

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4- P LR-103514-02
Date:
JANUARY 13, 2003

Re:

LEGEND:

- Spouse -
- Decedent -
- Trust #1 -

- Trustee -
- Family Trust #1 -
- Marital Trust #1 -
- Trust #2 -

- Family Trust #2 -
- Marital Trust #2 -
- Date 1 -
- Date 2 -
- Date 3 -
- \$x dollars -
- \$y dollars -

Dear :

This is in response to the request from your authorized representative for a ruling concerning the Federal gift tax treatment of the proposed transfer of your interest in a trust.

FACTS:

Decedent and Spouse, both residents of Arizona, established both Trust #1 and Trust #2 on Date 1. Both trusts were funded with community property. During their joint lives, either Decedent or Spouse could revoke or amend Trust #1 and/or Trust #2 with respect to that spouse's share of the community property held by the trust.

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Trustee, a corporate trustee, was the trustee of Trust #1. Decedent and Spouse were designated as the co-trustees of Trust #2.

Decedent died on Date 2, survived by Spouse. Both Trust #1 and Trust #2 became irrevocable upon Decedent's death. Trustee continued as the sole trustee of Trust #1 and Spouse became the sole trustee of Trust #2 and is currently serving in that capacity.

Trust #1

Pursuant to its terms, upon Decedent's death, Trust #1 was divided into two separate trusts: Marital Trust #1 and Family Trust #1. Marital Trust #1 was funded with Spouse's share of the community property plus the smallest pecuniary amount that would result in the least possible Federal estate tax payable by reason of the death of Decedent assuming that property passing to Family Trust #1 would not qualify for the marital deduction in the Decedent's estate. The trust instrument provides that it is the settlor's intent that the pecuniary amount qualify for the estate tax marital deduction. The income of Marital Trust #1 is paid to Spouse at least quarterly, during her lifetime. Trustee may also pay principal to Spouse as it deems necessary for Spouse's health, maintenance in reasonable comfort and best interests. No person has any power to appoint any part of the Marital Trust #1 to any person other than Spouse during Spouse's life. Upon Spouse's death, any remaining principal and accrued, but undistributed, income will be distributed to Family Trust #1.

The balance of Trust #1 passed to Family Trust #1. Under its terms, the income from Family Trust #1 is to be distributed to Spouse at least quarterly, during her lifetime. Trustee is authorized to pay Spouse any principal of Family Trust #1 for Spouse's health, maintenance and support. Upon Spouse's death, the remaining principal of Family Trust #1, including any amounts received from Marital Trust #1, is to be distributed as follows: two-thirds (2/3) to, or for the benefit of, the children of Decedent, equally, per stirpes; and the remaining one-third (1/3) to, or for the benefit of, the children of Spouse, equally, per stirpes.

You represent that, on Date 3, Spouse made a qualified disclaimer under § 2518 of her interest in Family Trust #1.

Trust #2

Trust #2 was executed the same day as Trust #1 and has dispositive provisions similar to those of Trust #1. Like Trust #1, upon Decedent's death, Trust #2 was divided into two separate trusts: Marital Trust #2 and Family Trust #2. Marital Trust #2 was funded with Spouse's share of the community property plus the smallest pecuniary amount that would result in the least possible Federal estate tax payable by reason of the death of Decedent assuming Family Trust #2 would not qualify for the marital

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deduction in the Decedent's estate (and taking into account the funding of Marital Trust #1). The trust instrument also provides that it is the settlor's intent that the pecuniary amount qualify for the estate tax marital deduction. The income of Marital Trust #2 is paid to Spouse at least quarterly, during her lifetime. The trustee may also pay principal to Spouse as the trustee deems necessary for Spouse's health, maintenance in reasonable comfort and best interests. No person has any power to appoint any part of Marital Trust #2 to any person other than Spouse during Spouse's life. Upon Spouse's death, any remaining principal and accrued, but undistributed, income will be distributed to Family Trust #2.

The balance of Trust #2 passed to Family Trust #2. Under the terms of Family Trust #2, trust income is to be distributed to Spouse at least quarterly, during her lifetime. The trustee may distribute principal to Spouse as the trustee deems necessary for Spouse's health, maintenance and support. Upon Spouse's death, the remaining principal of Family Trust #2, including any amounts received from Marital Trust #2, is to be distributed as follows: one-half (1/2) of the trust corpus is to be distributed equally to Decedent's two children from a prior marriage, or those children's then living descendants, per stirpes, if either child predeceases Spouse; and the remaining one-half (1/2) of the trust corpus is to be distributed equally to Spouse's two children from a prior marriage, or those children's then living descendants, per stirpes, if either child predeceases Spouse.

Article SEVENTH, Section 6 provides that Spouse, as sole trustee of Family Trust #2, may not make distributions of principal from Family Trust #2 to herself unless such distributions are limited by an ascertainable standard relating to the health, maintenance and support of the Spouse. In addition, Spouse must not participate in any decision to make discretionary distributions of principal to anyone Spouse is legally obligated to support.

Article SEVENTH, Section 5(g) authorizes the trustee of Trust #2, and each trust established under the provisions of Trust #2, to sell at public or private sale, contract to sell, convey, exchange, transfer and otherwise deal with the trust property and any reinvestments thereof, including, but not limited to the preparation, execution and delivery of deeds to real estate.

Article SEVENTH, Section 16 provides that trust assets consisting of residential real estate may be occupied by the settlors or surviving settlor free of rent; provided that they shall be responsible for payment of taxes, assessments, insurance coverage, maintenance costs, and general running and upkeep expenses.

On the Federal Estate Tax Return (Form 706) filed for Decedent's estate, the executor elected under section 2056(b)(7) of the Internal Revenue Code to treat the pecuniary amounts described above that passed to Marital Trust #1 and Marital Trust #2 as qualified terminable interest property (QTIP), described in § 2056(b)(7) of the

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Internal Revenue Code. Decedent's estate claimed a marital deduction on the federal estate tax return of \$x dollars for the pecuniary amount passing to Marital Trust #1 and a marital deduction of \$y dollars for the pecuniary amount passing to Marital Trust #2. Marital Trust #1 was funded with marketable securities and Marital Trust #2 was funded with cash and real estate, including Decedent's and Spouse's residence.

Proposed Transaction:

The trustee of Marital Trust #2 proposes to sell the residence, which is an asset of the trust and currently occupied by Spouse, to an independent third party in an arms length transaction. Following the sale, all parties having any interest in Marital Trust #2, including Spouse, will petition the appropriate court to terminate Marital Trust #2 and distribute the assets to the remainder beneficiaries (Decedent's children and Spouse's children). The termination of Marital Trust #2 and the transfer from Spouse to the transferees will be conditioned upon the transferees agreement to pay any gift tax liability imposed as a result of the transfer.

You requested the following rulings:

1. The transfer of Spouse's qualifying income interest in Marital Trust #2 will not be treated as a transfer of Spouse's qualifying income interest in Marital Trust #1, resulting in a deemed disposition of the property of Marital Trust #1 under § 2519 of the Internal Revenue Code.

2. For purposes of § 2519 and § 2511, in determining the value of Spouse's gifts, the value of the transferred property will be reduced by the amount of the gift tax paid by the transferees.

3. The transfer of Spouse's qualifying income interest in Marital Trust #2 will not result in Spouse's interest in Marital Trust #1 being valued at zero under § 2702.

4. The transfer of Spouse's qualifying income interest in Marital Trust #2 will not result in the inclusion of Marital Trust #2 in Spouse's gross estate under § 2044(b)(2).

LAW AND ANALYSIS:

Ruling Requests 1, 2 and 4:

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, in pertinent part, that no deduction shall be allowed under § 2056(a) where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or

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contingency to occur, an interest passing to the surviving spouse will terminate or fail, and on such termination, the property passes to a person other than the surviving spouse or the spouse's estate.

Section 2056(b)(7) provides an exception to the rule of § 2056(b)(1) in the case of qualified terminable interest property (QTIP). Under § 2056(b)(7)(A), QTIP property is treated as passing to the surviving spouse for purposes of § 2056(a) and no part of the property is treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1).

Under § 2056(b)(7)(B)(i), the term "qualified terminable interest property" means property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which an election under § 2056(b)(7)(B)(v) applies. Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's life.

Section 2044(a) provides that the value of the gross estate shall include the value of any property in which the decedent had a qualifying income interest for life. Section 2044(b)(2) provides that § 2044(a) applies to any property if § 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2502(c) provides that the payment of the gift tax is the liability of the donor. Section 2511 provides that the tax imposed by § 2501 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 2512(b) provides that, where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 25.2511-2(a) of the Gift Tax Regulations provides that the gift tax is a primary and personal liability of the donor, is an excise upon the donor's act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

Section 25.2511-2(b) provides that a gift is complete with respect to any property if the donor has so parted with dominion and control as to leave the donor no power to change its disposition. Section 25.2511-2(c) provides that a gift is incomplete, and thus not subject to gift tax, in every instance in which a donor reserves the power to revest the beneficial title to the property in the donor.

