Internal Revenue Service

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2 - PLR-104486-99
Date:
December 22, 1999

Decedent =

Spouse =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Agreement =

State 1 =

State 2 =

D1 =

Bank =

Dear :

This letter responds to your letter dated February 17, 1999, and subsequent correspondence submitted by you on behalf of Trust 1, Trust 2, Trust 3, and Trust 4 as their authorized representative, requesting several rulings concerning the income, gift, estate, and generation-skipping transfer tax consequences of proposed transactions consisting of the transfer of all assets and liabilities from Trust 1 to Trust 3 and from Trust 2 to Trust 4.

The facts submitted indicate that Decedent died on D1, a resident of State 1. Prior to Decedent's death, Decedent had created a revocable inter vivos trust that became irrevocable on his death. Under the terms of the trust agreement (Agreement), on Decedent's death, after payment of certain pre-residuary dispositions and the establishment of a "credit shelter" trust, the balance of the trust estate was to be distributed to two marital trusts, Trust 1 and Trust 2. Trust 1 was to be funded with an amount equal to Decedent's remaining GSTT exemption. Trust 2 was to be funded with the balance of the trust estate.

Under Article 4.2 of the Agreement, the trustee is to pay all Trust 1 income to Spouse, and in addition, the trustee has the discretion to pay corpus to Spouse in such sums as the trustee deems advisable taking into consideration Spouse's needs and station in life. On Spouse's death, after providing for the payment of death taxes, the trust estate is to be held in further trust for the benefit of Decedent's issue.

Under Article 4.3 of the Agreement, the trustee is to pay the income of Trust 2 to Spouse, and in addition such sums of principal as the trustee deems advisable to provide for the proper support, maintenance and health of Spouse. On Spouse's death, an amount equal to Spouse's remaining GSTT exemption is to be continued to be held in trust for the benefit of Decedent's issue. The balance is to be paid outright to Decedent's children, if living, or held in further trust for the issue of any deceased child.

Under Article 7.2 of the Agreement, trustees are directed to apply the State 1 Uniform Principal and Income Act in determining whether receipts and disbursements shall be allocated to principal or income, except as required in the trust instrument.

Under Article 7.4 of the Agreement, any trust created under the Agreement shall terminate, if not previously terminated, twenty-one years after the death of the survivor of Decedent and all individual beneficiaries named or described in the Agreement who are living at the date of the Agreement. Article 9.2 authorizes the trustees to change the situs of any trust created under the Agreement.

On Form 706, filed for Decedent’s estate, an election was made under § 2056(b)(7) of the Internal Revenue Code to treat Trust 1 and Trust 2 as qualified terminable interest property (QTIP). A § 2652(a)(3) "reverse QTIP" election was also made with respect to Trust 1. The Decedent’s remaining GSTT exemption was allocated to Trust 1.

Trust 3 and Trust 4 were established as irrevocable trusts by a trustee of Trust 1 and Trust 2, respectively, who is not a resident of State 1. Trusts 3 and 4 have a situs in and are governed by the laws of State 2. Bank and the individual trustees of Trust 1 are the trustees of Trust 3. Bank and the individual trustees of Trust 2 are the trustees of Trust 4.

The terms of Trust 1 and Trust 3 are substantially identical. Similarly, the terms of Trust 2 and Trust 4 are substantially identical. For example, Trust 1 and Trust 3 provide for the same beneficial interest for Spouse and the same disposition of trust assets on Spouse’s death. Spouse has the same powers to require that the trustee make the property productive. Both Trust 1 and Trust 3 are subject to the provisions of the Uniform Income and Principal Act of the state under which they were formed, which Acts are substantively identical, regarding allocation of receipts and expenditures. Further, both trusts must terminate at the same time in all events. Similarly, Trust 2 and Trust 4 provide for the same beneficial interest for Spouse and the same disposition of trust assets on Spouse’s death. Spouse has the same power to require that the trustee make the property productive. Both trusts must terminate at the same time in all events.

The trustees of Trust 1 and Trust 2 propose to transfer the assets of Trust 1 to Trust 3 and the assets of Trust 2 to Trust 4. You represent that the transfers will be approved in writing by all primary beneficiaries of each trust. A State 1 court has authorized the transfer of assets and liabilities from Trusts 1 and 2 to Trusts 3 and 4 respectively, and has approved the cessation of jurisdiction by State 1. The District Court of State 2 has issued an order confirming the trustees of Trusts 3 and 4 as trustees of State 2 trusts. After the transactions, the only assets held in Trust 3 and Trust 4 will be those assets received from Trust 1 and Trust 2, respectively. Trust 1 and Trust 2 will be terminated after the transactions.

RULING 1

Section 671 of the Code provides that where it is specified in subpart E of part I of subchapter J of chapter 1 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. Any remaining portion of the trust shall be subject to subparts A through D.

Sections 673 through 677 specify the circumstances under which the grantor is regarded as the owner of a portion of a trust.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust. In this case, Decedent, the original grantor, has died, and thus can no longer be treated as the deemed owner of Trusts 1 and 2. If the corpus of Trusts 1 and 2 became the property of someone (other than in trust) at any time during this transaction, then that person is the grantor of part or all of Trusts 3 and 4 (depending on the extent of that person’s property rights in the corpus).

Section 678 provides 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 therefrom 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.

Based on our analysis of the trust documents and the factual representations submitted, we conclude that the proposed transactions will not cause any of Trusts 1 through 4 to be considered a grantor trust, nor will any trustee or beneficiary of Trusts 1 through 4 be considered the owner of any portion of Trusts 1 through 4 under §§ 671 through 679 of the Code.

RULING 2

Section 61 provides that, except as otherwise provided in subtitle A of title 26, gross income means all income from whatever source derived.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 over the amount realized.

Section 1001(b) defines the amount realized from the sale or disposition of property as the sum of any money received plus the fair market value of any property received.

Section 1.1001-1(a) provides, as a general rule, that except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange is a disposition under § 1001(a).

An exchange of property results in the realization of gain under § 1001 if the properties exchanged are materially different. Cottage Savings v. Commissioner, 499 U.S. 554 (1991). There is a material difference when the exchanged properties embody legal entitlements "different in kind or extent" or they confer "different rights and powers." 499 U.S. at 565.

In Silverstein v. U.S., 419 F.2d 999 (7th Cir. 1969), aff'g 293 F. Supp. 1106 (N.D. Ill. 1968), cert. denied, 397 U.S. 1041 (1970), the court held that a nonrealization event occurs when, despite the form of the transaction, in substance the taxpayer holds the same property interest after a transaction as before, is as secure with respect to the interest after a transaction as before, and there is no realistic difference in the value of the property interest held as a result of the transaction.

Based on our analysis of the trust documents and the factual representations submitted, we conclude that the proposed transactions will not cause Trusts 1 through 4, or any beneficiary or trustee thereof, to recognize any taxable income, gain or loss relating to a deemed sale, exchange or other disposition of any trust asset by any of Trusts 1 through 4 under §§ 61 or 1001 of the Code.

RULING 3

Section 1015(b) provides that if property is acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by gift, bequest, or devise), the basis is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer is made.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than transfer in trust by gift, bequest, or devise) the basis of the property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

Section 1223 provides that, in determining the period for which the taxpayer has held property however acquired, there is included the period for which the property was held by any other person, if under chapter 1, the property has, for the purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer’s hands as it would have in the hands of the other person.

Based on our analysis of the trust documents and the factual representations submitted, we conclude that, for the purposes of determining the amount and character of gains or losses on any sale or exchange, the assets of Trust 3 immediately after the proposed transactions will have the same holding period and basis as those same assets in Trust 1 immediately prior to the proposed transactions, and the assets of Trust 4 immediately after the proposed transactions will have the same holding period and basis as those same assets in Trust 2 immediately prior to the proposed transactions.

RULING 4

Section 2501 imposes a tax on the transfer of property by gift to any individual.

Section 2511 provides that the gift tax shall apply 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(a) of the Gift Tax Regulations provides that the gift tax applies to a transfer 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(c)(1) defines a gift as any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed.

Section 2512 provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

In this case, the interests of the beneficiaries will be the same before and after the proposed transaction. Further, the application of State 2 law will have no effect on the beneficial interests of the parties or the duration of the trusts, as originally provided for under Trust 1 and Trust 2. Therefore, no property will be gratuitously transferred for less than adequate and full consideration. Accordingly, no taxable gift will be made as a result of the transfer of assets from Trust 1 and Trust 2 to Trust 3 and Trust 4, respectively.

RULING 5

Section 2601 imposes a tax on every generation-skipping transfer made by a "transferor" to a skip person (a person assigned to a generation that is 2 or more generations below the generation assignment of the transferor). Under § 2652(a), a "transferor" is defined, generally, as the last person with respect to whom the property was subject to an estate or gift tax.

Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2611-1 provides that a generation-skipping transfer is an event that is either a direct skip, a taxable distribution, or a taxable termination. The determination as to whether an event is a generation-skipping transfer is made by reference to the most recent transfer subject to estate or gift tax.

Section 2612(c)(1) defines the term "direct skip" to mean a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2612(a) defines the term "taxable termination" to mean the termination (by death, lapse or time, release of power, or otherwise) of an interest in property held in trust unless – (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2613 defines the term "skip person" to mean: (1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or (2) a trust (A) if all interests in such trust are held by skip persons, or (B) if: (i) there is no person holding an interest in trust, (ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

In general, under § 2602 the amount of GST tax is computed by multiplying the taxable amount by the "applicable rate." Under § 2641, the applicable rate is defined as the product of the highest estate tax rate and the inclusion ratio with respect to the trust.

Under § 2642(a)(1) the "inclusion ratio" with respect to any property transferred in a generation-skipping transfer is the excess (if any) of 1 over the "applicable fraction" determined for the trust from which such transfer is made, or in the case of a direct skip, the applicable fraction determined for such skip.

Section 2642(a)(2) defines the term applicable fraction, in general, as a fraction, the numerator of which is the amount of the GST exemption (discussed below) allocated to the trust (or in the case of a direct skip, allocated to the property transferred in such skip), and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip).

Under § 2631(a) in determining the inclusion ratio, every individual is allowed a GSTT exemption of $1,000,000 (adjusted as provided in § 2631(c)), which may be allocated by the individual or his executor to any property with respect to which such individual is the transferor.

Under § 2632(a), the allocation of exemption may be made at any time on or before the date prescribed for filing the individual's estate tax return (including extensions). Under § 2632(c), any portion of an individual’s GSTT exemption not allocated within the time prescribed in § 2632(a), is allocated in accordance with that section.

Section 2652(a) provides that for purposes of the GSTT, the estate of the decedent or the donor spouse may elect to treat all of the property in a qualified terminable interest property (QTIP) trust as if the election to be treated as qualified terminable interest property under § 2056(b)(7) had not been made. This election is referred to as the "reverse" QTIP election. The consequence of a reverse QTIP election is that the decedent remains, for GSTT purposes, the transferor of the QTIP trust for which the election is made. As a result, the decedent's GSTT exemption may be allocated to the QTIP trust.

In this case, the dispositive and administrative provisions of Trust 3 are identical to Trust 1, and the dispositive and administrative provisions of Trust 4 are identical to Trust 2. Further, the timing of the termination of Trust 3 and Trust 4 are the same as provided for under Trust 1 and Trust 2. Finally, the application of State 2 law to Trust 3 and Trust 4 will have no effect on the beneficial interests provided for under the terms of the original Trust 1 and Trust 2. Accordingly, the proposed transfer of assets from Trust 1 and Trust 2 to Trust 3 and 4 after the transaction, respectively, will not constitute a transfer for GSTT purposes. The inclusion ratio with respect to Trust 3 and Trust 4 will be the same as the inclusion ratios with respect to Trust 1 and Trust 2, respectively, immediately prior to the transaction. Further, in view of the "reverse" QTIP election, Decedent will remain the transferor of Trust 3 for GSTT purposes.

RULING 6

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides the general rule that no deduction shall be allowed for an interest passing to the surviving spouse if, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest will terminate or fail, and after the termination of the spouse’s interest, an interest in the property passes to someone other than the spouse.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property, the entire property shall be treated as passing to the surviving spouse for purposes of § 2056(a) and no part of the property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) defines "qualified terminable interest property" (QTIP) as property: (1) which passes from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2044 includes in the gross estate of the surviving spouse the value of all property in which the decedent has a qualifying income interest for life and with respect to which an election was made under § 2056(b)(7).

In this case, an election was made under § 2056(b)(7) to treat Trust 1 and Trust 2 as QTIP. As discussed above, the dispositive and administrative provisions of Trust 3 and Trust 4 are identical to those of Trust 1 and Trust 2, respectively. Further, the application of State 2 law will have no effect on the beneficial interests of the parties or the duration of the trusts, as originally provided for under Trust 1 and Trust 2. In addition, Spouse has the same interests in Trust 3 and Trust 4 as Spouse had in Trust 1 and Trust 2. Therefore, Trust 3 and Trust 4 will continue to be QTIP for purposes of §§ 2056(b)(7) and 2044. The fair market value of the assets of Trust 3 and Trust 4 (determined as of the date of Spouse’s death or alternate valuation date, if applicable) will be includible in Spouse’s gross estate under § 2044.

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions of the Code or any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to the trustees of Trusts 1 through 4.

Sincerely yours,
J. THOMAS HINES
Acting Branch Chief,Branch 2
Office of the Assistant,Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
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