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In 1997 Delaware adopted the Qualified Dispositions In Trust Act (the "Act").[1] The Act allows for the creation of a domestic asset protection trust whereby a grantor can transfer assets to an irrevocable trust of which the grantor is a beneficiary and in certain situations prevent the grantor's creditors from reaching the trust assets.[2] Alaska, Colorado, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah and Wyoming have adopted comparable statutes.

Several Private Letter Rulings[3] confirm that under Delaware law a grantor can create a non-grantor asset protection trust for income tax purposes under Subpart E of Subchapter J of the Internal Revenue Code (the "Code"), fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes and still retain the right to receive discretionary distributions of trust income and principal from the trust. In Delaware such trusts are commonly known as "DING" trusts. The acronym stands for "Delaware Incomplete Gift Non-Grantor Trust."

Delaware does not impose state income tax on income and capital gains accumulated in trust for ultimate distribution to out of state beneficiaries.[4] If the grantor and beneficiaries of a DING reside in a state that does not tax trusts based on the residence of the grantor or

[1] 12 Del. C. § 3570, et. seq.

[2] 12 Del. C. § 3572.

[3] See PLR 200612002; PLR 200502014; PLR 200247013; and PLR 200148028.

[4] 30 Del. C. § 1636(a).

beneficiaries, it is possible to eliminate state income taxes. This presents a planning opportunity for an individual that owns a low basis asset and contemplates the sale of such asset in the future. For instance, a New York City resident who is the owner of a closely held S-corporation could create a DING and transfer his S-corporation stock to the DING. When the DING sells the assets, the gain will escape New York State and City income tax. Many individuals residing in states such as New York, New Jersey, Kentucky, Massachusetts, Michigan and Missouri have established DINGs not only for the asset protection feature, but also to minimize or avoid state income tax.

On July 9, 2007, the IRS issued News Release IR-2007-127[5] announcing that the IRS is reconsidering a series of Private Letter Rulings that address, in part, the gift tax consequences of DINGs. IR-2007-127 cast doubt on whether the conclusions reached in the Private Letter Rulings relating to the gift tax consequences of the distribution committee members is correct. This has caused a chilling effect on the use of DINGs.

Structuring a DING

A DING must be drafted in accordance with the provisions of the Act. There are six requirements to create a trust under the Act. These requirements are as follows: (1) a disposition by a transferor by means of a trust instrument;[6] (2) the trust instrument must appoint a qualified trustee within the meaning of the Act;[7] (3) the qualified trustee must maintain or arrange for custody in Delaware of at least some of the trust assets, maintain records for the trust on an

[5] 2007 IRB LEXIS 589.

[6] 12 Del. C. § 3570(7).

[7] 12 Del. C. § 3570(11).

exclusive or non-exclusive basis, prepare or arrange for the preparation of fiduciary income tax returns for the trust or otherwise materially participate in the administration of the trust;[8] (4) the trust must provide that Delaware law governs the validity, construction and administration of the trust;[9] (5) the trust must be irrevocable;[10] and (6) the trust must contain a spend-thrift clause with reference to the Bankruptcy Code.[11]

A DING must also be carefully drafted to avoid grantor trust status. Because the grantor is retaining a beneficial interest in the DING, it is necessary to use adverse parties when making discretionary distributions to the grantor.[12] Typically the DING will create a distribution committee comprised of adverse parties. The consent of the adverse parties is required in order for the grantor or the grantor's spouse to receive distributions from the trust or for the trustee to accumulate income in the trust subject to the grantor's testamentary limited power of appointment.[13]

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[8] 12 Del. C. § 3570(8)b.

[9] 12 Del. C. § 3570(11)a.

[10] 12 Del. C. § 3570(11)b.

[11] 12 Del. C. § 3570(11)c.

[12] I.R.C. § 677(a)(1) provides that a grantor will be treated as the owner of any portion of a trust if the income may be distributed to the grantor or the grantor's spouse without the approval or consent of an adverse party.

[13] I.R.C. § 674(b)(3) provides that a testamentary limited power of appointment over the trust assets exercisable by the grantor will not cause the trust to be a grantor trust for income tax purposes if income of the trust may only be accumulated with the consent of an adverse party.

