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Washington, DC 20224

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Legend:

Trust =

D1 =

Grantor =

Primary Beneficiary =

D2 =

Dear

This responds to the letter dated March 22, 2011, and related correspondence, submitted on behalf of Trust, requesting rulings under §§ 678, 1361(c), and 2041 of the Internal Revenue Code.

FACTS

The information submitted states that Trust was created for the benefit of Primary Beneficiary, who is also the trustee of Trust. Primary Beneficiary is a citizen of the United States. Trust is a domestic trust.

Under the trust instrument of Trust, Grantor may contribute, at any time and from time to time, to the principal of the Trust corpus. Primary Beneficiary has the power, following any such contribution to Trust by Grantor during Grantor's life, to withdraw the entire value of the contribution. Primary Beneficiary's power of withdrawal is cumulative. On D2 of each year, the total amount Primary Beneficiary may withdraw with respect to all preceding calendar years is reduced by the amount of \$5,000.00, or 5 percent of the value of the Trust principal on D2 of that year, whichever is the greater amount and to that extent Primary Beneficiary's power of withdrawal shall lapse.

The trust instrument also provides that the trustee of Trust may exercise or join in the exercise of power to pay over, use, apply or expend income or principal of Trust to or for his own benefit, as a beneficiary, subject to an ascertainable standard. The trustee of Trust, however, shall not exercise or join in the exercise of power to pay over, use, apply or expend income or principal of Trust to any beneficiary who the trustee is legally obligated to support.

The trust instrument further provides that Primary Beneficiary has the power, in a non-fiduciary capacity, to acquire the Trust corpus by substituting other property of an equivalent value as determined by an independent appraiser selected by Trustee of Trust. Primary Beneficiary may exercise this power without the consent of any fiduciary and no fiduciary duty may be asserted as a defense against the exercise of this power by Primary Beneficiary.

Under the trust instrument, Grantor is not a beneficiary under Trust, and has no interest under Trust. Further, neither Grantor nor Grantor's spouse acts as a trustee of Trust. Additionally, neither Grantor nor any other "nonadverse party" (as defined in § 672(b)) shall have the power to purchase, exchange or otherwise deal with or dispose of all or any part of the principal or income of Trust for less than an adequate consideration in money or money's worth, or to enable Grantor or Grantor's spouse to borrow all or any part of the corpus or income of Trust, directly or indirectly, without adequate interest or security.

Grantor intends to transfer to Trust, as a gift, shares of stock of a corporation which has elected to be taxed as a subchapter S corporation.

Trust requests rulings with respect to the following issues: (1) Whether Primary Beneficiary will be treated as the owner of Trust under §§ 671 and 678; (2) Whether Trust will be treated as an eligible S corporation shareholder with respect to the S corporation stock Grantor transfers to Trust; and (3) To what extent the assets of Trust will be included in the estate of Primary Beneficiary for federal estate tax purposes upon the death of Primary Beneficiary.

LAW AND ANALYSIS

Issue 1

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Sections 673 through 679 specify the circumstances under which the grantor or another person will be regarded as the owner of a portion of a trust.

Under § 675 and applicable regulations, the grantor is treated as the owner of any portion of a trust if, under the terms of the trust agreement or circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust.

Section 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term “power of administration” includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 678(a) provides, in general, that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income there from in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. Section 678(b) provides that § 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom § 679 applies) is otherwise treated as the owner under the provisions of subpart E other than § 678.

Based solely upon the facts submitted and the representations made, we conclude that, Primary Beneficiary will be treated as the owner of Trust under section 678(a)(1) of that portion of Trust over which his withdraw power has not lapsed. To the extent that Primary Beneficiary fails to exercise a withdraw power and the power lapses, Primary Beneficiary will be treated as having released the power, while retaining a power of administration, exercisable in a non-fiduciary capacity, to acquire Trust corpus by substituting other property of an equivalent value.

The circumstances surrounding the administration of Trust determine whether this power of administration is exercisable in a fiduciary or nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the Internal Revenue Service office where the returns are filed. Therefore, with respect to the portion of Trust over which Primary Beneficiary had a power of withdraw that has been released, we cannot determine at this time whether Primary Beneficiary will be treated as the owner of Trust for purposes of § 678(a)(2).

Provided that Primary Beneficiary has a withdraw power over all contributions to Trust and circumstances indicate that the power of administration is exercisable in a nonfiduciary capacity, Primary Beneficiary will be treated as the owner of Trust in its entirety.

Issue 2

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation.

Provided that Primary Beneficiary is treated as the owner of Trust in its entirety, we conclude that Trust is a permitted shareholder of an S corporation under §1361(c)(2)(A)(i).

Issue 3

Section 2036(a) provides, in part, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1) provides, in part, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b)(1) defines a general power of appointment as one that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power, is considered a release of the power to the extent that the property that could have been appointed by the exercise of the lapsed power exceeds the greater of \$5,000 or 5 percent of the aggregate value, at the time of such lapse, of the assets out of which the exercise of the lapsed power could have been satisfied.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides, in part, that the term "power of appointment" includes all powers that are in substance and effect

powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. Further, a power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment.

Section 20.2041-3(d)(3) provides, in part, that the failure to exercise a power of appointment created after October 21, 1942, within a specified time, so that the power lapses, constitutes a release of the power. However, § 2041(b)(2) provides that such a lapse of a power of appointment during any calendar year during the decedent's life is treated as a release for purposes of inclusion of property in the gross estate under § 2041(a)(2) only to the extent that the property which could have been appointed by exercise of the lapsed power exceeds the greater of (i) \$5,000 or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could have been satisfied. For example, assume that A transferred \$200,000 worth of securities in trust providing for payment of income to B for life with remainder to B's issue. Assume further that B was given a noncumulative right to withdraw \$10,000 a year from the principal of the trust fund (which neither increased nor decreased in value prior to B's death). In such case, the failure of B to exercise his right of withdrawal will not result in estate tax with respect to the power to withdraw \$10,000 which lapses each year before the year of B's death. At B's death there will be included in his gross estate the \$10,000 which he was entitled to withdraw for the year in which his death occurs less any amount which he may have taken during that year. However, if in the above example B had possessed the right to withdraw \$15,000 of the principal annually, the failure to exercise such power in any year will be considered a release of the power to the extent of the excess of the amount subject to withdrawal over 5 percent of the trust fund (in this example, \$5,000, assuming that the trust fund is worth \$200,000 at the time of the lapse). Since each lapse is treated as though B had exercised dominion over the trust property by making a transfer of principal reserving the income therefrom for his life, the value of the trust property (but only to the extent of the excess of the amount subject to withdrawal over 5 percent of the trust fund) is includable in B's gross estate (unless before B's death he has disposed of his right to the income under circumstances to which §§ 2035 through 2038 would not be applicable).

Based solely upon the facts submitted and the representations made, we conclude that Primary Beneficiary's power to withdraw any contribution to Trust constitutes a general power of appointment within the meaning of § 2041(b)(1). Accordingly, at the time of Primary Beneficiary's death, the gross estate will include the value of the Trust corpus to which Primary Beneficiary may withdraw in that year less

any amount which may have been withdrawn during that year. § 20.2041-3(d)(3); *Estate of Dietz v. Commissioner*, T.C. Memo. 1996-471.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. We express or imply no opinion as to whether future activities involving Primary Beneficiary, Trust, and the substitution power are the same as or substantially similar to the transaction of interest identified in Notice 2007-73, 2007-36 I.R.B. 545. However, Primary Beneficiary and Trust are alerted to the potential obligation under § 1.6011-4 to disclose any future transactions that are the same or potentially similar to the transactions identified in Notice 2007-73 and to the potential penalties for the failure to disclose such transactions. The Service also expresses no opinion on the gift tax consequences if the Primary Beneficiary exercises his lifetime power of appointment.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to your authorized representative.

Sincerely,

Faith P. Colson
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes

cc: