INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Number: **200341002**
Release Date: 10/10/2003
Index (UIL) Nos.: 2001.02-00, 2503.03-00, 2522.02-02
CASE MIS No.: TAM-158067-02/CC:PSI:B4

JUNE 05, 2003

Taxpayer's Name:

Taxpayer's Identification No:
Date of death:
Date of Conference:

LEGEND:

Decedent	=
Child A	=
Child A's Spouse	=
Child B	=
Charity 1	=
Charity 2	=
Charity 3	=
Charity 4	=
Trust	=
Policy A	=
Policy B	=
State	=
Case #1	=
Case #2	=

State Statute	=
Jurisprudence #1	=
Jurisprudence #2	=
Jurisprudence #3	=
Jurisprudence #4	=
Jurisprudence #5	=
S	=
T	=
U	=
Date	=
Date 1	=
Date 2	=

ISSUES

(1) Do the transfers to Trust subject to the charities' withdrawal power qualify for the gift tax charitable deduction under § 2522 of the Internal Revenue Code?

(2) Alternatively, do the transfers to Trust subject to the charities' withdrawal power qualify for the gift tax annual exclusion under § 2503(b)?

(3) How are those transfers treated in computing adjusted taxable gifts under § 2001(b)?

CONCLUSIONS

(1) A gift tax charitable deduction is not allowable under § 2522 for the transfers to Trust subject to the charities' withdrawal power.

(2) The gift tax annual exclusion is not allowable under § 2503(b) for those transfers.

(3) Because the transfers do not qualify for the annual exclusion, each such transfer is includible in the computation of adjusted taxable gifts.

FACTS

On Date 1, Decedent created an irrevocable trust ("Trust") and designated his adult child, Child A, as the trustee ("Trustee"). Under Article III of Trust, Child A, Child A's Spouse, and Child B are designated as the individual beneficiaries. Charity 1, Charity 2, Charity 3, and Charity 4, all organizations described in § 501(c)(3), are designated as the charitable beneficiaries.

Article V, Paragraph A, of Trust provides that, during Decedent's life, the trustee is to pay to any one or more of the beneficiaries so much (including the whole or a lesser amount) of the income and principal, in such shares (equal or unequal) as the trustee decides from time to time in her absolute discretion, for the education, health, maintenance and support of the beneficiaries. Under Paragraph B, the payment of principal may be made before a withdrawal power (discussed below) arising on a transfer to Trust has lapsed, to the extent there is a reasonable reserve, determined in the trustee's absolute discretion, from which the withdrawal power may be satisfied.

Under Article VI, Paragraphs A and B, during the Trust term, the beneficiaries (characterized as "the powerholders") have the right to withdraw the following proportionate amounts (not to exceed $10,000) of each transfer made to Trust in any calendar year.

Powerholder	Proportionate amount
Child A	20%
Child A's Spouse	20%
Child B	20%
Charity 1	25%
Charity 2	5%
Charity 3	5%
Charity 4	5%

Under Article VI, Paragraphs C and D, the trustee is to promptly notify each powerholder in writing of the amount of any transfer or deemed transfer to Trust. With respect to Decedent's initial transfer to establish the trust, made on Date 1, the powerholders may exercise the right to withdraw a portion of the initial amount transferred by written request delivered to the trustee on or before Date 1+8 days. After the initial transfer, a powerholder may exercise the withdrawal right in a written request delivered to the trustee within thirty days of the powerholder's receipt of the notice. The powerholder's withdrawal right will lapse on the expiration of the 30-day notice period.

Article IV provides that the trustee may apply for and own policies of insurance on Decedent's life. Under Article XI, Paragraph K, the trustee may deal with, purchase assets from, or make loans to any trust made by Decedent or any member of Decedent's family or a trust or estate in which any beneficiary of Trust has an interest, though the trustee is the fiduciary, and to retain any property so purchased.

Under Article VII, Paragraphs A through G, on Decedent's death, the trustee is to distribute the remaining undistributed income and principal as follows: 20% to each of Child A, Child A's Spouse, and Child B; 25% to Charity 1; and 5% to each of Charity 2, Charity 3, and Charity 4. The amounts distributable to the charities are to be distributed outright. The amounts distributable to Child A, Child A's Spouse, and Child B are to be distributed either outright or held in further trust.

The facts indicate that each charity received a copy of the Trust agreement, which was treated as notice of Decedent's initial transfer on Date 1. Thereafter, Trustee sent written notifications of the transfers. During the Trust term, the charities were granted, in the aggregate, 44 separate withdrawal rights with respect to contributions to Trust. However, none of the charities exercised any withdrawal right. Although Child A, as Trustee, had the power to distribute income and principal, in her discretion, for the beneficiaries' education, health, maintenance and support, no such distributions were made. Nor did Trustee lend or transfer any Trust property to other trusts.

The only assets held by Trust, other than amounts of cash from time to time, were two modified whole life policies, Policy A and Policy B, insuring Decedent's life. Trust was designated the beneficiary of both policies. Policy A was issued on Date, more than 4 months before the creation of Trust, to Child A as trustee of Trust dated Date 1. Policy B was obtained two years later. During the term of the trust, all of Decedent's transfers to Trust were applied in full to pay the insurance premiums.

The documents, including Trustee's Notification Letters ("the Notification Letters") sent to the charities, indicate that Decedent made 11 (or possibly 12) transfers to Trust. Each Notification Letter states:

> I hereby notify you that a transfer of . . . has been made to the trust. Under the terms of the trust (in order to comply with certain federal tax regulations), you are entitled to withdraw . . . of this transfer . . . In order to exercise this right, you must submit to me a written request within thirty (30) days of your receipt of this letter; otherwise, your right of withdrawal with respect to this transfer shall expire and you shall cease to have any further withdrawal right with respect to this . . . transfer.
>
> At that time the transfer will become part of the principal of the trust. *The Trustee has the right to make certain discretionary distributions for proper education, health, maintenance and support of the beneficiaries* and each year all income not so distributed is added to principal. *To date there has never been a discretionary distribution from the trust.* Upon the death of [Settlor], the charitable beneficiaries will receive [an] outright distribution of their designated percentage interest of the principal and accrued interest in the trust. [Emphasis supplied.]

Decedent filed gift tax returns reporting transfers to Trust and claimed a deduction under § 2522 for the amount subject to each charity's withdrawal right. In addition, the gifts to the trust were characterized as gifts of present interests in property.

In several instances, the Notification Letters to the charities contained information and statements inconsistent with the actual facts with respect to the contribution. For example:

> (1) For 4 of Decedent's transfers, Notification Letters were sent to the charities long before Decedent made the respective transfer. As a result, in the case of 3 of these transfers, the charities' withdrawal rights expired before the transfers were actually made.
>
> (2) For 3 other transfers and another included in (1) above, the Notification Letters to Charity 2, Charity 3, and Charity 4 stated that those charities could withdraw amounts greater than what was allowable under the terms of Trust. It would have been impossible for Trustee to satisfy the withdrawal requests if all the beneficiaries exercised the withdrawal rights described in the Notification Letters.
>
> (3) Three of the Notification Letters sent to Charity 4 are undated.
>
> (4) Although Trustee sent a total of eight Notification Letters to the charities for 2 other transfers to Trust made by Decedent, these transfers were not reported on gift tax returns.

Decedent, a resident of State, died on Date 2. At his death, Trust received the $S proceeds of Policy A and $T proceeds of Policy B. In all, Trust received insurance proceeds of $U, which was divided proportionately amongst the individual beneficiaries and the charities.

On the Federal estate tax return (Form 706) filed for Decedent's estate, the executor did not include any of the transfers to Trust for the benefit of the charities in computing "adjusted taxable gifts," under § 2001(b). It was asserted that the transfers were not taxable gifts, for gift tax purposes, as the gifts qualified for the gift tax charitable deduction allowable under § 2522 or, alternatively, the gifts qualified for the annual exclusion under § 2503.

ISSUE 1

LAW AND ANALYSIS

Section 2501 provides that a tax is imposed on the transfer of property by gift during the calendar year by any individual.

Section 2522(a) provides that, in computing taxable gifts for the calendar year, there shall be allowed as a deduction the amount of all gifts made during the calendar year to or for certain charitable, etc., uses described in §§ 2522(a)(1)-(4) of the Gift Tax Regulations.