The PLRs

A series of Private Letter Rulings[14] (the "Distribution Committee PLRs") was issued by the Office of the Associate Chief Counsel, Passthroughs and Special Industries addressing the transfer tax consequences of DINGs. In each of the Distribution Committee PLRs, the grantor creates a discretionary trust for the benefit of the grantor and others (the "permissible beneficiaries"). A Delaware corporate trustee is appointed as sole trustee of the trust. A committee (the "Distribution Committee") consisting of two of the permissible beneficiaries of the trust, has the power, by unanimous consent, to direct the trustee to distribute trust assets to or among the permissible beneficiaries. In addition, the grantor and one member of the Distribution Committee may by agreement direct the trustee to make distributions. If a member of the Distribution Committee resigns or otherwise ceases to serve, a permissible beneficiary other than the grantor or the grantor's spouse is appointed as a successor Distribution Committee member. The grantor retains a limited testamentary power of appointment over the trust assets to appoint the remaining trust assets to any person or organization other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate.

The Distribution Committee PLRs conclude that the grantor has not made a completed gift upon establishment of the DING due to the retention of the Grantor's limited testamentary power of appointment over the trust assets.[15] However, the grantor will be treated as making a taxable gift when a trust distribution is made to someone other than the grantor. The Distribution

[14] See PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; and PLR 200502014.

[15] Reg. § 25.2511-2(b) provides that if upon a transfer of property in trust the donor reserves a power over its disposition, the gift may be wholly incomplete.

Committee PLRs also conclude that the Distribution Committee members have substantial adverse interests to each other for purposes of Section 2514 of the Code and therefore do not possess general powers of appointment over the trust.[16] As such, distributions from the trust will not be subject to gift tax with respect to the Distribution Committee members.

IR-2007-127 and the Revenue Rulings

In IR-2007-127, the IRS states that the conclusions reached in the Distribution Committee PLRs with respect to the gift tax consequences to the Distribution Committee members may not be consistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 (the "Revenue Rulings").[17] The Revenue Rulings have facts that are identical. In the Revenue Rulings, three siblings A, B and C owning equal one-third interests in their family business contribute their respective interests in the business to an irrevocable trust for the benefit of their descendants. The trust permits the trustees to distribute trust property to whomever they select, including themselves, in such proportions and at such time as they see fit. Each trustee has the ability to designate one of the trustee's relatives to serve as successor trustee upon the trustee's death or resignation. In the event a trustee fails to designate a successor, the oldest adult living descendant of the deceased or resigned trustee is to occupy the vacant trustee position.

The decedent, D, was selected by A to be one of the three original trustees and D served in this position until D's death. The Revenue Rulings address whether any of the trust assets are includible in D's gross estate under Section 2041 of the Code under the view that D had a general power of appointment over the trust assets held jointly with the other two co-trustees.

[16] I.R.C. § 2514(c)(3)(B) provides that a power exercisable only in conjunction with a person having a substantial adverse interest is not a general power of appointment.

[17] See Rev. Rul. 76-503 and Rev. Rul. 77-158.

The Revenue Rulings conclude that one-third of the value of the trust as of the date of D's death is includible in D's gross estate under Section 2041 of the Code as property subject to a general power of appointment.

In reaching the conclusions, the Revenue Rulings focused on the language of Section 2041 of the Code.[18] Section 2041(b) of the Code sets forth the definition for a general power of appointment. Section 2041(b)(1)(C)(ii) of the Code provides that a power that is not exercisable by the decedent except in conjunction with a person having a substantial adverse interest in the property subject to the power is not a general power of appointment.[19]

The Revenue Rulings determine that the Section 2041(b)(1)(C)(ii) safe harbor did not apply to D because the remaining co-trustees did not have a substantial adverse interest to D. The terms of the trust provide that upon D's death a successor trustee is to be appointed in D's place. The remaining co-trustees do not receive the entire power of appointment upon D's death. Instead, the surviving co-trustees must continue to share the power with D's replacement. The Revenue Rulings determine that this does not put the surviving co-trustees in a better economic position after D's death and as such their interest is not substantially adverse to D.

In reaching this conclusion, the Revenue Rulings also focus on the Regulations under Section 2041.[20] The Revenue Rulings state that had the trust been drafted so that upon D's death the power of appointment would vest solely in the remaining co-trustees, the co-trustees interest would be substantially adverse to that of D and D would not have a general power of

[18] I.R.C. § 2041.

[19] I.R.C. § 2041(b)(1)(C)(ii).

[20] See Reg. § 20.2041-3(c)(2) and (3).

appointment resulting in the inclusion of one-third of the trust assets in D's estate under Section 2041.

Analysis

In the Distribution Committee PLRs, upon the resignation of any Distribution Committee member, a permissible beneficiary is to be appointed as a successor Distribution Committee member in place of the resigning Distribution Committee member. The Distribution Committee PLRs therefore have facts similar to those contained in the Revenue Rulings. The distribution power does not vest in the remaining Distribution Committee members but instead must be shared with the successor Distribution Committee member. This does not put the remaining Distribution Committee members in a better economic position after the resignation of a Distribution Committee member.

There is an important fact which distinguishes the Distribution Committee PLRs from the facts of the Revenue Rulings. The Distribution Committee PLRs conclude that the transfer to the trust by the grantor is an incomplete gift and that a distribution from the trust to any person other than the grantor would be a completed gift by the grantor. In the Revenue Rulings, A, B and C irrevocably transfer their interests in the family business to the trust upon its creation at which time they make a taxable gift to the trust. Distributions from the trust to the beneficiaries would not be considered taxable gifts by A, B or C.

If the rationale of the Revenue Rulings were applied to the Distribution Committee PLRs, distributions from the trust would constitute completed gifts by the Distribution Committee members. This would produce unprecedented gift tax results. For instance, a distribution from the trust to the grantor would constitute a taxable gift made to the grantor of property which the

grantor is already treated for federal transfer tax purposes as owning. Furthermore, a distribution to any other person besides the grantor would constitute a taxable gift of the same property to the same person at the same time by both the grantor and the Distribution Committee members.

It seems fundamental from a transfer tax perspective that a person can never be treated as holding a general power of appointment over property which for transfer tax purposes is considered owned by another until the owner has made a completed gift of such property. The only authority to suggest that such a result could occur is Revenue Ruling 67-370.[21]

In Revenue Ruling 67-370, a settlor established a revocable trust which provided that upon the settlor's death the decedent or his estate was to receive the remaining trust assets. The settlor reserved the right to modify, alter or revoke the trust during her lifetime. The decedent predeceased the settlor. Revenue Ruling 67-370 holds that the decedent's interest in the trust is includible in the decedent's estate for federal estate tax purposes under Section 2033 of the Code because the decedent's interest was descendible, devisable and alienable as a matter of New York law.

Revenue Ruling 67-370 does not involve powers of appointment but it does conclude that property owned by one taxpayer who has never made a completed gift of such property may be simultaneously includible in the gross estate of another taxpayer. Revenue Ruling 67-370 appears to be the only authority which supports the proposition that the same property can be simultaneously includible in the gross estates of two different taxpayers prior to the time either of them has made a completed gift. Many practitioners believe that Revenue Ruling 67-370 was wrongly decided.

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[21] See Rev. Rul. 67-370.

Conclusion

It is uncertain how the IRS will resolve the gift tax issue raised by IR-2007-127. Until a determination is made, grantors must be cautious when establishing DINGs with Distribution Committees where a member is replaced by a successor member upon his or her resignation. Hopefully the IRS will address this issue soon and provide certainty as to the gift tax consequences of the members of the Distribution Committee.

There are still options for grantors who wish to establish a DING prior to the IRS decision on the gift tax issue. The DING could be structured with multiple Distribution Committee members who are not replaced by a successor Distribution Committee member upon death or resignation. Applying the rationale of the Revenue Rulings, if a successor Distribution Committee member is not to be appointed upon the resignation of a Distribution Committee member, the distribution power would vest in the remaining Distribution Committee members giving them substantially adverse interests in the trust property.

Another alternative is to provide that distributions may only be made pursuant to an ascertainable standard. If the Distribution Committee members can only make distributions for the health, education, support or maintenance of the permissible beneficiaries then they would not have a general power of appointment.[22] This would however restrict the purposes for which distributions could be made and may be an undesirable result to the grantor.

[22] I.R.C. § 2514(c)(1) provides that a power to invade property limited by an ascertainable standard relating to the health, education, support or maintenance of the possessor is not a general power of appointment.

It will be a matter of time until the IRS rules on the gift tax issue. Until then, it is likely that cautious taxpayers will likely not engage in DING transactions. The states with high income tax rates will be the winners during the pause.