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Articles

Two attempts to shield trust transfers from gift tax fail (03/01/2012)

Federal Taxes Weekly Alert,**Two attempts to shield trust transfers from gift tax fail****Chief Counsel Advice 201208026**

In Chief Counsel Advice (CCA), IRS has rejected two attempts by donors to avoid gift tax on transfers made to trusts. First, it rejected their argument that, because they retained testamentary limited powers of appointment, the gifts were incomplete. Next, it found that the completed transfers weren't shielded from gift tax by the annual exclusion because withdrawal rights given to beneficiaries could not be enforced by them.

Facts. Husband and wife donors (Donors) gratuitously transferred property to a trust (Trust), designating their adult child, Andrew, as the sole trustee. Trust beneficiaries are Donors' children, grandchildren, and their spouses (beneficial term interest holders). Trust will terminate when both Donors have died.

Trust states that it is irrevocable, and that Donors renounce any power to determine or control the beneficial enjoyment of Trust income or principal. However, Trust provides the Donors with testamentary limited powers of appointment. If the Donors do not exercise these powers, the property remaining in Trust at termination will be distributed to Andrew and his sibling.

Andrew has absolute and unreviewable discretion in administering the Trust for the benefit of beneficial term interest holders. Income and principal may be distributed at any time for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for any other purpose. Income and principal may also be distributed to a charitable organization.

Each beneficiary may withdraw an amount of property (based on the Code Sec. 2503(b) annual exclusion amount) in any year in which a transfer is made to Trust. However, this may be voided by the trustee for additions made to Trust.

Trust provides that the construction, validity, and administration of Trust are to be determined by State law, but provision is made for Other Forum Rules. Specifically, all questions and disputes concerning Trust must be submitted to the Other Forum that is charged with enforcing Trust. A beneficiary filing or participating in a civil proceeding to enforce Trust will be excluded from any further participation in the Trust.

Completed gift background. Under Code Sec. 2511, the gift tax applies 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. A gift is complete when the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for the donor's own benefit or for the benefit of another. If upon a transfer of property 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. (Reg. § 25.2511-2(b))

Gift was complete except as to remainder. The CCA said that when each Donor transferred property to Trust, he or she retained a testamentary limited power to appoint so much of it as would still be in Trust at his or her death. Donors did not retain any powers or rights to affect the beneficial term interests. With respect to those interests, Donors fully divested themselves of dominion and control of the property when they transferred it to Trust. Accordingly, for gift tax purposes, Donors' transfers to Trust constituted a completed gift of the beneficial term interests. Their testamentary limited powers of appointment relate only to the Trust remainder.

Background on annual exclusion. For 2012, the first \$13,000 of gifts of a present interest made by a donor to each donee is excluded from the amount of the donor's taxable gifts. (Code Sec. 2503(b)) No annual exclusion is allowed for gifts of future interests. (Code Sec. 2503(b), Reg. § 25.2503-2) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property is a present interest in property. (Reg. § 25.2503-3 (b))

A "Crummey" power (in general, a trust beneficiary's noncumulative right to withdraw a specified amount of trust principal within a limited period) makes a transfer to the trust a gift of a present interest. To be a present interest, a withdrawal right must be legally enforceable. For example, if a trust provides for withdrawal rights, and the trustee refuses to comply with a beneficiary's withdrawal demand, the beneficiary must be able to go before a state court to enforce it. (Cristofani, 97 T.C. 74 (1991))

Withdrawal powers were unenforceable. Under Trust's terms, a beneficiary cannot enforce his withdrawal right in a State court. He may only press his demand before an Other Forum and be subject to the Other Forum's Rules. Notwithstanding any provisions in Trust to the contrary, the Other Forum will not recognize State or federal law. If the beneficiary proceeds to a State court, his existing right to income and/or principal for his health, education, maintenance and support will immediately terminate. He will not receive any income or principal for his marriage, to buy a home or business, to enter a trade, or for any other purpose. He will not have withdrawal rights in the future, and his contingent inheritance rights will be extinguished. Thus, a beneficiary faces dire consequences if he seeks legal redress. As a practical matter, he is foreclosed from enforcing his withdrawal right in a State court. Consequently, no annual exclusion under Code Sec. 2503(b)) is allowable for any of the withdrawal rights.

References: For when a gift in trust is completed, see Federal Tax Coordinator 2d ¶ Q-3004; United States Tax Reporter Estate & Gift ¶ 25,114.01; TaxDesk ¶ 715,004; TG ¶ 40085. For beneficiary's power to demand income or principal—"Crummey" power, see Federal Tax Coordinator 2d ¶ Q-5112; United States Tax Reporter Estate & Gift ¶ 25,034; TaxDesk ¶ 731,022; TG ¶ 40264.

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