Internal Revenue Service

Number: **201419001**
Release Date: 5/9/2014

Index Number: 1361.03-02, 1001.00-00, 1015.00-00, 2519.00-00, 2501.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-127263-13

Date:
December 30, 2013

LEGEND

Decedent =

Spouse =

Will =

Trust =

Trust P =

Trust R =

Trust 1 =

Trust 2 =

X =

State =

State 2 =

Statute =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This letter responds to a letter dated June 14, 2013, submitted by your personal representative, and subsequent correspondence, requesting rulings on the federal income and gift tax consequences of the proposed division of an irrevocable trust, Trust.

The facts submitted and the representations made are as follows. Decedent died on Date 1. Pursuant to Article III of Will, Trust was established for the benefit of Spouse during Spouse's lifetime. Spouse is the trustee of Trust and Trust is governed by the laws of State. Spouse, as executrix of Decedent's estate, listed Trust on Part A of Schedule M of Form 706, United States Estate (and Generation-Skipping) Tax Return, and is deemed to have made the election to treat the Trust property as qualified terminable interest property (QTIP).

Article III, paragraph B, section 1 of Will, provides that the trustee of Trust must pay the net income of Trust in quarterly or more frequent installments to Spouse during her lifetime. Article III, paragraph A, provides that Trust terminates upon the date of death of Spouse. Trust does not provide for distributions of principal during Spouse's lifetime. At Spouse's death, the assets of trust are to be divided equally between Trust P and Trust R.

Article IX of Will grants the trustee of Trust uncontrolled discretion to exercise all rights, powers, and authorities conferred under applicable state law. In addition, Article IX provides that if future changes in the law expand trustee powers, the trustee shall have the expanded powers.

Under Article IX of Will, the trustee of Trust will have no authority to restrict Spouse's enjoyment of the Trust income in a manner inconsistent with qualified terminable interest property as presently defined in § 2056(b)(7) of the Code.

Spouse has represented that neither state law nor the provisions of Trust will be interpreted as granting the trustee of Trust or Spouse the power to make distributions of Trust's principal during the life of Spouse.

On Date 2, shares of X were transferred to Trust. X is a State 2 corporation that elected to be taxed as a subchapter S corporation. On Date 4, Spouse, as beneficiary of Trust, filed an election to treat Trust as a qualified subchapter S trust (QSST) effective Date 3, a date that is within two years of Date 2.

Statute provides that the trustee may, unless specifically prohibited by the terms of the instrument establishing the trust, divide a trust into two or more separate trusts without a judicial proceeding if the result does not impair the rights of any beneficiary or adversely affect achievement of the purpose of the original trust.

Spouse, as trustee of Trust, proposes to exercise her trustee powers under the terms of Trust and Statute to divide Trust into two new, equal trusts, Trust 1 and Trust 2. The assets of Trust will be divided pro-rata between Trust 1 and Trust 2. Spouse will continue as trustee of both trusts and will receive all of the distributions of income from each new trust during her lifetime. After the death of Spouse, the assets of Trust 1 will be distributed to Trust P and the assets of Trust 2 will be distributed to Trust R. Spouse represents that the terms of Trust 1 and Trust 2 will be identical to those of Trust, except that the beneficiaries will differ as described above.

The trustee has requested the following rulings:

1. The division of Trust into Trust 1 and Trust 2 will not cause any of those trusts to realize gain or loss under §§ 61 or 1001.
2. The adjusted bases of the assets received by Trust 1 and Trust 2 from Trust will be the same as the adjusted bases of the assets held by Trust immediately prior to the division pursuant to § 1015.
3. Trust 1 and Trust 2 will qualify as QSSTs as defined by § 1361(d)(3)(B).
4. The division of Trust into two new trusts, Trust 1 and Trust 2, will not constitute a disposition of all or any part of qualified terminable interest property as defined in § 2519.
5. The division of Trust into Trust 1 and Trust 2 will not cause any beneficiary of Trust, Trust 1, or Trust 2 to have made a gift under § 2501.

RULING 1

Section 61 of the Code provides that gross income includes all income from whatever source derived. Section 61(a)(3) specifically includes gains derived from dealings in property.

Section 1001(a) provides that the gain realized from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss realized is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss realized must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in the realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court of the United States in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 reasonably interprets § 1001(a), and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

Based upon the information submitted and representations made, we conclude that the legal entitlements and interests of the beneficiaries of Trust 1 and Trust 2 will not differ materially in kind or extent from their interests in Trust. Accordingly, the division of Trust into Trust 1 and Trust 2 does not result in the recognition of gain or loss under §§ 61 and 1001 by Trust, Trust 1, or Trust 2.

RULING 2

Section 1015(a) provides that if property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in § 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.

Section 1015(b) provides that if property was 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 such transfer.

In this case, based upon the facts submitted and the representations made and provided that all of Trust's assets are divided pro-rata among the successor trusts, we conclude that because neither § 61 nor § 1001 applies to the proposed transaction, the basis of the assets for each of the successor trusts will be the same as Trust's basis in the assets at the time of the transfer.

RULING 3

Section 1361(b)(1) defines a “small business corporation” as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A)(i) of the Code provides that for purposes of section 1361(b)(1) a trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States may be an S corporation shareholder.

Section 1361(d)(1) provides that, in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph 1361(d)(2), such trust shall be treated as a trust described in subsection 1361(c)(2)(A)(i) and, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph 1362(d)(2) is made.

Section 1361(d)(3) defines the term “qualified subchapter S trust” as a trust all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States. In addition, the terms of the trust must require that (i) during the lifetime of the current income beneficiary, there shall be only one income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary.

In this case, based on the facts submitted and representations made, we conclude that the creation of Trust 1 and Trust 2 is a modification of Trust for Federal income tax purposes, and Trust 1 and Trust 2 are treated as a continuation of Trust. Therefore, a division of Trust into Trust 1 and Trust 2 will not be treated as a distribution or a right to distribute principal for purposes of the application of § 1361(d)(3). Further, Trust 1 and Trust 2 will be treated as a continuation of Trust for purposes of the QSST election made for Trust. Provided that the QSST election for Trust is otherwise valid and provided that Trust 1 and Trust 2 distribute their income currently to Spouse during the life of Spouse, Trust 1 and Trust 2 will be treated as QSSTs after the division of Trust.

RULINGS 4 and 5

Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, except as limited by § 2056(b), 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, but only to the extent that such interest is included in determining the value of the gross estate.

Under § 2056(b)(1), a marital deduction is not allowable for an interest in property passing to the surviving spouse that is a "terminable interest." An interest passing to the surviving spouse is a terminable interest if it will terminate or fail on the lapse of time or on the occurrence of an event or contingency, or on the failure of an event or contingency to occur and, on termination, an interest in the property passes to someone other than the surviving spouse.

Section 2056(b)(7) allows an estate tax marital deduction for qualified terminable interest property. Under § 2056(b)(7)(B)(i), the term "qualified terminable interest property" means property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which the qualified terminable interest 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 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual, resident or nonresident.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift will be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration received shall be deemed a gift.

Section 25.2511-1(c)(1) of the Gift Tax Regulations provides that the gift tax applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which § 2519 applies is treated as a transfer of all interests in the property other than the qualifying income interest.

Section 2519(b) provides, in part, that § 2519 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) provides that if a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under § 2056(b)(7), the donee spouse is treated for purposes of chapters 11 and 12 as transferring all interests in property other than the qualifying income interest. If the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under § 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is treated as making a gift under § 2519 of the entire trust less the qualifying income interest, and is treated for purposes of § 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable. A transfer of all or a portion of the income interest of the spouse is a transfer by the spouse under § 2511.

Pursuant to the terms of Trust and pursuant to the deemed election made by Spouse, as trustee, the assets of Trust are treated as qualified terminable interest property under § 2056(b)(7)(B)(i). In this case, after the division of Trust into Trust 1 and Trust 2, Spouse will continue to be entitled to all the income, payable at least annually from the property in Trust 1 and Trust 2. Accordingly, Spouse will continue to have a qualifying income interest in Trust 1 and Trust 2. Consequently, based on the facts submitted and the representations made, we conclude that the division of Trust into Trust 1 and Trust 2 will not constitute a disposition of all or any part of the qualified terminable interest property as defined in § 2519.

Further, the division of Trust into Trust 1 and Trust 2 will not change the beneficial interests of the trust beneficiaries. As stated above, Spouse will continue to have a

qualifying income interest in Trust 1 and Trust 2, and Trust P and Trust R will remain the principal beneficiaries of one-half of Trust after Spouse's death, as provided in the trust instrument. Trust P will be the principal beneficiary of Trust 1 after Spouse's death, and Trust R will be the principal beneficiary of Trust 2 after Spouse's death. Accordingly, based upon the facts submitted and the representations made, we conclude that the division of Trust into Trust 1 and Trust 2 will not cause any beneficiary of Trust, Trust 1, or Trust 2 to have made a taxable gift for federal gift tax purposes under § 2501.

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.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the foregoing transactions under any other provisions of the Code or regulations.

Under a power of attorney on file with this office, we are sending a copy of this letter to the trustee's authorized representatives.

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

Sincerely,

Faith P. Colson
Faith P. Colson
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes