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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-142976-13

Date:
March 11, 2014

RE:

Legend

Decedent
Marital Trust
Revocable Trust
Family Trust
Spouse
Child 1
Child 2
Child 3
Child 4
Child 5
Child 6
Individual
State
Date 1
Date 2
Date 3
State Statute 1
State Statute 2
State Statute 3
State Statute 4
Court
x

Dear :

This letter responds to your authorized representative's letter dated August 27, 2013, requesting gift, estate, and income tax rulings with respect to the proposed division of a marital trust.

The facts and representations submitted are summarized as follows:

Decedent executed Revocable Trust on Date 1. Revocable Trust was amended and restated on Date 2.

Revocable Trust provides that after the death of Decedent, Marital Trust is to be established from the assets of Revocable Trust with an amount that will produce the smallest marital deduction necessary to minimize the Federal estate tax on Decedent's estate. The remaining assets of Revocable Trust will be used to fund Family Trust. The net income of Marital Trust is to be paid over and distributed to or for the benefit of Spouse, for Spouse's life, in convenient installments, not less frequently than quarter-annually. The trustees have the discretion to distribute principal to (1) support Spouse in her accustomed standard of living, and (2) pay for Spouse's health, medical, dental, hospital, nursing expenses, and expenses of invalidism.

Revocable Trust further provides that upon the death of Spouse, the entire principal of Marital Trust is to be paid by the trustees to or for the benefit of the issue of Decedent in such amounts or proportions as Spouse may direct by making specific reference to this special power of appointment in her will. Any unappointed principal remaining after Spouse's death is to be distributed to Family Trust. Upon Spouse's death, x percent of the assets of Family Trust will be distributed to Decedent's children, per stirpes, provided that the share of any issue under age 30 will be retained in trust for the use and benefit of such issue until such issue attains the age of 30, and the remainder to two other individuals.

Decedent died on Date 3, survived by Spouse and Child 1, Child 2, Child 3, Child 4, Child 5, and Child 6. Decedent's executor elected to treat Marital Trust as qualified terminable interest property (QTIP) under § 2056(b)(7) of the Internal Revenue Code. Spouse, Child 1, Child 2, and Individual currently serve as trustees of Marital Trust. Marital Trust is currently administered under the laws of State.

The trustees of Marital Trust propose to divide Marital Trust into three separate trusts, Trust 1, Trust 2, and Trust 3. The terms of Trust 1 will be identical to the terms of Marital Trust. Following the division, the trustees intend to convert Trust 2 to a total return unitrust with an annual unitrust payment equal to not less than three percent or more than five percent of the fair market value of the assets of Trust 2 determined as of the first day of each taxable year. The trustees, with the consent and joinder of the trustees of Family Trust and Decedent's children, will petition Court for a court order to terminate Trust 3 and distribute the assets of Trust 3 equally to Decedent's children.

Pursuant to § 2207A(b), Decedent's children will reimburse Spouse for any and all gift taxes occasioned by the termination of Trust 3.

State Statute 1 provides that after notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust.

State Statute 2 provides, in relevant part, that a noncharitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust. Upon termination of a trust, the trustee shall distribute the trust property as provided in the terms of the trust or in default of such terms of the trust as agreed by all the beneficiaries.

State Statute 3 provides, in relevant part, that a trustee, other than an interested trustee, or where two or more persons are acting as trustees, a majority of the trustees who are not interested trustees may, in its sole discretion and without the approval of the district court, (i) elect to release the power to adjust and to convert an income trust to a total return unitrust; (ii) reconvert a total return unitrust to an income trust and reinstate the power to adjust, or (iii) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust.

State Statute 4 provides that the percentage to be used in determining the unitrust amount shall be a reasonable current return from the trust, in any event not less than three percent nor more than five percent, taking into account the intentions of the settlor of the trust as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust, and projected inflation and its impact on the trust.

You have requested the following rulings:

1. After the division of Marital Trust into three separate trusts, each separate trust will be a QTIP trust under § 2056(b)(7).

2. The division of Marital Trust into three separate trusts will not be a deemed gift or other disposition under § 2519.

3. Upon termination of Trust 3, Spouse will be deemed to make a gift of her qualifying income interest in Trust 3 under § 2511 and a gift of the entire fair market value of the assets in Trust 3, as determined on the date of the

disposition, less the value of the qualifying income interest in the assets in Trust 3 under § 2519.

4. Upon termination of Trust 3, the amount of the gift from Spouse to Decedent's children, for purposes of §§ 2511 and 2519, will be reduced by the amount of gift taxes paid by Decedent's children.

5. The termination of Trust 3 will not cause Spouse to be deemed to have made a gift of the property in Trust 1 or Trust 2 under § 2519.

6. The termination of Trust 3 will not cause Trust 1 or Trust 2 to fail to qualify as QTIP trusts under § 2056(b)(7).

7. The conversion of Trust 2 to a total return unitrust will not be deemed to be a gift or other disposition of any interest in Trust 2 under § 2519, will not cause Spouse to be deemed to have made a gift to the remainder beneficiaries, and will not cause the remainder beneficiaries to be deemed to have made a gift to Spouse.

8. The termination of Trust 3 will not cause the value of Spouse's lifetime income and discretionary interests in Trust 1 and Trust 2 to be valued at zero under § 2702.

9. Following the termination of Trust 3, the value of the assets previously held in Trust 3 will not be includible in Spouse's gross estate under § 2044(a) because of § 2044(b)(2).

10. The division of Marital Trust into three separate trusts and the funding of such trusts on a pro rata basis will not cause Marital Trust to recognize gain or loss under § 1001.

11. The conversion of Trust 2 to a total return unitrust will not cause Trust 2 to recognize gain or loss under § 1001.

<u>Ruling 1</u>

Section 2001(a) 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) provides an exception to the terminable interest rule in the case of qualified terminable interest property (QTIP). Under § 2056(b)(7), qualified terminable interest property 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 for purposes of § 2056(b)(1). Section 2056(b)(7)(B)(i) provides that the term “qualified terminable interest property” 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 § 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 (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals and (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

In this case, after the division of Marital Trust into Trust 1, Trust 2, and Trust 3, Spouse will continue to be entitled to all the income from the property, payable annually or at more frequent intervals in the trusts. Further, no person, other than Spouse, will have a power to appoint any part of the property in the trusts to any person other than Spouse. Accordingly, Spouse will continue to have a qualifying income interest in the trusts. Based upon the facts presented and representations made, we conclude that after the division of Marital Trust into three separate trusts, each separate trust will be a QTIP trust under § 2056(b)(7).

Rulings 2 - 6

Section 2501 imposes a tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by § 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 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 his 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 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount of the gift is the amount by which the value of the property transferred exceeds the value of the consideration received in exchange.

Section 2519 provides that for gift tax purposes any disposition by the surviving spouse of all or part of a qualifying income interest for life in any property for which a deduction was allowed under § 2056(b)(7) is treated as a transfer by the surviving spouse of all interests in the property other than the qualifying income interest. The transfer of the qualifying income interest of the spouse is a transfer by the spouse subject to gift tax under § 2511. Section 25.2519-1(a).

Section 25.2519-1(c)(1) 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 qualified terminable interest 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 the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.

Section 25.2519-1(c)(4) provides that the amount treated as a transfer under § 25.2519-1(c)(1) is further reduced by the amount of gift tax the donee spouse is entitled to recover under § 2207A(b). If the donee spouse is entitled to recover gift tax under § 2207A(b), the amount of the gift tax recoverable and the value of the remainder interest treated as transferred under § 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b).

Under §§ 2207A(b) and 25.2207A-1(a), if an individual is treated as transferring an interest in property by reason of § 2519, the individual is entitled to recover from the "person receiving the property" (as defined in § 25.2207A-1(e)) the amount of gift tax attributable to that property. 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, and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. Under § 25.2207A-1(b), the failure of a person to exercise a right of recovery provided by § 2207A(b) is treated as a transfer for federal gift tax purposes of the unrecovered amounts to the persons from whom the recovery could have been obtained.

Rev. Rul. 75-72, 1975-1 C.B. 310, holds that if, at the time of the transfer, a 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 § 2512(b), the value of the gift is the fair market value of the property passing from the donor less the amount of the gift tax to be paid by the donee or from the property itself.

Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift tax liability that is to be subtracted from the value of the transferred property, the donor's available unified credit must be used to reduce the gift tax liability that the donee has assumed to the extent unified credit is available.

In this case, the trustees will divide Marital Trust into three trusts. At the moment of division, Spouse will retain her qualifying income interest in all three trusts. Accordingly, we conclude that after the division of Marital Trust into three separate trusts each separate trust will be a QTIP trust under § 2056(b)(7) and the division will not be a deemed gift or other disposition under § 2519.

The termination of Trust 3 will result in Spouse making a gift, under § 2511, of her income interest in Trust 3 and a gift, under § 2519, of the entire fair market value of the assets in Trust 3, as determined on the date of the disposition, less the value of the qualifying income interest. We further conclude that upon the termination of Trust 3, and such termination is conditioned upon Decedent's children paying all gift taxes attributable to the transfer, the amount of the gift from Spouse to Decedent's children, for purposes of §§ 2511 and 2519, will be reduced by the amount of gift taxes paid by Decedent's children.

We also conclude, based on the facts presented and representations made, that the termination of Trust 3 will not cause Spouse to be deemed to have made a gift of the property in Trust 1 or Trust 2 under § 2519. We further conclude that the termination of Trust 3 will not cause Trust 1 or Trust 2 to fail to qualify as QTIP trusts.

Ruling 7

Section 20.2056(b)-7(d)(2) of the Estate Tax Regulations provides that the principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

Section 20.2056(b)-5(f)(1) provides that if an interest is transferred in trust, the surviving spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire trust, if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. In addition, the surviving spouse shall be entitled for life to all of the income from the entire interest or a specific portion of the entire interest if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1.

Section 1.643(b)-1 of the Income Tax Regulations provides, in part, that an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than three percent and no more than five percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

In this case, the trustees propose to modify Trust 2 pursuant to State Statute 3 and State Statute 4, which meet the requirements of § 1.643(b)-1. Accordingly, we conclude that the conversion of Trust 2 to a total return unitrust will not be deemed to be a gift or other disposition of any interest in Trust 2 under § 2519, will not cause Spouse to be deemed to have made a gift to the remainder beneficiaries, and will not cause the remainder beneficiaries to be deemed to have made a gift to Spouse.

Ruling 8

Section 2702(a)(1) provides that solely for the purpose 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 (as defined in § 2701(e)(2)) shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides that the value of any retained interest which is not a qualified interest (as defined in § 2702(b)) shall be treated as being zero and the value of any retained interest that is a qualified interest (as defined in § 2702(b)) shall be determined under § 7520. Under § 25.2702-2(a)(3), the term "retained" means held by the same individual both before and after the transfer in trust.

In this case, the trustees will divide Marital Trust into three separate trusts, Trust 1, Trust 2, and Trust 3. We concluded earlier that the termination of Trust 3 will not result in a transfer under § 2519 with respect to any interest in Trust 1 or Trust 2. Accordingly, Spouse will not be treated as making a deemed gift under § 2519 with respect to Trust 1 or Trust 2. Accordingly, based upon the facts presented and representations made, we conclude that the value of Spouse's interest in Trust 1 and Trust 2 will not be valued at zero under § 2702.

Ruling 9

Section 2044(a) provides that the value of the gross estate shall include the value of any property to which § 2044 applies in which the decedent had a qualifying income interest for life. Section 2044(b) provides that § 2044 applies to any property if (1) a deduction was allowed with respect to the transfer of such property to the decedent under § 2056(b)(7) or § 2523(f), and (2) § 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

As stated above, the termination of Trust 3 will result in Spouse making a gift, under § 2519, of the entire fair market value of the assets in Trust 3, as determined on the date of the disposition, less the value of the qualifying income interest. Section 2044(a) provides that the value of Spouse's gross estate shall include the value of any property in which Spouse had a qualifying income interest for life. Section 2044(b)(2) provides that § 2044(a) does not apply to any property if § 2519 applies to the disposition of part or all of that property prior to Spouse's death. Therefore, the value of the assets previously held in Trust 3 will not be includible in Spouse's gross estate under § 2044(a) because of the application of § 2044(b)(2).

Rulings 10 and 11

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

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(c) provides that, except as otherwise provided in subtitle A of the Code, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property must be recognized.

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.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Supreme 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. Id. at 566. 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. Id. at 564-65.

A pro rata partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. See Rev. Rul. 56-437, 1956-2 C.B. 507.

Section 1.643(b)-1 provides that for purposes of determining the meaning of the term income as used in various Internal Revenue Code sections relating to the income taxation of trusts, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year. Under the regulation, a state statute providing that income is a unitrust amount of no less than three percent and no more than five percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Section 1.643(b)-1 further provides that a switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of § 1001.

In this case, the trustees will divide Marital Trust into three new trusts, Trust 1, Trust 2, and Trust 3. Each new trust will have the same income and remainder beneficiary as Marital Trust. The distribution of trust assets from Marital Trust into Trust 1, Trust 2, and Trust 3 will be pro rata on a fractional basis among the new trusts.

Neither the beneficiaries nor their legal entitlements will be changed by the proposed trust partition and asset distribution, because the current income and remainder beneficiaries of Marital Trust will be the income and remainder beneficiaries of the new trusts under the same terms as Marital Trust. Consequently, the distribution of assets from Marital Trust to the new trusts with the approval of the state court on a pro rata basis will not cause the legal entitlements and interests of the beneficiaries of these separate trusts to differ materially from their legal entitlements and interests under Marital Trust. Correspondingly, the distribution of assets to the new trusts will not cause Marital Trust to recognize gain or loss under § 1001.

After the initial division of Marital Trust into the new trusts, Trust 2 is to be converted into a total return unitrust with an annual payment amount of not less than three percent and not more than five percent pursuant to state law and without judicial intervention. The proposed conversion meets the requirements of § 1.643(b)-1. Accordingly, based upon the facts presented and representations made, we conclude that the conversion of Trust 2 to a total return unitrust will not cause Trust 2 to recognize gain or loss under § 1001.

In accordance with the Power of Attorney on file with this office, we have sent a copy of this letter to your authorized representatives.

Except as expressly provided herein, we neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

____

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures
Copy for § 6110 purposes
Copy of this letter

cc: