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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
**CC:PSI:4-PLR-129163-01**  
Date:  
APRIL 23, 2002

Re:

LEGEND:

Decedent	=
Spouse	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
y%	=
z%	=
County	=
State	=
State Statute 1	=

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State Statute 2 =

Bank =

Date 1 =

Dear :

This is in response to your correspondence dated April 30, 2001, requesting a ruling concerning the estate and gift tax consequences of the proposed severance of the Marital Trust and Spouse's proposed renunciation of her interest in one of the severed trusts under §§ 1222, 2207A, 2511, 2519, and 2702 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Decedent, a resident of County, State, died testate, on Date 1, survived by his wife, Spouse. Under the terms of Article Eight of Decedent's will, if Spouse survives Decedent, the residue of Decedent's estate is to be distributed to a Marital Trust for the benefit of Spouse.

Under Article Nine, the trustees of Marital Trust are to distribute or apply all of the net income to or for the benefit of Spouse, in quarterly or more frequent installments during her lifetime. The trustees may distribute or apply, from time to time, so much or all of the corpus of Marital Trust to or for the benefit of Spouse in the trustees absolute discretion to provide for Spouse's maintenance in health and reasonable comfort and support in her accustomed manner of living.

Upon Spouse's death, the trustees of Marital Trust are to pay the personal representative of Spouse's estate, the portion of death taxes due resulting from the inclusion of Marital Trust in Spouse's gross estate. The remaining property of Marital Trust is to be distributed as follows: (1) If the generation-skipping transfer (GST) tax inclusion ratio of the Marital Trust property is zero, the property is to be distributed to Decedent's then living descendants, per stipes, subject to the provisions of Article Ten, or, if none, as directed in Article Eleven. If the generation-skipping transfer tax inclusion ratio (as determined under § 2642) of the property is one, the property is to be distributed as directed in Article Eleven.

Article Ten is applicable to property that is to be distributed from Marital Trust to a child or more remote descendant of Decedent, who at the time of Spouse's death is under the age of 21 years. Otherwise, the Marital Trust property is to pass pursuant to Article Eleven. Article Eleven provides that the Marital Trust property is to be distributed to beneficiaries named below in specified shares as follows:

- E - \$y%
- F - \$y%

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G - \$y%  
D - \$z%  
H - \$y%  
I - \$y%  
J - \$y%

If any of the named beneficiaries who are children of Decedent fail to survive Spouse, the share for the deceased beneficiary is to be distributed to his or her then living descendants, per stipes, and if none, to Decedent's other living descendants, per stipes, excluding D and any of D's descendants then living, unless Spouse has no other living descendants.

Decedent's executors elected to make a qualified terminable interest property (QTIP) election with respect to the Marital Trust. The trustees of Marital Trust are Spouse, D, and Bank.

It is represented that because of different investment philosophies and risk tolerances, Spouse, D, Bank, and the other remainder beneficiaries have disagreed about the investment and management of the Marital Trust. As a result, the parties have not been able to take advantage of desired investment and management decisions. These differences have been most pronounced with respect to Decedent's son, E.

In an effort to preserve the relationships among the parties and resolve their investment difficulties, Spouse, Bank, D, and the other remainder beneficiaries have proposed a settlement (Settlement Agreement) whereby they will divide the Marital Trust into seven marital trusts, one created for each of the remainder beneficiaries. Each separate trust would be funded with a pro rata portion of the property of the Marital Trust based on the percentage set forth in Decedent's will for each remainder beneficiary. Except as provided in the Settlement Agreement with regard to the separate marital trust created for E, each separate trust will be held and administered pursuant to the same terms and conditions as the original Marital Trust. Thus, Spouse would retain rights in and to the income and principal of the trust estate of each of the separate trusts in the same manner as provided in Article Nine. Each remainder beneficiary will be permitted to render advice to the trustees as to the management of the separate trust created for such beneficiary. Upon Spouse's death, the trust estate of each separate trust will be distributed to the remainder beneficiary for whom the trust was created, if he or she survives Spouse. If he or she does not survive Spouse, the trust estate of the separate trust would be distributed to his or her descendants, pursuant to the terms of Decedent's will.

In addition, the Settlement Agreement provides that, after the Marital Trust has been severed into seven separate trusts and each has been funded with a pro rata share of the Marital Trust, with respect to the separate trust created for E, Spouse will sell her qualifying income interest in the trust property to E, and E will purchase

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Spouse's qualifying income interest for its actuarial value. The sale of Spouse's qualifying income interest will result in the termination of the separate trust created for E. The property of the terminated separate trust will be distributed pursuant to the terms of the Settlement Agreement to E, the remainder beneficiary of the terminated trust.

Under the terms of the Settlement Agreement the trustees of the Marital Trust will determine the actuarial value of Spouse's qualifying income interest in the property of the terminated trust by taking into account Spouse's life expectancy, based on applicable Internal Revenue Service tables, the fair market value of the property of the terminated separate trust on the relevant valuation date, the § 7520 rate in effect for the relevant valuation date, and applicable estate and gift tax regulations, including § 20.2031-7(d) of the Estate Tax Regulations. This amount will be deposited in an escrow fund and paid to Spouse within thirty days of being deposited. Under the terms of the Settlement Agreement, Spouse agrees that neither she nor her agents will assert any claim or demand whatsoever against the trustees of Marital Trust, the separate marital trusts, or the remainder beneficiaries by reason of the financial, tax or other consequences of the Settlement Agreement.

In addition, the Settlement Agreement provides that the trustees will sell an amount of the property of the terminated separate trust sufficient to pay the state and federal gift taxes due on the termination, and the state and federal capital gains taxes due on such sale. Further, the Settlement Agreement states that the trustees of the terminated separate trust shall pay all state and federal taxes incurred by Spouse as a result of the termination of the trust, as finally determined for state and federal gift tax purposes.

Lastly, the trustees will transfer to E, the remainder beneficiary of the terminated separate trust, the property of that trust less the escrow fund. The escrow fund will be equal to the sum of: (i) the amount of state and federal gift taxes paid by the trustees pursuant to § 2207(A)(b), (ii) the actuarial value of Spouse's qualifying income interest as determined above, and (iii) the amount of state and federal estate taxes that would be payable by Spouse's estate on the gift taxes paid by the trustees pursuant to § 2207A(b) if Spouse were to die within three years of Spouse's § 2519 gift. The escrow fund will be held and distributed by an escrow agent pursuant to an escrow agreement.

Prior to undertaking the proposed transaction, Spouse intends to file a "Petition to Modify the Marital Trust and Approve the Settlement Agreement," with the Probate Court of County, State, which has jurisdiction over the Marital Trust. The petition will request the Court to approve the severance of the Marital Trust into the separate trusts, the funding of the separate trusts, and the termination and disposition of the property of the separate trust to be established for the benefit of E. The Settlement Agreement is contingent upon the Court's approval and, if approved, the proposed transaction will take effect ten days after the date of the Court's Order.

You have requested the following rulings:

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1. Upon Spouse's sale of her qualifying income interest in the separate marital trust created for E, Spouse will not be deemed to have made a taxable transfer of any property in the remaining separate marital trusts under § 2519.

2. Assuming that: (a) Spouse retains her qualifying income interest in the property of the separate marital trusts other than the separate trust established for the benefit of E; (b) Spouse receives an amount equal to the actuarial value of her qualifying income interest in the terminated trust in exchange for such interest and; (c) Spouse is reimbursed for the gift taxes due on Spouse's § 2519 gift, pursuant to § 2207A(b), Spouse will not be treated as making a gift of her qualifying income interest under § 2511.

3. Upon the termination and disposition of the separate marital trust established for the benefit of E, and the payment by the trustees of all state and federal gift taxes attributable to such termination and distribution, pursuant to § 2207A(b), the value of Spouse's § 2519 gift will be reduced by the gift taxes paid by the trustees.

4. In determining the value of Spouse's gift resulting from Spouse's sale of her qualifying income interest in the separate marital trust established for E: (a) The value of Spouse's income interest in the remaining separate marital trusts will not be valued at zero under § 2702 and (b) The amounts that Spouse actually receives for her qualifying income interest in the property of the terminated separate marital trust will not be valued at zero.

5. Upon Spouse's sale of her qualifying income interest in the property of the separate marital trust established for the benefit of E, in exchange for its actuarial value, the character of the income to Spouse from the sale will constitute long-term capital gain under § 1222(3).

## Law and Analysis

### Rulings 1-4

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 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 § 2056(b)(1) in the case of qualified terminable interest property. Under § 2056(b)(7)(A), qualified terminable interest property (QTIP) 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. Section 2056(b)(7)(B)(i) provides that the term "qualified terminable interest property" means property: (i) which passes from the decedent; (ii) in

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which the surviving spouse has a qualifying income interest for life; and (iii) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2501 imposes a tax on the transfer of property by gift during the year by an individual, resident or nonresident. Section 2502(c) provides that the gift tax is the liability of the donor.

Section 2511(a) provides that the gift tax imposed by § 2501 applies 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's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 2702 provides special valuation rules in the case of transfers of interests in trust. Under § 2702(a), in 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 § 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 2519(a) provides that for gift and estate tax purposes, any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest. Section 2519(b) 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 § 2056(b)(7).

Section 25.2519-1(a) of the Gift Tax Regulations provides that a transfer of all or a portion of the income interest of the surviving spouse in QTIP property is a transfer by the surviving spouse under § 2511. 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 disposition. The gift tax consequences of the disposition of the qualifying income interest are determined under § 25.2511-2.

Section 25.2511-2(a) 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.

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Section 2207A(b) provides that, if for any calendar year tax is paid under chapter 12 (gift tax) 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(e), if the property is in trust at the time of the transfer, the person receiving the property is the trustee.

Rev. Rul. 75-72, 1975-1 C. B. 310, holds that if, at the time of the transfer, the gift is made subject to a condition that the gift tax is to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under section 2512(b), the value of the gift is measured by the fair market value of the property passing from the donor minus the amount of the gift tax to be paid by the donee. See also, Rev. Rul. 81-223, 1981-2 C.B. 189.

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(b) statutorily shifts the burden, but not the liability for paying the gift tax to the donee. By reimbursing the donor for the gift tax paid pursuant to the statute, the donee provides consideration for the gift. The donee's payment inures to the benefit of the donor because it reimburses the donor for gift tax that the donor was liable for and would otherwise be required to pay out of the donor's own funds. See Rev. Rul. 75-72. Accordingly, net gift treatment of a transfer under § 2519 is implicit under § 2207(b).

State Statute 1 provides that a trustee is authorized to divide any trust, before or after its initial funding, into two or more separate trusts, and to make payments of distributions that are authorized by or directed in the governing instrument from one or more separate trusts.

State Statute 2 provides that when all the adult beneficiaries who are not disabled consent, the court may, upon finding that such variation will benefit the disabled, minor, unborn and unascertained beneficiaries, vary the terms of a private trust so as to reduce or eliminate the interests of some beneficiaries and increase those of others, to change the times or amounts of payments and distributions to beneficiaries, or to provide for termination of the trust at a time earlier or later than that specified by the terms.

Based upon the facts and representations submitted, the authority above, and the issuance of the County, State's order approving the proposed transaction, we conclude that if Spouse sells her qualifying income interest in the separate trust to be established for the benefit of E, then:

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1. Spouse will not be deemed, under § 2519, to have made a gift of the property in the remaining separate trusts that are proposed to be established.

2. Assuming that the trustees of the separate marital trust established for the benefit of E pay all state and federal taxes attributable to the termination of E's separate marital trust, the amount of Spouse's § 2519 transfer will be reduced by the gift taxes paid by the trustees of Marital Trust, as provided under § 2207A(b).

3. Upon the termination and disposition of the separate marital trust established for the benefit of E, and the payment by the trustees of all state and federal gift taxes attributable to such termination and distribution, pursuant to § 2207A(b), the value of Spouse's § 2519 gift will be reduced by the gift taxes paid by the trustees.

4. Upon termination of the separate marital trust established for the benefit of E, (a) the value of Spouse's income interest in the remaining separate marital trusts will not be valued at zero under section 2702 and (b) the amounts that Spouse actually receives for her qualifying income interest in the property of the terminated separate marital trust will not be valued at zero.

#### Ruling 5

Section 1222(3) defines the term "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

Rev. Rul. 72-243, 1972-1 C.B. 233, provides, in part, that the Service will follow the decision in McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947). In McAllister, the court held that the proceeds received by a life tenant of a testamentary trust, in consideration for the transfer of her entire interest in the trust to the remainderman, are to be treated as an amount realized from the sale or exchange of a capital asset under § 1222.

Under the present facts, in an effort to preserve the relationships among the parties and resolve their investment difficulties, Spouse, the trustees, and the remainder beneficiaries have proposed a settlement whereby the Marital Trust will be divided into seven separate marital trusts. Each separate trust would be funded with a portion of the property of the Marital Trust based on the percentages set forth in Decedent's will for each remainder beneficiary. Under the terms of this settlement, Spouse will then sell her qualifying income interest in the property of the separate marital trust created for E, to E, the remainder beneficiary of that trust, who will purchase such interest from Spouse for its actuarial value as determined above.

Pursuant to Rev. Rul. 72-243, the sale by Spouse of her entire interest in the separate marital trust is treated, as the sale of a capital asset. Since Decedent passed away on Date 1, more than one year prior to the proposed sale of Spouse's qualifying income interest, the asset will be considered held by Spouse for more than one year.

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Accordingly, any income to Spouse from the sale of her qualifying income interest in the terminated separate trust constitutes long-term capital gain under § 1222(3)

Except as ruled 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.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely yours,  
LORRAINE E. GARDNER  
Assistant to the Branch Chief  
Branch 4  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure

Copy of letter for section 6110 purposes