

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-PLR-162843-02
Date:

Re:

MAY 13, 2003

Legend:

Decedent =

Spouse =

Child 1 =
Child 2 =
Child 3 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Year 1 =
Year 2 =

Corporation =

U =
V =
\$W=
\$X =
\$Y =

\$Z =
Court =

Dear _____ :

This is in response to a letter dated April 9, 2003 and prior correspondence in which your personal representative, on your behalf, requested a ruling concerning an adjustment to your unified credit/applicable credit amount under § 2505 of the Internal Revenue Code, as described below.

Facts

The facts are submitted and represented to be as follows: Decedent died testate on Date 1, survived by his wife, Spouse, and three children, Child 1, Child 2 and Child 3.

Decedent's will provided for the establishment of a marital trust for the benefit of Spouse to be funded with the minimum amount necessary to reduce the estate tax to zero after taking into account all available credits and other property passing to Spouse that qualifies for the marital deduction. Under Article IV, Subarticle 4.3(a), during Spouse's lifetime, the entire net income is to be paid to Spouse, at least quarterly. Under Subarticle 4.3(b), the trustee (other than Spouse) may pay to Spouse as much or all of the principal for Spouse's comfortable support and maintenance in Spouse's accustomed manner of living, and for medical care. Under Subarticle 4.6, upon the death of Spouse, the trustee is to transfer the remaining principal of the trust to or for the benefit of any one or more of Decedent's living issue as Spouse may appoint. Subarticle 4.7, provided that any remaining principal of the trust which Spouse has not appointed by will is to be distributed to Decedent's issue, per stirpes. Under Article V, Decedent devised the remainder of his estate, if Spouse survived Decedent, to Decedent's issue, per stirpes. Finally, Article VII, Subarticle 7.3, provided that no beneficiary can, voluntarily or involuntarily, anticipate, sell, assign, mortgage, pledge, or otherwise dispose of or encumber all or any part of Decedent's trust estate. Further, no part of the trust estate, including income, is to be liable for the debts or obligations, including alimony, of any beneficiary or be subject to attachment, garnishment, execution, creditor's bill, or other legal or equitable process.

On the Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return filed for Decedent's estate, the executor elected to treat the property passing to the marital trust as qualified terminable interest property under § 2056(b)(7). Accordingly, a deduction was claimed for the value of the property passing to the marital trust.

Decedent's gross estate included U shares of stock in Corporation, a closely held company. The Decedent's executors decided to fund the marital trust, in part, with V shares of Corporation in exchange for an aggregate payment of \$W from the children. On Date 2, prior to August 5, 1997, Spouse executed an assignment agreement by which she assigned her entire interest in the marital trust to her three

children, Child 1, Child 2 and Child 3. Accordingly, the shares in corporation were not retitled in the name of the marital trust. Rather, the shares were transferred directly to Child 1, Child 2 and Child 3. Spouse's transfer was reported on Spouse's Year 2 United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). See §§ 2519, 2511, and 2512. Spouse had previously made taxable gifts in Year 1 and filed a Form 709 using \$X of her then available unified credit under § 2505. As a result of the combined Year 1 and Year 2 gifts, Spouse exhausted the remainder of her unified credit of \$Y in Year 2 and paid \$Z in federal gift tax because of the Year 2 transfers.

Soon thereafter, Spouse commenced a lawsuit contending that the transfers by assignment on Date 2 were not valid. On Date 3, Court ordered that, until further ordered, all parties were enjoined from taking any action to effectuate the transfer of the shares of Corporation. On Date 4, Court issued its decision concluding that, in view of the spendthrift provision in Subarticle 7.3, "[t]he clear and unmistakable intention of [Decedent] was to protect [Spouse] from improvidently divesting herself of the corpus of the marital trust." The Court reviewed the criteria that must be satisfied in order to allow premature termination of a spendthrift trust and determined that these requirements had not been satisfied. See Trust Co. of New Jersey v. Gardner, 133 N.J. Eq. 436 (Chan.1943); In re Stone, 21 N.J. Super. 117, 128 (Ch. Div. 1952); Mesce v. Gradone, 1 N.J. 159 (1948); In Re Ransom Testamentary Trust, 180 N.J. Super. 108 (Law Div. 1981); In the Matter of the Estate of George v. Branigan, 129 N.J. 324 (1992). Accordingly, the Court held that Spouse's assignment of her interest in the marital trust was null and void. On Date 5, Court issued an order stating that the gifts made by Spouse by the assignment agreement were "null and void." Finally, on Date 6, the appropriate appellate court issued an order of dismissal which terminated the litigation and resulted in a final determination of the invalidity of the gifts. Under the Court order, the parties were restored to status quo ante as of Date 2, and therefore, all assets have been restored to the marital trust subject to the qualified terminable interest property election under § 2056(b)(7).

Spouse requests a ruling that Spouse's unified credit/applicable exclusion amount used in Year 2 in the amount of \$Y be restored to reflect the Court's decision that gifts made by Spouse by the assignment agreement on Date 2 were "null and void."

Discussion

Section 2501 of the Internal Revenue Code provides for the imposition of gift tax on the transfer of property by gift. Section 2502 provides, generally, that the tax imposed by § 2501 shall be an amount equal to the excess of –

(1) a tentative tax on the aggregate sum of the taxable gifts for the calendar year and for each of the preceding calendar periods, over

(2) a tentative tax on the aggregate sum of the taxable gifts for each of the preceding calendar periods.

Section 2504(a) provides, generally, that in computing taxable gifts for preceding calendar years or calendar quarters for the purpose of computing the tax for any calendar quarter, there shall be treated as gifts such transfers as were considered to be gifts under the gift tax laws applicable to the years or calendar quarters in which the transfers were made and there shall be allowed such deductions as were provided for under such laws. Section 2504(c) further provides, prior to amendment by Taxpayer Relief Act of 1997 (the 1997 Act) applicable in the case of gifts made after August 5, 1997, that if the valuation of a transfer for gift tax purposes with respect to a gift made in a preceding calendar year or calendar quarter is at issue, and if the statutory period within which an assessment may be made with respect to the gift has expired and a tax has been actually assessed or paid for such prior calendar year or calendar quarter, then the value of the gift, for purposes of arriving at the correct amount of the taxable gifts for preceding calendar years and calendar quarters is the value that was used in computing the tax for the last preceding calendar year or calendar quarter for which a tax was assessed or paid under chapter 12 or the corresponding provisions of prior laws.

Section 25.2504-1(d) of the Gift Tax Regulations states that if interpretations of the gift tax law in prior calendar years or calendar quarters resulted in the erroneous inclusion of property for gift tax purposes that should have been excluded, or the erroneous exclusion of property that should have been included, adjustments must be made in order to arrive at the correct aggregate of taxable gifts.

Section 25.2504-2(a) of the Gift Tax Regulations discusses the application of § 2504(c) as the section applies to gifts made prior to August 6, 1997. The regulations provide that § 2504(c) does not prevent an adjustment in value where no tax was paid or assessed for the prior calendar year or calendar quarter. Furthermore, the rule preventing adjustments does not apply to adjustments involving issues other than valuation.

Section 2505(a), as effective for gifts made after December 31, 2001, but before December 31, 2009, provides that in the case of a citizen or resident of the United States, there shall be allowed as a credit against the tax imposed by § 2501 for each calendar year an amount equal to –

(1) the applicable credit amount in effect under § 2010(c) for such calendar year (determined as if the applicable exclusion amount were \$1,000,000) reduced by

(2) the sum of the amounts allowable as a credit to the individual under § 2505 for all preceding calendar periods.

Rev. Rul. 76-451, 1976-2 C.B. 304, considers a situation where donor made gifts to his spouse in 1961 and 1962, but failed to claim a marital deduction for the transfers that was otherwise allowable in computing taxable gifts. A gift tax was assessed and paid on the transfers. Subsequently, the donor made gifts in 1976. The ruling notes that under § 2504(c) (as that section applies prior to amendment by the 1997 Act) even if the time for the assessment of gift tax for 1961 and 1962 had expired and a gift tax

had been assessed and paid for those years, the gifts made in those years can be adjusted for purposes of computing the 1976 gift tax, because the basis for the adjustments is an issue other than valuation. Accordingly, the ruling concludes that the marital deduction not claimed by the donor in determining the amount of the taxable gifts for 1961 and 1962 would nonetheless be taken into account in determining the aggregate sum of prior taxable gifts in order to determine the tax rate applicable to the donor's 1976 gifts under § 2502(a). In addition, the ruling concludes that specific exemption under § 2521 (repealed by the Tax Reform Act of 1976 generally effective for gifts made after December 31, 1976) that was erroneously used by the donor by failing to claim a marital deduction, is restored to the donor and can be utilized in determining the donor's 1976 gift tax liability.

Rev. Rul. 84-11, 1984-1 C.B. 201, considers a situation where donor made a gift of stock to A in 1977. On a timely-filed gift tax return, the donor valued the gift at \$123,000 which resulted in a gift tax liability of \$29,800 that was fully offset by the unified credit. In 1982, donor made a gift to B of \$282,000. When the gift tax return that reported the 1982 gift was audited, an adjustment was made to increase the value of the 1977 gift to reflect the correct fair market value of the stock at the time of the 1977 gift. Although no gift tax could be assessed for the 1977 gift because the period of limitations on assessment had expired, the adjustment increased the aggregate sum of donor's taxable gifts. The donor contended that the adjustment was barred by § 2504(c) (prior to amendment by the 1997 Act) because utilization of the unified credit to offset the gift tax liability constitutes a payment of tax. The ruling concludes that the use of the unified credit does not result in the payment or assessment of gift tax that would preclude an adjustment to the value of the gift under § 2504(c). Accordingly, for purposes of determining the aggregate sum of the donor's taxable gifts, the value of the 1977 gift is increased. The ruling also concludes that the donor's available unified credit in 1982 is decreased to reflect the credit that would have been used if the 1977 gifts were reported correctly.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court held that where the issue involved is the determination of property interests for federal estate tax purposes, and the determination is based on state law, the highest court of the state is the best authority on its own law. The Service, however, is not bound by a lower court decision. If there is a decision by a lower court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In the present case, Court determined that the Year 2 transfers were null and void ab initio. We believe that the determination is consistent with applicable state law. Therefore, Spouse erroneously included property in determining taxable gifts for Year 2, that should have been excluded and Spouse erroneously utilized \$Y of unified credit /applicable exclusion amount in Year 2. Because this erroneous inclusion of assets in taxable gifts arose as a result of an issue other than valuation, the provision of § 2504(c) (prior to amendment by the 1997 Act) restricting the adjustment of prior reported gifts under certain circumstances is not applicable. Accordingly, in computing

Spouse's aggregate sum of taxable gifts under §§ 2502(a)(1) and (2), the Year 2 gifts can be decreased to reflect the erroneous inclusion of property in taxable gifts for Year 2. See §§ 25.2504-1(d) and 25.2504-2(a). See also, Rev. Rul. 76-451, cited above. Further, \$Y of unified credit/applicable exclusion erroneously utilized by Spouse in reporting the Year 2 transfers is restored to Spouse and can be utilized in determining Spouse's gift tax liability with respect to future transfers. Rev. Rul. 84-11, cited above.

The ruling contained in this letter is 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 the ruling, it is subject to verification on examination.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely yours,

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

Enclosure
Copy for section 6110 purposes

cc: