

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 00-17**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Applicability of Tennessee gift tax to assets transferred by wife to wife's living trust at husband's date of death.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

[CHILD A] is a Co-Conservator of the [MOTHER] Conservatorship and a Co-Trustee of the [MOTHER] Trust. [CHILD A] (who is also the daughter of [MOTHER]) is presently engaged in winding up the affairs of the estate of [MOTHER], who died [DATE].

[FATHER], [CHILD A]'s father, established a living irrevocable trust in [MONTH], [YEAR] (the "[FATHER] Trust"). The trust was funded with certain [ASSETS] referenced in the trust agreement and the grantor and others were permitted to contribute other property to the trust by fully relinquishing ownership and control of such property.

The [FATHER] Trust provided that, upon the grantor's death, all income was to be paid quarterly to grantor's wife, [MOTHER], as long as she lived. Such trust further authorized the Trustee to encroach upon the corpus of the trust in order to maintain [MOTHER] in the standard of living to which she was accustomed or to care for her in the event of physical, mental or emotional illness. At the death of the grantor's wife, the trustee was directed to divide the proceeds of the trust equally between the grantor's children, [CHILD B] and [CHILD A].

In [FATHER]'s Last Will and Testament dated [DATE], [FATHER] gave all his personal effects to his wife, [MOTHER], with the residuary estate to be transferred to a testamentary trust (the "[FATHER] Testamentary Trust"). The trustee was required to pay all net income to [FATHER]'s wife in installments at least quarter-annually during her life. The trustee was authorized, within its discretion, to pay to [FATHER]'s wife so much of the principal as the trustee determined to be "required or desirable for her support, welfare and best interests." At the death of the survivor of [FATHER] and his wife, the trustee was directed to divide the trust property between his children ([CHILD B] and [CHILD A]) equally¹.

[MOTHER] established a living trust dated [DATE] (the "[MOTHER] Trust"). The trust agreement provided that [MOTHER] transferred, effective upon the death of her husband, [FATHER], all real and personal property, wherever situated, in which she had any interest at the time of her husband's death not otherwise effectively disposed of, but not including property over which she had power of appointment, to the [MOTHER] Trust.

The [MOTHER] Trust Agreement further provided that all the net income was to be paid to [MOTHER] during her life at least quarter-annually. The trustee had the discretion to pay such portion or all of the principal to [MOTHER] from time to time as the trustee determined to be "required or desirable for her support, welfare and best interests." After her death, the trustee was directed to divide the trust property equally between her children ([CHILD B] and [CHILD A])².

Additionally, the [MOTHER] Trust Agreement contained a spendthrift provision that attempted to protect beneficiaries of the trust from claims of creditors. Article I, Paragraph 3 of the Agreement provided as follows:

¹ The Will of [FATHER] provided for a reduction in the share of [FATHER]'s [CHILD B] to satisfy a loan the latter received from [FATHER] to the extent the loan was still outstanding.

² The [MOTHER] Trust Agreement provided for a reduction in the share of [MOTHER]'s [CHILD B] to satisfy a loan the latter received from [MOTHER]'s husband to the extent the loan was still outstanding.

No interest under this instrument shall be transferable or assignable by any beneficiary or be subject during his life to the claims of his creditors or to any claims for alimony or for the support of his or her spouse.

On [DATE], [FATHER] established a Conservatorship to manage the affairs of his wife, [MOTHER], since the [ILLNESS] she suffered from had grown worse.

On [DATE], [FATHER] died. This event triggered the funding of the [FATHER] Testamentary Trust and the [MOTHER] Trust. However, because of the similar disposition of the trust assets in all three [SURNAME] family trusts (i.e., the [YEAR] Trust, the [FATHER] Trust and the [MOTHER] Trust), these trusts were treated as one trust and a single federal tax identification number was obtained.

The value of the property transferred into the [MOTHER] Trust according to the initial inventory of the [MOTHER] Conservatorship and Conservator Activity Report was approximately [AMOUNT].

On [DATE], [MOTHER] died at the age of [AGE].

[CHILD A] and [SIBLING], [CHILD B], are currently the Co-Conservators of the Conservatorship for their mother³ and Co-Trustees of the [MOTHER] Trust. [CHILD A] is the respondent in a lawsuit⁴ filed by [CHILD B] regarding the [MOTHER] Trust and the Conservatorship.

The conservators of [MOTHER], from the time the [MOTHER] Trust was established, anticipated that [MOTHER]'s monthly cash needs would be easily met by the [MOTHER] Trust income. This was confirmed in the Conservator Property Management Plan filed [DATE] in the [COURT] of [COUNTY], Tennessee.

[CHILD B], a beneficiary of a remainder interest in the [MOTHER] Trust and a Co-Conservator of his mother's Conservatorship during the years following his father's death, was adamant that principal of the trust (trusts) not be invaded for [MOTHER]. In a [DATE] memorandum to [CHILD A]'s [SPOUSE], [CHILD B] stated that

[EXCERPT FROM MEMORANDUM]

To the best knowledge of [CHILD A], there was never an invasion of principal of the trust (trusts) for [MOTHER]'s benefit during her life.

