set forth in the PLRs, the analysis at the end of V.A. above may also be relevant to the income tax analysis set forth in the PLRs.

As indicated above, the PLRs conclude that nothing in the relevant trust agreement indicates that the trust would be treated as a grantor trust under any of sections 673, 674, 675 and 676. In the case of section 674, section 674(a) provides the general rule that the grantor of a trust, generally the person who funds the trust, is to 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

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[18] Presumably a Committee Member who has been offered all of the trust property by the Settlor would immediately join with the Settlor in the exercise of the Settlor Consent Distribution Power in favor of that Committee Member.

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 674(b) sets forth various exceptions to section 674(a), including section 674(b)(3) which provides that section 674(a) shall not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Applying these provisions to the trust structure at issue in the PLRs, the PLRs conclude that the Settlor's retained testamentary limited power of appointment does not result in grantor trust treatment under section 674(a), presumably because (i) the power is exercisable only by will, (ii) although the power is exercisable by the Settlor, income cannot be accumulated for disposition by the Settlor pursuant to the exercise of the testamentary power without the ongoing consent of the Committee Members who are authorized to make current distributions, and (iii) as indicated by the general power of appointment analysis, each Committee Member is adverse to the accumulation of income for future disposition pursuant to the Settlor's retained testamentary power because (x) acting unanimously, the Committee Members have the power to make current distributions of all of the trust property for their own benefit and (y) no Committee Member improves his economic position by delaying an immediate distribution. In fact, if a Committee Member delays an immediate distribution, the Committee Member may die and a successor Committee Member may be

appointed (with the successor presumably exercising the Committee Distribution Power in the successor's own interest) or the Settlor may die and exercise the Settlor's testamentary power of appointment in favor of beneficiaries other than the Committee Member.

In addition to the retained testamentary power of appointment, however, the above incomplete gift analysis indicates that, until such time as there is an actual exercise of the Combined Distribution Power in favor of a beneficiary other than the Settlor, the Settlor retains the effective ability to control the disposition of the property among the Committee Members by, for example, deciding to give all of the trust property to one Committee Member and nothing to the other Committee Members. Such a retained power could potentially be classified for section 674(a) purposes as a presently exercisable power of disposition exercisable by the Settlor without the consent of any adverse party,[19] a type of section 674(a) power for which there is no exception under section 674(b).[20]

C. Distinguishing PLRs from Revenue Rulings

The Request itself questions the potential significance of incomplete gift treatment for purposes of distinguishing the facts present in the PLRs from those in Rev. Rul. 76-503 and Rev. Rul. 77-158 by citing Treas. Reg. § 25.2514-1(e), Example (1), and Rev. Rul. 67-370, 1967-2 C.B. 324. Although the relevance of

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[19] As indicated above, a Committee Member who has been offered all of the trust property by the Settlor presumably would immediately join with the Settlor in the exercise of the Settlor Consent Distribution Power and be a party who is non-adverse to such an exercise of the power.

[20] A more detailed analysis of this issue is beyond the scope of the Report.

both the Example[21] and the Revenue Ruling[22] can be questioned, we believe that the better technical analysis is that the nature of an underlying transfer as an incomplete gift should not prevent a power of appointment from existing and that, once a power exists,[23] it should be subject to categorization under the rules set forth in section 2514. Moreover, the "economic interest" analysis underlying the rationale set forth in Rev. Rul. 76-503 and Rev. Rul. 77-158 for categorizing powers of appointment under section 2514(c)(3)(B) is not affected by the status of the initial transfer to the trust as an incomplete gift. Whether or not the initial transfer to the trust is an incomplete gift, the Participants have the same economic incentives to agree to an immediate one-third distribution to each of them. Under these circumstances, it does not appear that incomplete gift treatment should be relevant to the analysis under section 2514(c)(3)(B).

At the same time, we believe that subjecting the holder of a power of appointment to transfer tax with respect to property that has not yet been the

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[21] Example (1), relating to when a power of appointment is created, is best understood as illustrating the transition rules for applying the differing rules applicable to powers of appointment created under instruments executed before October 22, 1941 or after October 21, 1941, as opposed to illustrating when a particular power should be deemed to exist.

[22] Rev. Rul. 67-370, 1967-2 C.B. 324, considered the interest of a decedent in an inter vivos trust governed by New York law. The trust provided that the decedent or his estate was to receive the trust principal upon the death of the settlor. The settlor, however, had reserved the right to modify, alter, or revoke the trust during her lifetime. Subsequent to the decedent's death, the settlor modified the trust in a manner that extinguished the estate's defeasible remainder interest. The Revenue Ruling held that because the interest survived the decedent's death it was includible in the decedent's estate under section 2033 notwithstanding that the interest was defeasible. Under these facts, property as to which the settlor had not made a completed gift at the time of the decedent's death was nevertheless subject to transfer tax in the decedent's estate. A power of appointment, however, is not an interest in property under section 2033.

[23] The Committee Distribution Power exists as a property law matter. It is a power exercisable by the Committee Members under the terms of an irrevocable trust instrument.

subject of a completed gift, and which therefore continues to be includible in the gross estate of the owner of the property, could have potentially anomalous transfer tax results. In this regard, we note that the general policy consideration underlying the exception from general power of appointment classification under section 2514(c)(3)(A) (applicable to powers that may be exercised only with the consent of the creator of the power) is that there is no need to treat a power exercisable only with the consent of the creator of the power as a general power of appointment, since the underlying property over which the power may be exercised continues to be includible in the gross estate of the creator of the power.[24] Under these circumstances, one might reasonably conclude that the Settlor's retained dominion and control that causes an underlying transfer to be an incomplete gift should also cause the Committee Distribution Power to be treated in the same manner as a power exercisable only with the consent of the Settlor.

It may be more difficult as a technical matter to reach such a conclusion in the case of a power, such as the Committee Distribution Power, that by its express terms is exercisable without the consent of the creator and which is granted under an irrevocable trust instrument than to reach such a conclusion with respect to a similar power granted under a revocable trust instrument. In this regard, we believe that powers granted under instruments, such as revocable trust agreements and durable powers of attorney, that continue to be revocable by the creator of the

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[24] 1951 U.S.C.C.A.N. 1530 at 1533 ("Some but not all joint powers created after October 21, 1942 are exempt. Three rules for total or partial exemption of these future joint powers are provided. First, a future joint power is totally exempt if it is not exercisable by the decedent except with the consent or joinder of the creator of the power, since in this case the property would be includible in the gross estate of the creator of the power.").

power, either directly or through the appointment of a court appointed guardian or conservator to act on behalf of the creator of the power, should, so long as the powers continue to be revocable, be treated as powers exercisable only with the consent of the creator of the power within the meaning of section 2514(c)(3)(A).

VI. ALTERNATIVE STRUCTURE PLR

The Alternative Structure PLR involves a trust structure substantially similar to that at issue in the PLRs, except that (i) there are three initial Committee Members, (ii) upon the death or resignation of the first Committee Member to die or resign, that Committee Member is not replaced, and (iii) thereafter, there must at all times be two Committee Members (for example, if either of the two remaining Committee Members dies, there is a successor, replacement Committee Member).

Focusing on the Committee Distribution Power in the Alternative Structure PLR in isolation, that power would fall within the example in Treas. Reg. § 25.2514-3(b)(2) described in IV.B above. Under these circumstances, the conclusion in the Alternative Structure PLR that, so long as all three of the initial Committee Members are acting, none of them possesses a general power of appointment would appear to be correct. The conclusion in the Alternative Structure PLR that the trust is not a "grantor trust" for federal income tax purposes, however, may merit further consideration.

As an initial matter, the general income tax concern raised in V.B above is applicable to both the trust structure at issue in the PLRs and the trust structure at issue in the Alternative Structure PLR. Moreover, the structure at issue in the

Alternative Structure PLR further complicates the analysis of the income tax consequences associated with the Settlor's retention of a testamentary power of appointment.

As indicated above, section 674(b)(3) provides that section 674(a) (which might otherwise treat the Settlor as the owner of the portion of the trust over which the Settlor may exercise a testamentary power of appointment) shall not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. In the case of the trust structure at issue in the PLRs, the Committee Members would appear to be adverse to the accumulation of income.[25] In the case of the Alternative Structure PLR, however, the general power of appointment analysis indicates that one Committee Member has a substantial adverse interest to an immediate exercise of the distribution power by another Committee Member, namely the possibility of potentially receiving one-third of the trust property instead of one-quarter of the trust property. Under these circumstances, it is less clear than in the PLRs that income, at least for some initial period, is being accumulated only with the consent of an adverse party since, under the rationale of the general power of appointment analysis, a Committee Member might very well want income to be accumulated so as to

[25] This is discussed in V.B above.

further increase the one-third share to which the Committee Member may eventually receive in lieu of a one-quarter share.

VII. MODIFIED TRUST STRUCTURE

By adding additional provisions to the trust agreements at issue in the PLRs, it may be possible to provide a mechanism for trust property to be returned to the Settlor without adverse gift tax consequences for the Committee Members or the Settlor even if the Committee Members are deemed to possess general powers of appointment. This can arguably be achieved by way of qualified disclaimers of the Committee Distribution Power by Committee Members instead of the exercise of the Committee Distribution Power or the Settlor Consent Distribution Power.

Section 2518 provides that, if a person makes a "qualified disclaimer" with respect to any interest in property, subtitle B of the Code (covering federal gift and estate tax but not federal income tax) shall apply with respect to such interest as if the interest had never been transferred to such person.

Section 2518(c)(2) provides that a power with respect to property is to be treated as an interest in such property for purposes of Section 2518. Treas. Reg § 25.2518-(3)(a)(1)(iii) further provides that

> "[a] power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. . . . Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard."

Correspondingly, under Treas. Reg. §25.2514-3(c)(5), a disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered a release of the power for gift tax purposes if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. If the disclaimer or renunciation is not a qualified disclaimer, it is considered a release of the power.

Section 2518(b) provides that

> "the term 'qualified disclaimer' means an irrevocable and unqualified refusal by a person to accept an interest in property but only if–
>
> (1) such refusal is in writing;
>
> (2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of–
>
> (A) the date on which the transfer creating the interest in such person is made, or
>
> (B) the day on which such person attains age 21,
>
> (3) such person has not accepted the interest or any of its benefits, and
>
> (4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either–
>
> (A) to the spouse of the decedent, or
>
> (B) to a person other than the person making the disclaimer."

Under Treas. Reg. §25.2518-2(c)(3) governing the time limitation for making a "qualified disclaimer" of an interest in property, including for these

purposes the disclaimer of a power of appointment,[26] the nature of an underlying transfer as an incomplete gift extends the applicable time period for making a qualified disclaimer of the power. Treas. Reg. §25.2518-2(c)(3)(i) explains in relevant part that

> "the 9-month period for making a disclaimer generally is to be determined with reference to the transfer creating the interest in the disclaimant. With respect to *inter vivos* transfers, a transfer creating an interest occurs when there is a completed gift for Federal gift tax purposes regardless of whether a gift tax is imposed on the completed gift. . . . In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power [which in the case of an *inter vivos* transfers occurs when there is a completed gift] in which to disclaim."

Therefore, the time period within which a Committee Member should be permitted to make a qualified disclaimer of the Committee Distribution Power should extend through the expiration of nine months after the transfer to the trust becomes a completed gift.

Of course, all of the other requirements for a qualified disclaimer set forth above, including the requirements that the disclaimant not accept the interest or any of its benefits and that the disclaimed interest pass without any direction on the part of the disclaimant, must also be met. In this regard, the exercise of the Settlor Consent Distribution Power in favor of the Settlor as discussed in the PLRs is problematic for disclaimer purposes since, if the exercise constitutes a deemed exercise of the Committee Distribution Power as discussed above, a Committee Member could no longer disclaim the Committee Distribution Power

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[26] Section 2518(c)(2) provides that a power with respect to property is to be treated as an interest in such property for purposes of Section 2518.

as it relates to the distributed property. Similarly, even if the exercise of the Settlor Distribution is not a deemed exercise of the Committee Distribution Power, any deemed release of the Committee Distribution Power would result in a distribution of property at the direction of the person releasing the power. Alternative mechanisms, however, may be employed to cause trust property to pass to the Settlor that do not require the direction of a Committee Member.

If the terms of the trust instrument provided that property with respect to which a Committee Member disclaims the Committee Distribution Power is to be distributed to the Settlor, the Committee Member's interest in the distributed property (the power to further direct the beneficiaries of the property, etc.) would pass without any direction on the part of the Committee Member making the disclaimer. Under these circumstances, and assuming that the Settlor's initial transfer to the trust was an incomplete gift and that a Committee Member had not yet exercised a Committee Distribution Power or Settlor Consent Distribution Power or otherwise accepted any impermissible benefit, a disclaimer of the Committee Distribution Power at any time prior to the expiration of nine months from the death of the Settlor (or such earlier time as the Settlor's initial transfer to the trust becomes a completed gift) should constitute a qualified disclaimer that results in a distribution of trust property to the Settlor without any adverse gift tax consequences for either the Settlor or the Committee Member disclaiming the Committee Distribution Power.

Moreover, as mentioned above, the general rule under section 2518 that a qualified disclaimer results in the same treatment as if the interest had never been

transferred applies for gift and estate tax purposes but not for income tax purposes. Accordingly, the use of the suggested qualified disclaimer provision should not affect the income tax analysis set forth in the PLRs.[27]

[27] As indicated in V.B above, however, the income tax conclusions set forth in the PLRs may themselves merit further consideration.