

**Internal Revenue Service**

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04-PLR-139627-01

Date:

APRIL 11, 2002

Re:

Legend:

Grantor =  
Spouse =  
Living Trust =

Marital Trust =  
Date 1 =  
Date 2 =  
Date 3 =  
X =  
Probate Court =  
State Statute =  
Child 1 =  
Child 2 =  
Child 3 =  
a =

Dear :

This is in response to your July 23, 2001 letter and other correspondence requesting rulings concerning the income, gift, estate, and generation-skipping transfer tax consequences of the proposed severance of the Marital Trust.

You have requested the following rulings:

1. The proposed severance of the Marital Trust will not result in taxable gifts under sections 2501 or 2519 of the Internal Revenue Code.
2. The qualified terminable interest property (QTIP) election under section 2056(b)(7) in effect for the Marital Trust will remain in effect for each of the new trusts.

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3. Under section 2207A(a), each new trust created after the severance will be obligated to pay a proportionate part of the estate tax liability at the death of Spouse.
4. Neither the severance of the Marital Trust nor formation and funding of the new trusts will result in any generation-skipping transfers under Chapter 13 (either at the time of severance or thereafter).
5. The new trusts formed as a result of this severance will continue to be exempt from generation-skipping transfer tax (GSTT) under section 26.2601-1(b)(1)(iii) of the Generation-Skipping Transfer Tax Regulations.
6. The severance of the Marital Trust and formation of the three new trusts will not be considered to be a sale or other disposition of Marital Trust property.
7. The severance will not cause the Marital Trust, the new trusts, or the beneficiaries thereof to realize any taxable income, gains, or losses under section 61 or 1001.
8. Under sections 643(e)(1) and 1223(2) the basis and holding period of the assets of the Marital Trust will continue to apply to these assets after the transfer to the new trusts.
9. In the year of severance of the Marital Trust, the Marital Trust must file a final income tax return and the three new trusts each must file individual initial income tax returns, all in conformity with normal principles of Subchapter J.
10. The proposed severance of the Marital Trust and the formation of the three new trusts will not result in the transfer of any property interests subject to section 2702.

The facts submitted are as follows:

Grantor executed Living Trust, a revocable trust, on Date 1. Grantor last amended the Living Trust on Date 2. Grantor died on Date 3, prior to September 25, 1985, at which time the trust became irrevocable.

Section 5(C) of the Living Trust as amended provides at Grantor's death, half of the balance of Living Trust assets after paying debts, administration expenses, and a pecuniary bequest for the benefit of the former husband of Grantor, is to pass to the Marital Trust. Section 5(C) further provides that the income from the Marital Trust shall be paid to Spouse quarter-annually during his life. The Trustee of the Marital Trust may pay principal to Spouse for his care and support. Upon Spouse's death, the remainder of the assets in the Marital Trust shall be distributed among trusts provided for under section 5(D), "in shares determined by the rule per stirpes."

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Under section 5(D), the remaining half of the Living Trust assets is to be divided into equal shares, one share for each of Grantor's children then living, and one share for each child with issue then living. Section 5(D)(1) provides that each share allocated for the then living issue of a deceased child of Grantor shall be distributed outright to such issue by right of representation.

Section 5(D)(2) provides that each share allocated for a living child of Grantor shall be held as a separate trust for each such child. Section 5(D)(2)(e) provides that upon the death of the child for whom a trust is named, the trust shall terminate and the trust property shall be distributed to such child's spouse, issue, or Grantor's issue, in trust or otherwise, as the child for whom the trust is named shall appoint in his/her last will and testament by making specific reference to this power.

Section 5(D)(2)(f) provides that upon the death of the child for whom such trust is named, any trust property which has not been effectively appointed under the provisions of section 5(D)(2)(e) shall be distributed to the living issue of the child by right of representation.

