



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL, SAN DIEGO
CC:WR:SCA:SD

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2 (General Litigation)
CC:EL:GL:Br2

SUBJECT:

This memorandum responds to your General Litigation Transmittal Memorandum dated July 7, 1999 in which you requested that we pre-review your Memorandum to Revenue Officer Colette Frias, Collection Division—Large Dollar Group, Laguna Niguel, California, regarding a trust in which the above referenced taxpayer is a beneficiary. You conclude that the taxpayer's interest in the trust is not recoverable through the use of a nominee levy. Because normal lien and levy procedures are applicable against a taxpayer's interest in a valid trust, and there is no indication that the trust at issue in this case was not valid, we will discuss the possibility of the use of normal lien and levy procedures. This document is not to be cited as precedent.

ISSUES

- (1) Whether the terms of the trust prevent the attachment of the federal tax lien.
- (2) What collection device, if any, should be used to collect from the taxpayer's interest in the trust.

CONCLUSIONS

- (1) The taxpayer has a property interest in the trust subject to the federal tax lien, despite the spendthrift, discretionary, and remainder interest provisions. We believe that this property interest is limited to the payments to be made as provided for by the trust.
- (2) A suit to foreclose the federal tax lien would be the collection action, if any, that we would recommend.

FACTS

The facts are as follows: The taxpayer's mother and stepfather established a trust for the benefit of several beneficiaries including the taxpayer. Under the terms of the trust, the taxpayer's share was put into a benefit trust. As stated in _____ of the trust, the settlors intended that the taxpayer have the use of the income and principal of the trust; that the trust assets not be available to the taxpayer's creditors; and that the trust be a discretionary trust, not basic support trust. The benefit trust also provides that the trustee "shall pay to or apply for the benefit of _____, as much of the net income as the trustee, in the trustee's discretion, shall deem necessary for _____ proper health, maintenance, support, and education." _____ In addition, should the trustee determine that the income payments are insufficient, he "shall . . . pay to or apply for the benefit of _____ a sum out of the principal as the trustee, in the trustee's discretion, deems necessary for proper health, maintenance, support, and education" of the taxpayer. _____ The trust further provides that the taxpayer has the power to change the trustee at will. _____ ^{1/} Finally, the trust provides that the taxpayer may designate the beneficiary of the balance of the trust which is undistributed at the time of the taxpayer's death. If he fails to do so, the balance is to be paid the taxpayer's children.

DISCUSSION

The key question presented is whether the taxpayer has an interest in the trust which is subject to the attachment of the federal tax lien. Your office, in addressing a nominee issue, states that because the taxpayer's children have, under California law, a vested remainder interest in the trust assets (subject to displacement by the taxpayer), the taxpayer does not have property interest in the trust assets under California law to which the federal tax lien could attach. The existence of the remainder interests under California law may indicate, as your office suggests, that there is no merger under state law. The existence of the remainder interests do not, however, indicate that the taxpayer has no property interest subject to the tax lien. ^{2/} Instead, in asserting that the lien does not attach, beneficiaries and trustees

^{1/} The taxpayer was designated the first trustee under the terms of the trust, but apparently never served as trustee. The current trustee is the person designated as the second trustee under the trust.

^{2/} In your memorandum, you cited Ammco Ornamental Iron, Inc. v. Wing, 26 Cal.App.4th 409, 31 Cal.Rptr.2d 564 (1994). As you noted, the facts of Ammco are substantially similar to the facts here, including the fact that the beneficiary was named, but did not serve as trustee and that he could designate who would receive the remaining trust property, thereby divesting the named holders of the remainder interest.

in the past have typically argued that the spendthrift and discretionary provisions of a trust prevent lien attachment. However, it is now well settled that spendthrift provisions, which are state-created exemptions, cannot defeat a federal tax lien. See, e.g., First Northwestern Trust Company v. Internal Revenue Service, 622 F.2d 387 (8th Cir. 1980); United States v. Rye, 550 F.2d 682 (1st Cir. 1977); United States v. Dallas National Bank, 152 F.2d 582 (5th Cir. 1946) In Leuschner v. First Western Bank and Trust, 261 F.2d 705 (9th Cir. 1958), the Ninth Circuit held that the taxpayer's interest in a trust could be reached by the federal tax lien, observing:

Although a trust is a spendthrift trust or a trust for support, the interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary, . . . (d) by the United States . . . to satisfy a claim against the beneficiary. Restatement, Trusts, § 157 (1948 Supp.). There is no doubt that the paramount right to collect taxes of the federal government overrides a state statute providing for exemptions.

261 F.2d at 707 (footnotes omitted).

The issue presented by discretionary provisions is generally more complicated. Discretionary trusts are trusts which do not provide a standard for distributions. In such trusts, the trustee has absolute, uncontrolled discretion to pay (or not to pay) the beneficiary as he sees fit. Restatement of Trusts, Second, § 155. A support trust, on the other hand, provides that the trustee shall pay from the income and principal of the trust funds necessary to support the beneficiary. Restatement of Trusts, Second, § 154.

However, we note that the theory of case is different. In Ammco, the issue was not whether the lifetime beneficiary had any property interest in the trust, rather it was whether he was the sole beneficiary of the trust, such that the court would ignore the legal fiction of the trust and permit the beneficiary's creditor to reach the trust assets.