³ The Conservatorship has not yet been closed since all matters pertaining to the Conservatorship have not been concluded.

⁴ Lawsuit

[JUDGE], the judge of the legal proceedings filed by [CHILD B] against [CHILD A], has ordered the latter to request a tax ruling from the Tennessee Department of Revenue⁵. The ruling to be requested was whether “the transfer of assets into the [MOTHER] Trust by [MOTHER] through the conservatorship” constituted a taxable gift transaction for state gift tax purposes.

QUESTION PRESENTED

Does [MOTHER]’s transfer of assets to her living trust upon her husband’s death (according to the terms of the trust instrument) constitute a completed gift for Tennessee gift tax purposes?

RULING

No.

ANALYSIS

The ruling request concerns the gift taxability of assets transferred by [MOTHER] to her living trust - the [MOTHER] Trust. The asset transfer took place at the date of death of [MOTHER]’s husband, [FATHER], pursuant to the express terms of the trust.

The applicable Tennessee law, Tennessee Code Annotated Section 67-8-101, subsection (a) provides that a tax is generally imposed upon transfers by gift of various types of property depending on whether the transfer is from a resident or nonresident of Tennessee at the date of death. Subsection (c) provides that the gift tax applies “whether a gift is in trust or otherwise, and whether the gift is direct or indirect.” However, there appears to be no Tennessee court decision addressing a gift tax issue with facts comparable to those presented here.

Nevertheless, the Tennessee Gift Tax Act is modeled after the Federal Gift Tax Act in important respects, and Tennessee courts would look to judicial construction of the federal gift tax statute where such construction does not antagonize Tennessee laws and public policy. Third Nat’l Bank v. King, 387 S.W.2d 800 (Tenn. 1965). Similarly, consideration of administrative regulations and rulings of the Internal Revenue Service relative to the federal gift tax laws are useful in the resolution of gift tax issues under Tennessee law.

Internal Revenue Service Regulation Section 25.2511-2(b) provides, in part, as follows:

As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power

⁵ Order With Respect to Hearing on Petition for Final Accounting and Distribution of Assets, dated [DATE].

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. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

The facts presented in the ruling request are that a settlor granted a third-party trustee certain discretionary powers over the property placed in trust. In such case, the issue presented is whether the grantor relinquished sufficient dominion and control over the transferred property to make the transfer a “completed” gift for purposes of the applicable gift tax law.

A broad power given to a trustee to pay the income and/or corpus of the trust to the grantor – even though third parties are the primary beneficiaries of the trust income interest and the remainder – may result in a determination that the transfer is a completed gift.

However, a power given to a third party trustee may be considered only an indirect means by which the grantor may maintain control of the trust property and retain his property interest, thus resulting in a determination that no completed gift has been made under the gift tax law.

The facts presented are that [MOTHER], in the [MOTHER] Trust Agreement, gave her trustee discretion to pay her such portion or all of the principal as the trustee determined to be “required or desirable for her support, welfare and best interests.” Since the trustee could exercise such discretion that he could distribute all or none of the principle, the trustee was given broad power by the trust instrument, indicative of a completed gift. However, since the trustee’s discretion to distribute principal was in favor of the grantor, the grantor appears to have maintained control over the property, thus suggesting the gift was not complete for gift tax purposes.

It appears that [MOTHER]’s transfer of property to the [MOTHER] Trust was not a completed gift for gift tax purposes because, during here life, her creditors would have had legal recourse against the trust property and the holders of remainder interests in such property did not have vested interests.

I.

A SPENDTHRIFT TRUST CREATED BY A DEBTOR CANNOT DEPRIVE THE DEBTOR’S CREDITORS OF LEGAL RECOURSE AGAINST THE TRUST PROPERTY.

A spendthrift trust is defined as a “trust that prohibits the beneficiary’s interest from being assigned and also prevents a creditor from attaching that interest.” BLACK’S LAW DICTIONARY 1518 (7th ed. 1999).

Article I, Paragraph 3 of the [MOTHER] Trust Agreement - in which [MOTHER] agreed that no beneficial interest under the trust instrument would be transferable or assignable by a beneficiary or be subject to the claims of his creditors – is a “spendthrift” provision, thus making the Trust a spendthrift trust.

The Tennessee courts have consistently determined that a settlor may not create a spendthrift trust for his own benefit. Waldron v. Commerce Union Bank, 577 S.W.2d 674 (Tenn. App., Middle Section, 1978); McArthur v. Faw, 193 S.W.2d 763 (Tenn. 1945); Rose v. Third National Bank, 183 S.W.2d 763 (Tenn. 1945).⁶

[MOTHER], as settlor of the [MOTHER] Trust, established a spendthrift trust and, by retaining a beneficial interest in the net income during her lifetime, created the trust for her own benefit.