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Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which the section applies is treated as a transfer for gift tax purposes of all interests in the property other than the qualifying income interest. Section 2519(b) provides that § 2519(a) applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056(b)(7).

Section 25.2519-1(c) provides that the amount treated as a transfer under § 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.

Section 2207A(b) provides that, if for any calendar year, tax is paid under Chapter 12 with respect to any person by reason of property treated as transferred by such person under § 2519, such person shall be entitled to recover from the person receiving the property the amount by which (1) the total tax for such year under Chapter 12 exceeds (2) the total tax which would have been payable under such chapter for such year if the value of such property had not been taken into account for purposes of Chapter 12.

Under § 25.2207A-1(a), if an individual is treated as transferring an interest in property by reason of § 2519, the individual is entitled to recover from the "person receiving the property" the amount of gift tax attributable to that property. The value of property to which § 25.2207A-1(a) applies is the value of all interests in the property other than the qualifying income interest. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the total amount of gifts, if no federal gift tax is attributable to the property. The right of recovery arises at the time the federal gift tax is actually paid by the transferor subject to § 2519.

Section 25.2207A-1(c) provides that the amount of federal gift tax attributable to all properties includible in the total amount of gifts under § 2519 made during the calendar year is the amount by which the total federal gift tax for the calendar year (including penalties and interest attributable to the tax) under Chapter 12 that has been paid, exceeds the total federal gift tax for the calendar year (including penalties and interest attributable to the tax) under Chapter 12 that would have been paid if the value of the properties includible in the total amount of gifts by reason of § 2519 had not been included.

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Section 25.2207A-1(d) provides that a person's right of recovery with respect to a particular property is an amount equal to the amount determined in § 25.2207A-1(c) multiplied by a fraction. The numerator of the fraction is the value of the particular property included in the total amount of gifts made during the calendar year by reason of § 2519, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the total amount of gifts made during the calendar year by reason of § 2519, less any deductions allowed with respect to those properties.

Section 25.2207A-1(e), provides that, if the property is in trust at the time of the transfer, the "person receiving the property" is the trustee, and, if the property does not remain in trust, any person receiving the property prior to the expiration of the right of recovery.

Rev. Rul. 75-72, 1975-1 C.B. 310, holds that, if a transfer of property is conditioned on the payment by the donee of the gift tax imposed on the transfer, then in determining the amount of the gift, the amount of gift tax actually paid by the donee is deducted from the value of transferred property; that is, the gift is treated as a "net gift." Under § 2502(c), the donor is primarily liable for the payment of the gift tax. Thus, if at the time of the transfer, the gift is made subject to a condition that the gift tax be paid by the donee or out of the transferred property, the donor receives consideration for the transfer in the amount of gift tax to be paid by the donee. Accordingly, under § 2512, the value of the gift is measured by the fair market value of the property or property right or interest passing from the donor, minus the amount of the gift tax actually paid by the donee. Rev. Rul. 81-223, 1981-2 C.B. 189, holds that in determining the gift tax liability actually assumed by the donee, the donor's available unified credit must be used to reduce the tax in determining the liability.

In the instant case, following the sale by the trustee of the residence in Marital Trust #2, the assets of Marital Trust #2 will consist of property or the proceeds of the sale of property for which a marital deduction was taken in Decedent's estate, plus Spouse's share of the community property that initially funded the trust. All parties having any interest in Marital Trust #2, including Spouse and a *guardian ad litem* for any contingent beneficiaries, will petition the appropriate court to terminate Marital Trust #2 and distribute the assets to the remainder beneficiaries (Decedent's children and Spouse's children), conditioned upon the transferees' agreement to pay Spouse's gift tax liability resulting from the transfer.

Marital Trust #2 was funded with Spouse's interest in community property and a pecuniary portion of Decedent's interest in community property. Spouse's transfer of her interest in the community property to Marital Trust #2 constituted an incomplete gift under § 25.2511-2(b), in view of Spouse's retained income interest and retained power, as trustee, to distribute trust corpus to herself. Spouse's proposed relinquishment of her retained income and corpus interests in the portion of Marital Trust #2 attributable

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to her community property will constitute a completed gift of that portion of the trust corpus under § 2511. The transfer will be conditioned upon the transferees' agreement to pay any gift tax imposed on Spouse as a result of the transfer.

In addition, Spouse's proposed relinquishment of her qualifying income interest in the portion of Marital Trust #2 consisting of qualified terminable interest property (QTIP) will be treated as a transfer under § 2519 of the fair market value of the portion of the corpus of Marital Trust #2 subject to the QTIP election on the date of the renunciation, less the value of Spouse's qualifying income interest for life in that portion of the corpus. In addition, Spouse's relinquishment of her qualifying income interest in Marital Trust #2 with respect to the QTIP property is a gift under § 2511 of the value of that interest. This transfer will also be conditioned upon the transferees' agreement to pay any gift tax imposed on Spouse as a result of the transfer.

With respect to the treatment of Spouse's gift resulting from the application of § 2519, although § 2502(c) provides that the tax on the gift is the liability of the donor, in Rev. Rul. 75-72 and Rev. Rul. 81-223, the burden of the tax was shifted to the donees by agreement. The amount of the gift on which the gift tax was computed was reduced by the amount of the gift tax paid by the donee. As discussed above, with respect to the gift tax imposed as a result of a transfer under § 2519, § 2207(A) statutorily shifts the burden, but not the liability for paying the gift tax, to the donee. Because the statute imposes the burden of paying the gift tax on the donee, the donee provides consideration for the gift. The donee's undertaking under the statute inures to the benefit of the donor because it relieves the donor of the obligation to pay gift tax that the donor is liable for and is otherwise required to pay out of the donor's own funds. See Rev. Rul. 75-72.

Accordingly, Spouse's gift under § 2519 is treated as a "net gift". The amount of the gift is determined by reducing the amount of the transfer under § 2519 and § 25.2519-1(c) by the amount of gift tax Spouse is entitled to recover under § 2207(A).

Similarly, with respect to the gift resulting from Spouse's relinquishment of her interests in her community property held in Marital Trust #2, and Spouse's relinquishment of her qualifying income interest for life with respect to Marital Trust #2, as a condition of the transfer, the transferees have agreed to pay any gift tax imposed on the transfer. Thus, in determining the amount of the gift under § 2511 resulting from these transfers, the value of the relinquished interests is reduced by the amount of gift tax paid by the transferees.

Trust #1 and Trust #2 were separately created by Decedent and Spouse under separate trust agreements. Because Marital Trust #1 and Marital Trust #2 are separate trusts, the relinquishment by Spouse of her interests in Marital Trust #2 will not be treated as a gift under § 2519 of Spouse's qualifying income interest in Marital Trust #1,

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and will not result in a deemed disposition of the property of Marital Trust #1 under § 2519.

Finally, if the renunciation by Spouse of Spouse's qualifying income interest in Marital Trust #2 is executed as proposed, such transfer will not result in the inclusion of Marital Trust #2 in Spouse's gross estate under § 2044(b)(2).

Ruling Request 3:

Section 2702 provides special valuation rules in the case of transfers of interests in trusts. Under section 2702(a)(1), solely for the purpose of determining whether a transfer of an interest in trust to or for the benefit of a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in § 2701(e)(2)) shall be determined as provided in § 2702(a)(2). Section 2702(a)(2) provides that the value of any retained interest that is not a qualified interest shall be treated as being zero. The value of any retained interest that is a qualified interest is determined under § 7520.

Section 25.2702-2(a)(3) defines retained interest as an interest held by the same individual both before and after the transfer in trust.

Spouse's interest in Marital Trust #2 is separate and distinct from her interest in Marital Trust #1. Any interest that Spouse has in Marital Trust #1 is separate and apart from any interest in Marital Trust #2 that she transferred. Consequently, Spouse's interest in Marital Trust #1 is not treated as a retained interest for purposes of § 2702(a)(1).

Accordingly, the renunciation by Spouse of her qualifying income interest in Marital Trust #2 will not result in Spouse's interest in Marital Trust #1 being valued at zero under § 2702.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative. A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling specifically does not address any gift tax consequences of Spouse's transfer of her community property to Marital Trust #2 at the time of Decedent's death. In addition, this ruling is contingent upon all the parties with an interest in Marital Trust

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#2 (including Spouse and a *guardian ad litem* representing any unnamed remaindermen and any remaindermen not in being) obtaining a valid court order from the appropriate court terminating Marital Trust #2 consistent with the law of Arizona as applied by the highest court in that state.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

George L. Masnik
Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure (1)
Copy for 6110 purposes