Under § 2522(c), where a donor transfers an interest in property for a charitable purpose, and an interest in the same property is transferred for a private purpose, then in general, in the case of a remainder interest, no deduction is allowed for the charitable transfer unless the charitable interest is in the form of either a charitable remainder trust described in §664, or a pooled income fund described in § 642(c). In the case of any other interest, the interest must be in the form of a guaranteed annuity or unitrust interest described in §§ 25.2522(c)-3(c)(2)(vi) and (vii).

Section 25.2522(c)-3(b)(1) provides that, if, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or of the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest has passed to, or is vested in, charity on the date of the gift and the interest would be defeated by the performance of some act or the happening of some event, the possibility of occurrence of which appeared on such date to be so remote as to be negligible, the deduction is allowable. If the trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so given by the donor, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

In Example (2) of § 25.2522(c)-3(b)(2), C transfers a tract of land to a city government for as long as the land is used by the city for a public park. If on the date of gift the city does plan to use the land for a public park and the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.

Commissioner v. Estate of Sternberger, 348 U.S. 187, 198 (1955), involved a situation in which a decedent's will provided for a bequest to charity that was to take effect only if his 27-year old daughter died without descendants surviving her and her mother. At the time of the decedent's death, the daughter had no children. In part, the Court considered the application of the predecessor estate tax regulation to § 25.2522(c)-3(b)(2) to determine whether an estate tax deduction was allowable for the transfer. The Court noted that if it ruled in favor of the estate, then an irrevocable deduction from the gross estate would be allowed for a transfer to charity, even though there was a real possibility that the charity would never receive any portion of the bequest. The Court concluded that, under the regulation, the deduction was not allowable for the bequest. The Court stated:

> This Court finds no statutory authority for the deduction . . . of any percentage of a conditional [transfer] to charity where there is no assurance that charity will receive . . . some determinable part of it.

Commissioner v. Estate of Sternberger, 348 U.S. at 199. See also, Connecticut Bank and Trust Company v. United States, 439 F.2d 931 (2d Cir. 1971); Estate of Clopton v. Commissioner, 93 T.C. 275, 283(1989) ("While the estate tax provisions encourage charitable bequests by authorizing deductions for charitable purposes, they provide no deduction for bequests which may never reach charity.”).

In this case, under the terms of Trust, an interest in property passed for both charitable and private purposes. Because Trust did not satisfy the requirements of § 2522(c), a charitable deduction is not allowable with respect to any transfer to Trust. This is the case, notwithstanding the withdrawal powers held by the charities with respect to contributions to Trust. First, there is no statutory or regulatory exception that alleviates the need to comply with the requirements of § 2522(c) and the applicable regulations merely because charity has a power to withdraw a portion of each contribution to the trust. Further, as discussed below, under the facts presented, we do not believe that the charities’ withdrawal powers were viable powers. However, even assuming there was no impediment to the exercise of these powers, under the provisions of Trust, each charity’s right to withdraw a respective portion of a transfer expired 30 days after the charity received the corresponding Notification Letter. Once this withdrawal period terminated, the charity’s right to receive any portion of the transfer as a result of the withdrawal power terminated, and the transfers remained in Trust subject to invasion for the benefit of the individual beneficiaries. Thus, the situation presented here is analogous to a transfer subject to a condition or power described in § 25.2522(c)-3(b)(2).

As was the case in <u>Commissioner v. Estate of Sternberger</u>, cited above, under these circumstances, there existed a real possibility that the charities would not receive any portion of a transfer through the exercise of the withdrawal power. Indeed, this case presents an even stronger situation for not allowing the charitable deduction with respect to amounts subject to the withdrawal power, since the charities, in fact, never exercised the withdrawal powers and, thus, nothing ever passed to charity as a result of those powers. As the court noted in <u>Estate of Clopton v. Commissioner</u>, a charitable deduction is not allowed if the bequest may never reach charity. This would also be the case if the purported charitable transfer, in fact, <u>never</u> reaches charity. Accordingly, a charitable deduction is not allowable under § 2522(a) for any portion of the transfers to Trust.

<u>ISSUE 2</u>

<u>LAW AND ANALYSIS</u>

Section 2511 provides that 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.

Section 25.2511-1(g)(1) provides that donative intent on the part of the transferor is not an essential element in applying the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

Section 2503(b)(1) provides that, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not be included in the total amount of gifts made during such year.

Section 25.2503-3(a) provides that no part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar period. "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.

Section 25.2503-3(b) provides that an unrestricted right to the immediate use, possession or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest.

A transfer to a trust pursuant to which a donee has the unrestricted right to demand the immediate possession and enjoyment of trust principal or income generally provides the beneficiary with a present interest in the transferred property. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Cristofani v. Commissioner, 97 T.C. 74 (1991); Kohlsaat v. Commissioner, TC. Memo 1997-212. Nonetheless, in Holland v. Commissioner, T.C. Memo 1997-302, the court stated that "if the beneficiaries, trustees and donor had an agreement or understanding that limited the ability, in a legal sense, of the beneficiaries to exercise their right of withdrawal, then the beneficiaries may not have received gifts of a present interest." See also, Heyen v. Commissioner, 945 F. 2d 359 (10th Cir. 1991); Estate of Trotter v. Commissioner, T.C. Memo 2001-50 (involving the application of § 2036, where the court determined that, under the facts presented, an implied understanding did exist among the parties that the beneficiaries' withdrawal powers would not be exercised.)

In Estate of Kohlsaat v. Commissioner, cited above, the donor made a transfer in trust under which 16 beneficiaries held rights to withdraw a pro rata portion of the transfer. The rights were to lapse 30 days later. The Commissioner asserted that the facts presented evidenced an understanding between the donor and the beneficiaries that the withdrawal rights would not be exercised, and, therefore, annual exclusions were not allowable for the transfers. However, the court found that the beneficiaries provided credible reasons for not exercising their withdrawal rights, and the sole fact that none of the beneficiaries exercised the demand rights did not imply an agreement not to do so. Accordingly, the court held that the beneficiaries had unrestricted rights to legally demand immediate distribution of property, and, therefore, the transfers constituted a gift of a present interest and qualified for the annual exclusion.

Similarly, in Estate of Holland v. Commissioner, cited above, the court allowed annual exclusions for the withdrawal rights arising on the donor's annual transfers to 8 trusts. The trusts provided that a beneficiary could, within 60 days of receiving notice of a transfer to his or her trust, demand its distribution. Before making the gifts, the donor and the trustees (her adult children) discussed how the gifts would be used, and she financed the gifts with a loan guaranteed by one of the trustees. The trustees pooled the gifts to obtain a certificate of deposit to secure the guarantee. The Commissioner argued that the transfers were not gifts of present interests because the facts evidenced an agreement that the withdrawal rights would not be exercised. The court concluded that, if the beneficiaries, trustees, and donor had an agreement or understanding that limited the beneficiaries' ability, in a legal sense, to exercise their withdrawal rights, then the beneficiaries may not have received gifts of a present interest. However, under the facts of that case, the court found no evidence to support a finding that the donees' legal ability to demand payment was limited by an informal agreement.

Under State law, a gift to a charity is considered as held in trust by the charity for its charitable uses. Jurisprudence #1; Jurisprudence #2; Case #2 ("[A] gift to a [charity] . . . is given in trust to carry out the objects for which the [charity] was created."). See also Scott and Fratcher, IVA The Law of Trusts, § 348.1 (4th ed. 2001). Thus, a charitable gift must be applied by the charity to its charitable activities. The gift is inalienable by the charity for any other purpose. Case #1; Jurisprudence #3. See also, IVA The Law of Trusts, supra at § 376. The use of charitable property for private purposes may jeopardize the charity's tax privileges and exemptions allowed by State. State Statute.

A charity's officer or director is a trustee and fiduciary with respect to the charity and the charity's property. Case #2; Jurisprudence #4. Likewise, the officer or director is duty-bound to use care to preserve the charity's property, protect the property against loss or dissipation, and hold the property exclusively for the charity's charitable purposes. Jurisprudence #5; 2A The Law of Trusts, supra, at § 176.

Under the terms of Trust, each charity could withdraw a percentage of each contribution, if a written request was delivered to Trustee during the 30-day notice period. If the withdrawal right was not exercised, the amount subject to withdrawal was to be held in the trust subject to distribution, at the trustee's discretion, to Child A, Child A's Spouse, and Child B, for the beneficiary's education, health, maintenance, and support during Decedent's life. Thus, the Trustee could disperse all of the Trust property among the individuals and terminate Trust before Decedent's death, leaving nothing remaining for the charities at Decedent's death. Moreover, because the standard for invasion (education, health, maintenance and support) was ascertainable, the individual beneficiaries possessed an enforceable right to distributions that a beneficiary could enforce in the appropriate State court. II The Law of Trusts, supra at § 128.4. Thus, any amounts the charities failed to withdraw could have been distributed to the individual beneficiaries during Decedent's life.

Similarly, under the terms of Trust, Trustee could lend the Trust property to other trusts created by Decedent and his family members. Similar in effect to Trustee's distribution power, this power could be exercised by Trustee, before Decedent's death, to transfer the Trust property to the other family trusts under circumstances that could jeopardize the value of the Trust principal and the charities' remainder interest. Consequently, if a withdrawal right was not exercised, the forfeited amount would become Trust property and be thereby exposed to dissipation for the private interests of Decedent's family.

It is clear that the charitable remainder trust, pursuant to which property has been transferred in trust for the lifetime benefit of an individual or individuals with the remainder passing to charity, is a common estate planning vehicle. Prior to the Tax Reform Act of 1969 and the enactment of §§ 664, 2055(e)(2), and 2522(c), it was common that the trust corpus was subject to invasion for the benefit of the income beneficiary. Charities' interests in these trusts as remainder beneficiaries, or even as potential discretionary distributees during the income beneficiaries' lifetime, presented no legal issues to the charities.

However, the charities' withdrawal rights in this case present a different situation. Here, Trust purportedly gave the charities the option of either withdrawing the funds from each contribution, or allowing the funds to remain in the trust subject to distribution to Decedent's relatives for private noncharitable purposes with the possibility of the charities receiving a distribution on Decedent's death. In view of the strict prohibition on the use of a charity's property for private purposes and the fiduciary obligations imposed on a charity and its directors, it is doubtful that any officer or director of a charity could properly participate in this kind of gamble, where funds charity purportedly controls are to be set aside for private utilization until some future date.

Thus, we believe that there was a legal impediment prohibiting these withdrawal powers from ever becoming effective. Indeed, as noted above, the charities, in the aggregate, were granted 44 separate withdrawal rights, none of which were ever exercised. Further, as discussed above, in some cases, the Notification Letter was sent to the charities before the transfer was made, such that the withdrawal period expired before the date of the transfer. In other cases, the Notification letter did not accurately describe the amount subject to withdrawal or was undated, so it was unclear when the withdrawal period commenced. The failure to make any of the withdrawals coupled with the haphazard execution of the notification procedure, without any adverse comment from the charities, evidence that at least the charities' understood that they were legally precluded from actively participating in this withdrawal arrangement that allowed funds to enure for private purposes.

This legal impediment distinguishes this case from Holland v. Commissioner and

Kohlsaat v. Commissioner, where the court found no basis for reaching a determination other than that the withdrawal rights constituted viable rights of the donees. Rather, here, the charities' withdrawal powers never came into existence in the first instance. See Estate of Trotter v. Commissioner, supra.

ISSUE 3

LAW AND ANALYSIS

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent. Section 2001(b) provides that the tax imposed by § 2001(a) shall be the amount equal to the excess (if any) of - (1) a tentative tax computed under § 2001(c) on the sum of - (A) the amount of the taxable estate, and (B) the amount of the adjusted taxable gifts, over (2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the provisions of § 2001(c) (as in effect at the decedent's death) had been applicable at the time of such gifts. For purposes of § 2001(b), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of § 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

Section 2503(a) provides that the term taxable gifts means the total amount of gifts made during the calendar year less the deductions provided in § 2522 and following. In addition, under § 2503(b), gifts of a present interest in property are generally excluded from taxable gifts, to the extent the gifts do not exceed certain statutory per donee limits.

In this case, we have concluded that the transfers to Trust allocable to the four charities do not qualify for the gift tax charitable deduction under § 2522, or the gift tax annual exclusion under § 2503(b). Accordingly, each such transfer constituted a taxable gift under § 2503, and therefore is taken into account as an adjusted taxable gift under § 2001(b) in computing Decedent's estate tax liability.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.