Where a trust gives the trustee uncontrolled, absolute discretion with respect to the distributions, if any, made to a beneficiary, the beneficiary has no basis to compel the trustee to make a distribution. Therefore, he does not have any interest which is subject to the federal tax lien. On the other hand, a beneficiary does have a right to property subject to the federal tax lien where, under state law, he can force the trustee to act, as is the case with a support trust. 3/ See, e.g., Magavern v. United States, 550 F.2d 797, (2d Cir.) cert. denied, 434 U.S. 826 (1977). 4/ The trust involved in United States v. Taylor provided that the trustees “shall pay” to the beneficiary so much of the income from the trust as the trustees deemed necessary for the proper care, maintenance, and support of the beneficiary. The court found:

[T]he taxpayer has a lifetime, enforceable, equitable right to support from the income of the trust. The discretionary feature is limited to the trustees' determining the amounts they deem 'necessary' for the taxpayer's proper care, maintenance, and support. The provision that the 'trustees shall pay' is mandatory and conveys the intent of the testator that his son is to receive support payments from the net income of the trust if he needs support.

If the trustees refuse to act or act unreasonably, a court of competent jurisdiction may be invoked to obtain an order compelling the trustees to act in the exercise of discretion.

3/ Of course, the beneficiary is still only entitled to payment which will satisfy the terms of the trust. That is, he could not compel distribution of the entire amount held in trust, unless the trust so permits and the entire amount is necessary to meet his support needs.

4/ Like the trust here, the trust in Magavern gave discretion to the trustee. It provided that the trustee “shall” pay whatever part of the income or principal that he deems necessary for the comfortable support, maintenance, and/or education of the beneficiaries. The court held that the taxpayer-beneficiary had a property right subject to attachment because, under New York law, a beneficiary could enforce his right to the trust property against a trustee who declines to use the discretion afforded him under the trust. Compare Pulizzotto v. United States, 90-2 U.S.T.C. ¶ 50,421 (D.N.J. 1990) (trust merely gives the trustee the power to distribute, but does not command action.)

254 F.Supp. 752, 755 (N.D. Cal. 1966). 5/ The court concluded that the provision regarding the distribution of the principal, phrased as a grant of absolute discretion, empowers the trustees to invade the principal when the trust income is insufficient. The court concluded that the taxpayer would have an enforceable right: "In this regard, the courts will compel an honest exercise of discretion by the trustees." 254 F.Supp. at 756. 6/

We believe that, here, the taxpayer has, at a minimum, the right to an amount necessary for his health, maintenance, support, and education, as provided in the trust and that that right is subject to collection. 7/ However, one twist in this case is the fact that the settlors, in the trust, stated the intention that the trust be a discretionary, rather than support, trust. Generally, the extent to which a beneficiary has an interest in a trust will depend on "the manifestation of intention of the settlor." Restatement of Trusts, Second, §128. Here, while the settlors state that they intend the trust to be a discretionary one, the language they used is the typical support trust language. We cannot accurately predict how a court would read these apparently conflicting provisions. However, we believe that the trust provisions, taken as a whole, cut against it being a discretionary trust, given the support language used and the ability of the taxpayer to reach the entire trust at will.

However, even though the taxpayer could name himself trustee and could also designate the beneficiary of the remainder interest as we wishes, including his own estate, we do not believe that the Service can reach the entire trust (absent showing that the entire amount held in the trust is necessary for his health, maintenance, support, and education). We believe that the right to select himself as trustee does not render the entire trust available for collection because if he named himself trustee he would, as trustee, be legally obligated to honor the terms of the trust, even though as a practical matter he could raid the trust with

5/ Compare First of America Trust Company v. United States, 93-2 U.S.T.C. ¶ 50,507 in which the court held that the trust was discretionary with respect to the principal, where the trust provides that the trustee "shall" pay the income and so much of the principal as the trustee in his sole discretion deems necessary for the support, comfort and welfare to the beneficiaries.

6/ The opinion does not provide the specific language used in the provision on distribution from the principal; therefore we are not certain how it differs from the language used with respect to income distribution.

7/ Despite stating that the taxpayer has no interest in the trust, your office did note that in addition to levying on distributions which are actually made to the taxpayer, the Service can also levy on sums which can be reasonably be determined to be necessary for the "proper health, maintenance, support, and education" of the taxpayer.

impunity. 8/ In addition, we believe that the right to designate alternative payees, thereby divesting his children of their interest also does not render the entire trust subject to collection. While he can designate the remainder as he chooses, he cannot make the money available to himself to enjoy while he is alive. We see an analogy to life insurance proceeds. In United States v. Bess, 357 U.S. 51 (1958), the Supreme Court found that:

[The] right to change the beneficiary, even to designate his estate to receive the proceeds, gives him no right to receive the proceeds while he lives. Cf. Rowen v. Commissioner, 215 F.2d 641, 644. It would be anomalous to view as 'property' subject to lien proceeds never within the insured's reach to enjoy.

357 U.S. at 56. Here, there is no step which [redacted] could take to obtain an unrestricted right to use the trust assets.

Thus, we have concluded that the federal tax lien attaches to [redacted] right to receive payments necessary for his proper health, maintenance, support, and education, as determined by the trustee. [redacted]

[redacted]

9/

8/ If [redacted] were trustee and violated the terms of the trust the remaindermen would have a cause of action against him. However, he could divested the remaindermen of their interest by naming his estate or a straw man as the residual beneficiary and then raided the trust. Although there would still be the legal obligation to abide by the terms of the trust, there would be no one with standing to challenge him.

9/ [redacted]

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If you have any questions contact the attorney assigned to this matter at 202-622-3610 or 202-622-3620.