

PLR 201310002 AND ITS IMPLICATIONS FOR DING TRUSTS

On March 8, 2013, the IRS released PLR 201310002, another favorable ruling addressing the gift and income tax consequences of a so-called “DING trust” (The acronym stands for Delaware Incomplete Gift Non-Grantor Trust). If the trust is created in a state, such as Delaware, that does not tax income and capital gains accumulated in the trust, the trust can be a powerful state income tax planning vehicle for settlors living in states that would not tax the trust’s accumulated income and capital gains merely because the settlor resides in that state or because of some other connection between the trust and the settlor’s home state.

Since the initial DING trust PLR was issued in 2001, these trusts have had a somewhat rocky history. On July 9, 2007, the IRS announced in IR 2007-127 that it was reconsidering the series of private letter rulings (PLRs) that addressed DING trusts. The announcement said that it had come to the IRS’s attention that the conclusions in the PLRs regarding the application of Section 2514 of the Internal Revenue Code (the “Code”) to the Distribution Committee members might not be consistent with Rev. Rul. 76-503, 1976-2 C.B. 275, and Rev. Rul. 77-158, 1977-1 C.B. 285. After a request for comments, the IRS received responses from the Delaware Bankers Association and Delaware Bar Association, the American Bar Association, the New York Bar Association Tax Section, the New York City Bar Association and others. Following IR 2007-127, clients continued to form DING trusts, albeit with slight modifications that addressed some of the issues raised by the IRS and the subsequent comment letters. Then in 2010, there was an outright freeze on DING Trusts when Code Section 2511(c) became effective for one year. It provided:

“Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the

donor or the donor’s spouse under subpart E of part I of subchapter J of chapter 1.”

This provision arguably made it impossible during 2010 to create a trust that could be treated as both an incomplete gift and a non-grantor trust.

After 2010, clients again began to form DING trusts, although such trusts were less prevalent due to all of the uncertainty and changes in the law. Now, PLR 201310002 has been issued and it presents a slightly different iteration of the DING trust structure.

Background of the Ruling

In this ruling, during the settlor’s lifetime, the trustee must distribute such amounts of net income and principal to the settlor and his issue as directed by the Distribution Committee and/or settlor, as follows: (1) pursuant to the direction of a majority of the Distribution Committee members, with the written consent of the settlor (the “Settlor’s Consent Power”); (2) pursuant to the direction of all of the Distribution Committee members, other than the settlor (the “Unanimous Member Power”); and (3) such amounts of the principal (including the whole thereof) as the settlor deems advisable to provide for the health, maintenance, support and education of the settlor’s issue (the “Settlor’s Sole Power”). Although not explicitly stated in the PLR itself, under the facts of this case, there is no automatic replacement upon any member of the Distribution Committee ceasing to serve. In addition, the Distribution Committee will cease to serve if there are ever fewer than two members of the Distribution Committee. The settlor was a member of the Distribution Committee of this trust.

Income Tax Ruling

The IRS held that (i) none of the circumstances described in the PLR would cause the settlor to be treated as the owner of any portion of the trust under Sections 673, 674, 676, or 677 of the Code, and (ii) because none of the other Distribution

Committee members has a power to vest trust income or corpus in himself without the consent of an adverse party, none would be treated as the owner of any portion of the trust under Section 678(a) of the Code. The IRS further concluded that none of the circumstances described in the PLR would cause administrative controls to be considered exercisable primarily for the benefit of settlor under Section 675 of the Code. The income tax ruling was made with almost no analysis of the relevant authorities cited in the ruling.

Gift Tax Rulings

With respect to the Settlor's Consent Power, the IRS noted that under Treas. Reg. § 25.2511-2(e), a donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The Distribution Committee members are not takers in default for purposes of Treas. Reg. § 25.2514-3(b)(2). They are "merely coholders of the power." Also, under Treas. Reg. § 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 the settlor's death. Accordingly, the Distribution Committee members do not have interests adverse to the settlor under Treas. Reg. § 25.2514-3(b)(2) and for purposes of Treas. Reg. § 25.2511-2(e). Therefore, the settlor is considered as possessing the power to distribute income and principal to any beneficiary himself because he retained the Settlor's Consent Power. The ruling states that: "The retention of this power causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes."

This part of the ruling is interesting because the IRS appears to apply two separate tests for adversity under the income tax laws and the gift tax laws. Under Section 674 of the Code, a trust will also be considered a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a nonadverse party, or both, without the approval or consent of any adverse party. The IRS concluded that the trust is a nongrantor trust and, consequently, it must have necessarily concluded that the Distribution Committee members are adverse parties with respect to the settlor for

grantor trust purposes, although this is only implicit in the ruling because the IRS offered no discussion or analysis of its income tax ruling. Still, the IRS expressly concluded that the Distribution Committee members do not have interests adverse to the settlor under Treas. Reg. § 25.2514-3(b)(2) and for purposes of Treas. Reg. § 25.2511-2(e).

In addition, the IRS also concluded that the Settlor's Sole Power gives the settlor the power to change the interests of the beneficiaries and, accordingly, the retention of the Settlor's Sole Power causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes under Treas. Reg. § 25.2511-2(c).

Further, just as in the previous PLRs, the settlor retained a testamentary power to appoint the property to any person or persons or entity or entities, other than the settlor, the settlor's estate, creditors, or the creditors of settlor's estate. The IRS concluded that under Treas. Reg. § 25.2511-2(b) the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of the testamentary limited power of appointment causes the transfer of property to the trust to be incomplete with respect to the remainder of the trust for federal gift tax purposes.

No General Power Held by the Distribution Committee Members

The IRS concluded that the members of the Distribution Committee do not possess general powers of appointment. With respect to the powers held by the Distribution Committee members under the Settlor's Consent Power, the IRS found that those powers are exercisable only in conjunction with the creator, the settlor, and thus under Code Section 2514(c)(3)(A) the Distribution Committee members do not possess general powers of appointment by virtue of possessing this power. The IRS further held that the powers held by the Distribution Committee members under the Unanimous Member Powers are not general powers of appointment because, as in the example in Treas. Reg. § 25.2514-3(b)(2), the Distribution Committee members have substantial adverse interests in the property subject to this power, because the failure of any member of the Distribution Committee to serve will leave a vacancy and there is no automatic replacement.

Finally, the IRS concluded that (i) the trust's assets are includible in the settlor's taxable estate for federal estate tax purposes, (ii) any distribution to the settlor from the trust is merely a return of the settlor's property with no transfer tax consequences, (iii) any distribution to a person other than the settlor will be a taxable gift by the settlor, and (iv) distributions by the members of the Distribution Committee are not taxable gifts made by the Distribution Committee members.

Delaware Implications

With regard to the gift tax ruling, PLR 201310002 states: "The retention of [the Settlor's Consent Power] causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes." Consequently, it seems reasonable to conclude that the Settlor's Consent Power alone sufficed to cause the transfers to the trust to be wholly incomplete for gift tax

purposes (without the necessity of the settlor's inter vivos or testamentary limited powers of appointment). Under Delaware law, it is permissible for a settlor of a Delaware asset protection trust to retain a lifetime power to consent to all distributions and also a testamentary limited power of appointment under Section 3570(11)b of Title 12 of the Delaware Code. However, it is not permissible for a settlor to retain an inter vivos limited power of appointment over a Delaware asset protection trust, nor is it possible of the settlor to be an actual member of the Distribution Committee, although the structure in this PLR could be otherwise replicated in Delaware, absent the inter vivos limited power of appointment.

Please feel free to contact any member of the Morris Nichols Trusts, Estates & Tax Group to discuss how PLR 201310002 might impact you or your clients.

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