

INTERNAL REVENUE SERVICE
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Legend:
Decedent =
Trustee =
Date 1 =
Date 2 =
Date 3 =
Date 4 =

ISSUES:

(1) Is the value of the corpus of the grantor retained income trust created by the Decedent includible in the Decedent's gross estate under § 2035 of the Internal Revenue Code?

(2) Alternatively, did the Decedent make a gift to the trust remaindermen when the trustee commuted the Decedent's interest in the trust and paid the decedent less than the fair market value of the interest.

CONCLUSIONS:

(1) The value of the trust corpus is includible in the Decedent's gross estate under § 2035.

(2) Alternatively, the Decedent made a gift to the trust remaindermen when the trustee commuted the Decedent's interest in the trust and paid the Decedent less than the fair market value of the interest.

FACTS:

In 1988, Decedent created a Grantor Retained Income Trust. Under the terms of the trust, the trustee is to pay the trust income to decedent for ten years. If the decedent dies during the ten-year term, then the trust property passes to the decedent's revocable trust. Under Article Sixth, if the Decedent's interest terminates other than by reason of her death (e.g., the decedent survives the ten-year period), the property will pass in trust for the benefit of the decedent's three children.

Article Fifth of the trust grants the trustee the discretionary power to terminate the Decedent's interest in the trust as follows:

FIFTH: Notwithstanding the foregoing, the Trustee may terminate my interest in the trust at any time by distributing to me that fractional share of the property belonging to the principal of the trust which constitutes the then value as determined pursuant to Table B of the Treasury Regulations Section 25.2512-5(f) (or such other regulation as shall be applicable at the time of termination) of my interest in income and principal of the trust determined immediately prior to such termination.

On Date 1, in 1995, the decedent was admitted to the hospital. The Decedent had been diagnosed with terminal cancer.

Eight days later, on Date 2, the trustee wrote the three remaindermen and informed the remaindermen that if Decedent died during the ten-year trust term, then the entire value of the trust would be included in Decedent's gross estate. The letter further stated that, by commuting the Decedent's interest, and, thus avoiding inclusion of the entire trust corpus in the gross estate, a significant amount of estate tax could be saved. The letter then requested the beneficiaries' recommendation regarding commutation. The three remaindermen recommended commutation.

Eleven days later on Date 3, the trust was valued at \$6,159,479.05. The trustee distributed \$2,247,981.95 to a separate account for the Decedent. The balance of the trust, \$3,911,497.20, was distributed to the three remainder beneficiaries (pursuant to authority contained in Article TENTH). The amount distributed to the Decedent was the actuarial value of Decedent's interest on the date of the distribution, determined based on the actuarial tables contained in the regulations.

The Decedent died the following day on Date 4.

LAW and ANALYSIS ISSUE 1:

Section 2035(a), prior to amendment by the Taxpayer Relief Act of 1997, provided that the gross estate shall include the value of all property of which the decedent has "made a transfer" during the three year period ending on the date of the decedent's death. Under § 2035(b)(1), § 2035(a) did not apply in the case of a bona fide sale for adequate and full consideration in money or money's worth. Under § 2035(d)(1), the § 2035(a) three year inclusion rule also did not apply to estates of decedents dying after December 31, 1981. However, under § 2035(d)(2), § 2035(d)(1) did not apply:

to a transfer of an interest in property which is included in the value of the gross estate under §§ 2036, 2037, 2038 or 2042, or would have been included under any such sections if such interest had been retained by the decedent.

Section 2036 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death the possession or enjoyment of, or the right to the income from, the property.

In United States v. Allen, 293 F.2d 916 (10th Cir. 1961), the settlor created an irrevocable trust reserving an income interest for her life in a portion of the trust. Subsequently, the settlor sold her income interest in the trust to her son in exchange for an amount equal to the actuarial value of the income interest. The estate acknowledged that if the decedent had gratuitously transferred her income interest in the trust, the trust corpus would be includible under § 811(c)(1)(A) of the 1939 Code, the predecessor to § 2035¹. However, because the settlor received adequate consideration for the transfer of the income interest, the estate argued that § 811(c)(1)(A) did not apply. The court concluded that in order to remove the trust

District Director

¹ That section provided for the inclusion in the gross estate of all property to the extent of any interest therein that the decedent had made a transfer (except in the case of a bona fide sale for an adequate and full consideration) in contemplation of the decedent's death.

property from a decedent's gross estate under the bona fide sale exception to § 811(c)(1)(A), the consideration received for the sale had to be at least equal to the value of the property that would have been included in the gross estate if the interest had been retained. In Allen, since the settlor had reserved an income interest in part of the trust corpus, the portion of the trust associated with the reserved income interest would have been included in the settlor's gross estate upon the settlor's death. Thus, payment equal to the value of the income interest was not adequate and full consideration for purposes of the statute, because the value of the income interest was less than the value of the trust portion that would otherwise be included in the settlor's gross estate if the income interest had been retained until death. The court stated:

It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of the property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.

United States v. Allen, 293 F.2d at 918.

As noted above, under § 2035(d)(2), § 2035(a) applies if the Decedent, within three years of death, transferred an interest in property and such property would have been included in the gross estate if the transferred interest had been retained by the Decedent.

There is little distinction between the sale considered by the court in United States v. Allen and the commutation involved in the instant case. In Allen, the decedent transferred her interest to her son in exchange for cash. In this case, the commutation effectuated a transfer of the decedent's interest to the trust (or the trust remaindermen) in exchange for cash. The amount received by the Decedent for the transfer of her income interest did not constitute adequate and full consideration for purposes of the "bona fide sale" exception contained in § 2035, since the amount received was only a fraction of the value of the trust corpus subject to inclusion under § 2036. Further, it is questionable whether the commutation transaction could be characterized as a sale, but in any event, it would clearly not

constitute a "bona fide" sale. As the facts indicate, the intra-family transaction was consummated shortly before Decedent's death. The amount received by the Decedent, considering the state of Decedent's health, was wholly inadequate, in view of the right of Decedent's revocable trust to receive the entire trust corpus in the event Decedent died prior to the expiration of the 10 year trust term. The parties were clearly not dealing at arm's length. Accordingly, as was the case in Allen, the entire trust corpus (less the payment received for the income interest) should be included in the gross estate under § 2035.

Taxpayer argues that §§ 2035(a) and 2035(d)(2) do not apply to the transaction, because the Decedent did not "transfer" the retained interest. Rather the term "transfer" implies a volitional act. Here taxpayer was required to relinquish her interest pursuant to the terms of the trust authorizing the trustee to commute her interest. However, in this case, the Trustee's actions effectuated a transfer of Decedent's retained interest in the trust for a cash payment. Although the trustee may have initiated the transaction, nonetheless, the transaction resulted in a transfer by the Decedent of her retained interest for purposes of § 2035(d)(2). The Decedent authorized the commutation clause in the trust with the intent and expectation that the trustee would exercise the power in appropriate circumstances, such as a situation where the Decedent's death was imminent. Thus, although the Decedent did not formally initiate the commutation, the exercise of the power by the trustee was consistent with Decedent's intent and was authorized, if not implicitly directed, by the Decedent. Further, the transaction was entirely intra-family between the Decedent and her children, and was consummated solely to reduce the impending estate tax liability. Thus, even assuming that statute requires that an intra-family transaction must be initiated or consented to by the decedent, it is difficult to characterize the transaction in this case as other than a "transfer" within the purview of § 2035, by the Decedent. As the court noted in United States v. Allen, "It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates."

LAW AND ANALYSIS ISSUE 2:

In the alternative, the Decedent made a gift to the trust remaindermen at the time her interest was commuted.

Section 2511(a) 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(g)(1) of the Gift Tax Regulations provides that donative intent on the part of a transferor is not an essential element in the application of the gift tax to a transfer. Whether the gift tax is applicable is based upon the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. The tax, however, is not applicable to transfers for full and adequate consideration in money or money's worth or to ordinary business transactions.

Rev. Rul. 80-80, 1980-1 C.B. 194, declared obsolete in Rev. Rul. 96-3, 1996-1 C.B. 348, effective December 14, 1995, provides that the actuarial tables contained in the estate and gift tax regulations are disregarded in determining the value of an interest based on a measuring life of an individual if the individual is afflicted with an advanced state of an incurable disease such that the individual's death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. For example, death is not clearly imminent if the individual may survive for a year or more and if such a possibility is not so remote as to be negligible.

In the instant case, assuming that it is established that at the time of the transaction, Decedent's death was clearly imminent within the meaning of Rev. Rul. 80-80 (the Service position applicable at the time of the commutation), the Decedent should be deemed to have made a gift to the remaindermen when the trustee commuted her interest; or the Decedent's estate should include a right of action against the remaindermen. That is, under Rev. Rul. 80-80, the Decedent's income interest had little or no value. However, the right of her revocable trust to receive the entire trust corpus if she died within the 10 year term of the trust had a value equal to the entire value of the trust corpus, \$6,159,479.05. Thus, when the trustee distributed \$3,911,497.20 to the remaindermen, the decedent should be viewed as making a gift (or the decedent's estate has a claim against the remaindermen) of that amount. Under Article Fifth, the trustee was required to distribute to the Decedent her "then value... in income and principal of the trust determined immediately prior to such termination." The trustee ignored the application of Rev. Rul. 80-80, and valued the Decedent's income and reversion using the actuarial tables. This approach undervalued the decedent's interests by \$3,911,497.20.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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