On Schedule M of the Federal estate tax return (Form 706) filed for Grantor's estate, the executor of Grantor's estate elected under section 2056(b)(7) to treat the assets of the Marital Trust as qualified terminable interest property (QTIP). There have been no additions to the Marital Trust (constructive or otherwise) since September 25, 1985.

Grantor was survived by her spouse (Spouse) and three children, all of whom are currently living. Grantor has no deceased children.

The trustee of Marital Trust proposes to divide Marital Trust, pro rata, into three equal trusts (new trusts). The terms of each new trust, with respect to Spouse's interest during his life, will be identical to Marital Trust. Each new trust will pay income to Spouse during his lifetime, and each trustee will have discretion to distribute principal Spouse's care and support. No person other than Spouse will be entitled to principal distributions from any new trust during Spouse's lifetime. At Spouse's death, after payment of the trust's proportionate share of estate tax, each of the new trusts will terminate in favor of a designated child's trust that has been established under section 5(D) of Grantor's Living Trust for the benefit of that child.

State Statute provides that a trustee possesses the power to divide trust property into two or more separate portions or trusts with substantially identical terms and conditions and to allocate property between them, in order to simplify administration for generation-skipping transfer tax (GSTT) purposes, to segregate property for management purposes, or to meet another trust objective. The proposed severance of the Marital Trust will be submitted to Probate Court for approval. If Probate Court's approval is not forthcoming, the Marital Trust will not be severed.

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The Marital Trust is currently funded almost exclusively with Class B common stock in X, a publicly traded corporation. The stock owned by Marital Trust constitutes approximately a% of the issued and outstanding Class B common stock.

## LAW AND ANALYSIS

### Rulings 1 - 3

Section 2501 of the Internal Revenue Code 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 section 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 2056(a) provides that, for purposes of the tax imposed by section 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 section 2056(a) where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail.

Section 2056(b)(7) provides an exception to the rule of section 2056(b)(1) in the case of qualified terminable interest property (QTIP). Under section 2056(b)(7)(A), QTIP is treated as passing to the surviving spouse for purposes of section 2056(a), and no part of the property is treated as passing to any person other than the surviving spouse for purposes of section 2056(b)(1). Section 2056(b)(7)(B)(i) provides that QTIP means property: (i) which passes from the decedent; (ii) in which the surviving spouse has a qualifying income interest for life; and (iii) to which an election under section 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.

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Section 2044(b)(1) provides that section 2044 applies to any property if a deduction was allowed with respect to the transfer of such property to the decedent under section 2056(b)(7). Section 2044(b)(2) provides that paragraph (a) applies to any property if section 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

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 of all interests in the property other than the qualifying income interest. Section 2519(b)(1) provides that section 2519(a) applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under sections 2056(b)(7) or 2523(f).

Section 25.2519-1(a) provides that a transfer of all or a portion of the income interest of the spouse in QTIP is a transfer by the spouse under section 2511. Section 25.2519-1(c) provides that the amount treated as a transfer under section 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP 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 section 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 section 25.2511-2.

Section 2207A(a)(1) provides that, if any part of the gross estate consists of property the value of which is includible in the gross estate by reason of section 2044, the decedent's estate shall be entitled to recover from the person receiving the property the amount by which (A) the total tax for such year under chapter 11 which has been paid exceeds (B) the total tax under chapter 11 which would have been payable if the value of such property had not been included in the gross estate.

In the present case, after the proposed severance of the Marital Trust into the three new trusts the beneficial interests of Spouse, Child 1, Child 2, and Child 3 with respect to the new trusts will be identical to those provided under the Marital Trust. Specifically, under the new trusts, Spouse will have the same rights to current income and principal as provided under the Marital Trust. Child 1, Child 2, Child 3, and the more remote issue of Grantor will each have the same rights with respect to the new trusts as under the Marital Trust. Thus, the beneficial interests, rights, and expectancies of the beneficiaries of the new trusts are substantially the same as under the Marital Trust, both before and after the proposed transaction. Accordingly, based on the facts submitted and representations made, we conclude that the proposed severance of the Marital Trust will not result in Spouse making a taxable gift under section 2501 or 2519. Further, the proposed severance will not result in Child 1, Child 2, or Child 3 making a taxable gift under section 2501.