The fact that [MOTHER] created a spendthrift trust for her own benefit does not, however, render the trust invalid. Instead, the spendthrift clause is invalid as to [MOTHER]’s present and future creditors. See J. S. Menken Co. v. Brinkley, 31 S.W. 92 (Tenn. 1895); Nelson v. California Trust Co., 33 Cal. 2d 501, 202 P.2d 1021 (1949).⁷

II

WHEN THE TRUST SETTLOR’S CREDITORS WOULD HAVE HAD A LEGAL INTEREST IN THE TRUST PROPERTY, THE SETTLOR’S TRANSFER OF PROPERTY TO THE TRUST WOULD NOT CONSTITUTE A COMPLETED GIFT.

Since the spendthrift clause in the [MOTHER] Trust did not impair [MOTHER]’s creditors from having legal recourse against such trust’s assets for their claims against her, her transfer of property to the trust (at the death of her husband, by terms of the trust) was insufficient for a completed gift to have been made for purposes of the Tennessee gift tax.

This conclusion is supported by the holding in Paolozzi v. Commissioner, where the U.S. Tax Court held that, because Massachusetts state law permitted the donor’s creditors to reach the income of the trust for the settlement of their claims, the transfer was

⁶ See also J. S. Menken Co. v. Brinkley, 31 S.W. 92 (Tenn. 1895), where the court held that a trust could not be created by a grantor, he being the only beneficiary, either by a direct exemption of the property from his future debts, or indirectly by leaving it discretionary with the trustee to allow him benefits from the property. In the instant facts, [MOTHER] is not the only beneficiary. However, since she had a life interest in the income and the trustee could encroach upon the principal for her “support, welfare and best interests” to the extent of exhausting the principal, she could well have received the full benefit of all property held in trust to the exclusion of any other beneficiaries.

⁷ See also the rule the Massachusetts Supreme Court applied in the case of Ware v. Gulda, which rule was found in Restatement: Trusts, Section 156(2): “Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.” Ware v. Gulda, 117 N.E.2d 137 (Mass. 1954). Since the maximum amount the trustee of the [MOTHER] Trust could apply for [MOTHER]’s benefit was the entire principal, plus all the interest of the trust, her creditors would have legal recourse against all trust assets.

incomplete for purposes of the gift tax. *Paolozzi v. Commissioner*, 23 T.C. 182 (1954). The donor had established a trust of which she was the sole life beneficiary. The trustees were empowered, in their sole and absolute discretion, to distribute as much of the net income to the donor as they deemed to be to her best interest.⁸

In holding that the donor's creditors were entitled to reach the trust income, the Tax Court explained that the donor had not relinquished dominion and control because she could realize all the economic benefit of the income accruing to the trust merely by incurring indebtedness and subsequently relegating the creditor to the trust income for reimbursement.

In the facts presented, the grantor – [MOTHER] – as the sole income beneficiary of the trust, could not only realize all the economic benefit of the trust's income but also all the economic benefit of the trust principal if the trustee were to determine that the principal was needed to provide for [MOTHER]'s support, welfare or best interest. Thus, [MOTHER] had not relinquished sufficient dominion and control of the trust assets when they were transferred to the trust to make the conveyance a completed gift for Tennessee gift tax purposes.

III.

WHEN TRUST PROPERTY REMAINDERMEN DO NOT HOLD VESTED INTERESTS BECAUSE OF TRUSTEE DISCRETION TO EXHAUST PRINCIPAL, THE TRUST SETTLOR HAS NOT MADE A COMPLETED GIFT OF THE TRUST PROPERTY.

Since the trustee of the [MOTHER] Trust had the discretion to pay such portion or all of the principal of the trust to [MOTHER] based on the criteria stated, a possibility remained - as long as [MOTHER] lived - that the holders of the remainder interests would never enjoy the benefits of their property interests.

Black's Law Dictionary defines "vested in interest" as "consummated in a way that will result in future enjoyment." BLACK'S LAW DICTIONARY 1557 (7th ed. 1999).

With no certainty that their remainder interests in the [MOTHER] Trust would ever result in enjoyment of any property interest, [CHILD A] and [CHILD B] had no property interests that were "vested in interest."

Under these circumstances, [MOTHER]'s transfer of property to the trust cannot be considered a completed gift for purposes of taxation because the grantees (remaindermen) might never have received any property at all if the trustee, in the exercise of his discretion, distributed all of the trust principal to the grantor before the remainder interests could be distributed. It would indeed be incongruous to consider a

⁸ In the instant facts, all the income of the [MOTHER] Trust was payable to the grantor ([MOTHER]) but the trustee's discretion to encroach was upon the principal - for the grantor's "support, welfare and best interests." (Emphasis added.)

gift “complete” so as to impose a tax when the donees might never reap any benefits from the property considered to have been “gifted” for purposes of the tax laws.

Thomas R. Bain
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APPROVED: Ruth E. Johnson
Commissioner

DATE: 7/5/00