Furthermore, Spouse continues to have a qualifying income interest for life, as defined under section 2056(b)(7)(B)(ii), with respect to the new trusts. Accordingly,

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based on the facts submitted and representations made, we conclude that the QTIP election under section 2056(b)(7) in effect for the Marital Trust will remain in effect for each of the new trusts. Further, section 2207A(a) will apply in determining the estate tax liability of each new trust at the death of Spouse.

#### Rulings 4 - 5

Section 2601 imposes a tax on every generation-skipping transfer. The term generation-skipping transfer is defined in section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax (GSTT) is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iii) provides that, for purposes of Chapter 13, a trust that was irrevocable on September 25, 1985, and that holds qualified terminable interest property by reason of an election under section 2056(b)(7) (made either on, before, or after September 25, 1985) is treated in the same manner as if the decedent spouse had made an election under section 2652(a)(3) (providing for the "reverse" QTIP election). Thus, transfers from these trusts are not subject to Chapter 13, and the decedent spouse is treated as the transferor of the property. This rule does not apply to that portion of the trust that is subject to Chapter 13 by reason of an addition to the trust occurring after September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GSTT under section 26.2601-1(b) will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GSTT if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(i)(E), Example 5, illustrates a situation where a trust that is otherwise exempt from the GSTT is divided into two trusts. Under the facts

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presented, the division of a trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the division, and the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the two partitioned trusts will not be subject to the provisions of chapter 13.

For purposes of the present case, it is represented that no additions (actual or constructive) have been made to Marital Trust after September 25, 1985. The proposed severance of Marital Trust by the trustees will not result in a shift of any beneficial interest in Marital Trust or the new trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed severance will not extend the time for vesting of any beneficial interest in the new trusts beyond the period provided for in Marital Trust.

Accordingly, based on the facts submitted and representations made, we conclude that neither the severance of the Marital Trust nor formation and funding of the new trusts will result in any generation-skipping transfers under Chapter 13 (either at the time of severance or thereafter) and that the grandfathered, exempt status of the Marital Trust under section 26.2601-1(b)(1)(iii) will continue to apply with respect to the three new trusts.

#### Rulings 6 - 7

Section 61(a)(3) provides that gross income includes gains derived from dealing in property.

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 section 1011 for determining gain, and the loss is the excess of the adjusted basis over the amount realized.

Section 1.1001-1(a) of the Income Tax Regulations provides that 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 as loss sustained.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Supreme Court of the United States examined the issue of what constitutes a *material* difference in exchanged properties or a disposition of property for purposes of the realization requirement implicit in section 1001(a). In Cottage Savings, a savings and loan association sold 90-percent participation interests in 252 mortgage loans to four other lenders. Simultaneously, the association purchased 90-percent participation interests in 305 mortgage loans held by these lenders. The exchanged properties were derived from loans made to different obligors, secured by different homes, and thus embodied legally distinct entitlements. The association claimed a deduction under

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section 165(a) for the adjusted difference between the face value of the participation interest the association had traded and the fair market value of the participation interest it had received.

The Supreme Court determined that exchanged properties are materially different for purposes of section 1001 if those property owners enjoy legal entitlements that are different in kind or extent. Cottage Savings, at 565. Because the mortgages had different mortgagors and were secured by different properties, the loans were materially different. The Court therefore held that the taxpayer actually sustained a loss for purposes of section 165(a).

In Rev. Rul. 69-486, 1969-2 C.B. 159, a trust instrument required the trustee to distribute the corpus of a trust, consisting of promissory notes and common stock, one-half to an individual and one-half to a tax exempt charitable organization. The beneficiaries, however, agreed that the individual should receive all the notes and the charitable organization should receive all the stock. Although the trustee complied with their request, neither the trust instrument nor local law allowed the trustee to make an allocation of specific property in kind. Thus, the beneficiaries were considered to have received a pro rata distribution of the notes and stock, followed by a *deemed* exchange of their respective pro rata share of stock and notes. Rev. Rul. 69-486 therefore held that the individual recognized gain on the disposition of his shares of the common stock in an amount determined under section 1001.

In contrast to the situation in Rev. Rul. 69-486, the trustee represents that the severance of the Marital Trust would be pro rata and that each of the new trusts would be subject to the same trust provisions currently applicable to the Marital Trust. Accordingly, we conclude that the severance of the Marital Trust and the formation of the three new trusts will not be considered to be a sale or other disposition of Marital Trust property and, thus, will not cause the Marital Trust, the new trusts, or the beneficiaries thereof to realize any taxable income, gains, or losses under section 61 or 1001.

### Ruling 8

Section 1015(b) provides that, if property is acquired by a transfer in trust (other than a transfer in trust by gift, bequest, or devise), the basis shall be 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.

Section 1.1015-2(a)(1) of the Income Tax Regulations provides that, in the case of property acquired after December 31, 1920, by transfer in trust, (other than by a transfer in trust by gift, bequest, or devise), the basis of 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 upon such transfer under the law applicable to the year in which the transfer is made.



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Section 1.1015-2(a)(2) provides that the principles in section 1.1015-1(b) concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust.

Section 1.1015-1(b) provides that property to which the uniform basis rules apply has a single or uniform basis although more than one person may acquire an interest in the property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017.

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included in the period for which the property was held by any other person, if under chapter one such property has, for the purpose 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 such other person.

Accordingly, based on the facts submitted and representations made, the basis of the assets in the three new trusts will be the same as the basis of the assets currently held in the Marital Trust. Furthermore, we conclude that the assets in the new trusts, after the proposed severance, will have the same holding period as the assets had prior to the severance.

#### Ruling 9

Section 643(a) provides that "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with modifications described in section 643(a)(1)-(7).

Section 643(c) provides that the term "beneficiary" includes an heir, legatee, and devisee.

Section 1.643(c)-1 provides that an heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries: (a) any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in section 1.662(a)-4; (b) the grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust; and (c) the trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust.

Section 661(a) provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of a trust (other than a trust to which subpart B applies), the sum of (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may

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be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid or credited or required to be distributed for such taxable year; but such deduction shall not exceed the distributable net income of the trust.

Section 1.661(a)-2(a) provides that in computing the taxable income of a trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of: (1) the amount of income for the taxable year which is required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year. However the amount deductible cannot exceed the distributable net income of the trust.

The new trusts are not beneficiaries of the Marital Trust, and the transfer of the assets into the three new trusts is not a distribution under section 661. The distributable net income of the Marital Trust will be included in its final income tax return, and the distributable net income of the three new trusts will be included in the respective income tax returns of the new trusts. The distributable net income of the Marital Trust and the three new trusts will be taxable to Spouse, to the extent that each trust's accounting income is distributed to Spouse.

#### Ruling 10

Section 2702 provides special valuation rules in the case of transfers of interests in trusts. Under section 2702(a), for purposes 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 shall be determined as provided in section 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 section 7520.

As discussed above, the interests of each beneficiary of the new trusts (Spouse, Child 1, Child 2, Child 3, and their issue) will be identical to the respective interests provided under the Marital Trust. Accordingly, under the facts presented, the severance of the Marital Trust into three new trusts will not involve the transfer of property with a retention of an interest in the property. Therefore, based on the facts submitted and representations made, we conclude that section 2702 should not be applicable to the proposed severance.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

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.

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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.

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

Sincerely yours,  
George Masnik  
Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes