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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4 - PLR-104980-99
Date:
March 3, 2000

Re:

LEGEND:

Spouse =

Decedent =

K =

L =

M =

N =

County =

State =

Date 1 =

Date 2 =

Date 3 =

$x =

$y =

$z =

Dear :

This is in response to your letter of November 18, 1999, and prior correspondence submitted on behalf of Spouse in which rulings are requested concerning the application of §§ 61, 1001, 2511, 2519, 2601, and 2652(a)(3) of the Internal Revenue Code.

Facts:

The facts and representations submitted are summarized as follows: Decedent died testate on Date 1, a resident of County, State. Decedent was survived by his wife, Spouse, who is also a resident of County, State. Decedent and Spouse lived for the entire 22-year duration of their marriage in State, which is a community property state. Decedent and Spouse had no children. Spouse has five children from a prior marriage. Decedent was also survived by his nephew, K, and his grandnephews, L and N. L and N are the sons of Decedent's niece, M, who predeceased Decedent.

Under the terms of Decedent's will, certain tangible personal property was bequeathed to Spouse and to other individuals. The residue of Decedent's estate was bequeathed one-fourth to a marital trust governed by Article FOURTH of the will and three-fourths (or the entire residue if Spouse predeceased the Decedent) to be held, managed and distributed in accordance with Article FIFTH of the will.

Article FOURTH of the will provides that, commencing on the date of Decedent's death, the trustee is to pay or apply for Spouse's benefit all of the income from the Marital Trust, not less often than quarterly. The trustee is authorized, in the trustee's discretion, to pay or apply additional funds from the principal of the Marital Trust to provide for Spouse's reasonable maintenance, support, comfort and welfare as the trustee deems necessary or advisable.

Article Fourth further provides that upon the death of Spouse, all income of the Marital Trust which is undistributed is to be distributed to Spouse's estate and the balance of the trust property is to be held, managed and distributed in accordance with the provisions of Article FIFTH, in the same manner as though Decedent had died immediately after the death of Spouse.

The pertinent terms of Article FIFTH are as follows: The trustee is to divide the Article FIFTH property into two equal parts. One part is to be held in trust for the benefit of Decedent's nephew, K ("K Trust"). The other part is to be distributed free of trust to the living descendants (i.e., L and N) of Decedent's deceased niece, M, by right of representation.

The trustee of the K Trust is to pay or apply all of the net income from the K Trust to K or for his use or benefit, for and during his lifetime. Upon K's death, the remaining balance of the K Trust is to be distributed, free of trust, to K's descendants, and if K has no descendants then living, to the surviving descendants of Decedent's deceased niece, M, by right of representation.

Decedent's estate timely filed a federal estate tax return (Form 706). A qualified terminable interest property (QTIP) election under § 2056(b)(7) was made on the return for one-fourth of the residuary estate passing to the Marital Trust (hereinafter "QTIP Trust"). On Schedule R of Decedent's estate tax return, the estate made the election under § 2652(a)(3).

After Decedent's death, Spouse claimed that certain properties included in Decedent's gross estate on the federal estate tax return belonged to her as her separate property and her one-half interest in community property. Spouse alleged that the trustee of the QTIP Trust, L, improperly exercised his discretion to invade principal of the trust for her reasonable maintenance, support, comfort and welfare by refusing to make any distributions of principal to her. Spouse also objected to the investment strategy that the trustee pursued with regard to the QTIP Trust.

On Date 2, Spouse, K, L, and N reached an agreement to settle Spouse's claims. The stated purpose of the agreement is to resolve separate property claims and community property claims of Spouse, the administration of the probate estate and the QTIP Trust, and to preserve the relationships the parties have among themselves, their extended families, and mutual friends.

Under the terms of the settlement agreement, the amount of $x will be paid to Spouse in cash or other property in settlement of her claims for separate and community property. The agreement also directs that the trustee of the QTIP Trust pay the amount of $y to Spouse in exchange for Spouse's release of her rights to any part of the principal of the QTIP Trust. The agreement further provides that Spouse will sell her income interest in the QTIP Trust to K Trust, L, and N for cash or other property valued at $z. The consideration will be paid proportionately in accordance with the respective interests of K Trust, L and N in the remainder of the QTIP Trust.

The purchase price of the qualifying income interest in the QTIP Trust, $z, is equal to the actuarial value of Spouse's income interest as of Date 3, determined under § 20.2031-7 of the Estate Tax Regulations, based on the value of the corpus of the QTIP Trust as of Date 3. Until the sale of Spouse's interest in the QTIP Trust is completed, the QTIP Trust will continue to pay the income therefrom to Spouse according to the terms of the trust. However, income earned after Date 3 and paid to Spouse will reduce the purchase price, dollar-for-dollar. The settlement agreement recognizes that federal gift taxes will be imposed, as a result of the sale of Spouse's qualifying income interest in the QTIP Trust, under § 2519. The agreement confirms Spouse's right to recover such taxes from the persons who will receive the QTIP property, pursuant to § 2207A of the Internal Revenue Code. The settlement agreement, however, places a ceiling on Spouse's right of recovery. The settlement agreement provides that the QTIP Trust will terminate upon completion of the sale of Spouse's qualifying income interest, and the corpus will be distributed in two equal shares in accordance with Article FIFTH of Decedent's will. One part will be held in trust for the benefit of Decedent's nephew, K, and the other part will be distributed free of trust to L and N, the surviving descendants of Decedent's niece, M, by right of representation. The settlement agreement is contingent on court approval, which has been obtained by the parties, and favorable rulings from the Internal Revenue Service.

The following rulings are requested:

1. The receipt by Spouse of cash and other property pursuant to the settlement agreement relating to Spouse's community property and separate property claims does not constitute taxable income.

2. In the event that contingencies are removed and the sale by Spouse of her interests in the QTIP Trust becomes final, income of the QTIP Trust paid or payable to Spouse with respect to income earned by the trust after Date 3 is properly classified as proceeds from the sale of Spouse's income interest as of that date, as provided in the settlement agreement.

3. The sale of Spouse's income interest in the QTIP Trust constitutes a taxable sale for income tax purposes. The character of the income from all proceeds of such sale constitutes long-term capital gain. In determining the amount of gain or loss, any income tax basis in the income interest of Spouse relating to the income interest must be disregarded in accordance with § 1001(e).

4. The sale of Spouse's interest in the principal of the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. The character of the income is long-term capital gain. In determining the amount of gain or loss, any income tax basis relating to Spouse's rights to invade principal may be given regard.

5. The transfer of Spouse's income interest in the QTIP Trust is a transfer for full and adequate consideration and, therefore, does not constitute a gift subject to gift tax under § 2511.

6. Under § 2519, Spouse is treated as making a gift equal to the entire value of the QTIP Trust as of Date 3, reduced by:

a. the value of Spouse's qualifying income interest as of the date that the actual transfer occurs,

b. the amount paid to Spouse under the agreement for the release of her right to principal invasions, and

c. the amount of gift tax that Spouse may recover under § 2207A(b) as authorized under the settlement agreement.

7. For purposes of the generation-skipping transfer tax (GSTT), Spouse is not treated as the transferor of any portion of the QTIP Trust. The sale of Spouse's income interest in the QTIP Trust will not result in Spouse being treated as the transferor of the QTIP Trust. No GSTT will be imposed on Spouse with respect to the sale of the income interest or on the gift resulting from such sale under § 2519.

Ruling #1: 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 such section for determining loss over the amount realized.

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.

Section 102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. However, § 102(b) provides that § 102(a) does not exclude from gross income (1) the income from any property referred to in subsection (a), or (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

In Lyeth v. Hoey, 305 U.S. 188 (1938), an heir received property in a distribution from a decedent's estate under a "valid compromise agreement" with the executors of a will. The Court held that the exemption for property acquired by inheritance applied. The Court rejected an argument that one should look to local law to determine whether an heir has technically acquired property by inheritance for purposes of the exclusion. Id., at 193.

The cash and other property received by Spouse pursuant to the settlement agreement relating to Spouse's community property and separate property claims is cash or other property to which Spouse is already entitled. See, e.g., Rev. Rul. 76-68, 1976-1 C.B. 216; Rev. Rul. 74-278, 1974-1 C.B. 108; Rev. Rul. 74-68, 1974-1 C.B. 106, clarifying Rev. Rul. 68-408, 1968-2 C.B. 193. Thus, no sale or exchange will have taken place. See section 1.1001-1(a). Therefore, Spouse's receipt of such cash and other property pursuant to the settlement agreement relating to Spouse's community property and separate property claims does not constitute taxable income.

This ruling is contingent on the cash and other property that Spouse receives relating to her community property and separate property claims, in fact, being the community property or separate property of Spouse or the property of Decedent's estate. The fact that there is a settlement agreement does not, by itself, mean that the cash and other property that Spouse will receive is Spouse's community or separate property. See Marcus v. Commissioner, T.C.Memo. 1996-190, where the court found that even though cash was received pursuant to a settlement agreement and, therefore, under the rationale of Lyeth v. Hoey was a substitute for a bequest, the portion attributable to appreciation of the property was taxable income.

Therefore, this ruling does not apply to any portion of the cash or other property received by Spouse that represents income to the estate.

Ruling #2: Spouse requests a ruling that income of the QTIP Trust paid or payable to Spouse with respect to income earned by the trust after Date 3 and before the sale is made final is properly classified as proceeds from the sale of Spouse's income interest as of that date, as provided in the settlement agreement.

These payments are amounts that Spouse is entitled to receive as the income beneficiary of the Trust. These payments will belong to Spouse regardless of whether the sale of the income interest takes place. Because Spouse is receiving these amounts, irrevocably, as the income beneficiary of the Trust, the payments are not amounts realized from the sale or exchange of the income interest.

When a taxpayer receives a lump sum in exchange for the taxpayer's right to receive future income from property that does not represent a conversion of a capital investment, the taxpayer cannot characterize the transaction as a sale of property. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). The conversion of income already received by a beneficiary of an estate into principal was not permitted as part of a compromise agreement of a wife's claim against her deceased husband's will. Lemle v. United States, 579 F.2d 185 (2d Cir. 1978). This is especially the case in the present situation in which Spouse will already have received the payments from the trust at the time the sale of the income interest is consummated, and Spouse will be entitled to keep the payments whether or not the sale is consummated.

The fact that the amount that will be paid for the income interest will be reduced by the amount of income that is paid by the QTIP Trust to Spouse after Date 3 and before the sale is made final does not change our conclusion.

Accordingly, we conclude that income of the QTIP Trust paid or payable to Spouse with respect to income earned by the trust after Date 3 is properly characterized as income of the QTIP Trust that is paid to Spouse as the income beneficiary.

Ruling #3: Section 1001(e)(1) provides that in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to §§ 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. For purposes of § 1001(e)(1), "term interest in property" means (A) a life interest in property, (B) an interest in property for a term of years, or (C) an income interest in trust. Section 1001(e)(2).

Rev. Rul. 72-243, 1972-1 C.B. 233, states that the Service will follow McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947), which holds that the proceeds received by the 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.

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 that such gain is taken into account in computing gross income.

Under Rev. Rul. 72-243, the sale by Spouse of her life interest in the QTIP Trust will be treated as the sale of a capital asset. Since the Decedent died on Date 1, the gain would be long-term capital gain. Under § 1001(e) any income tax basis of Spouse in her income interest in the Trust will be disregarded.

We conclude that the sale of Spouse's income interest in the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. In determining the amount of gain or loss, any income tax basis in the income interest of Spouse relating to the income interest must be disregarded in accordance with § 1001(e). The character of the income from the proceeds of such sale constitutes long-term capital gain; however, this characterization does not include income referred to above in # 2.

Ruling #4: The sale of Spouse's interest in the principal of the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. Any gain or loss on the sale of Spouse's interest in the principal of the trust would be recognized under § 1001. The gain would be long-term capital gain, since the Decedent died on Date 1. Since § 1001(e) applies to income interests in trust, but not rights to principal, Spouse's basis in her interest in trust principal would not be disregarded.

We express no opinion on the allocation in the proposed settlement agreement of amounts to Spouse's community property interest, Spouse's separate property interest, Spouse's income interest in the QTIP Trust, and Spouse's right to receive principal distributions from the QTIP Trust. The validity of the allocation is a factual question.

Ruling #5. Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

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

Section 25.2511-1(g)(1) provides that for purposes of § 2511, the gift tax is not applicable to a transfer for full and adequate consideration in money or money's worth.

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 by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Section 25.2512-8 provides that transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate consideration in money or money's worth.

In the present case, the determination of the price at which the remainder beneficiaries agreed to buy and the Spouse agreed to sell Spouse's qualifying income interest for life in the QTIP Trust was the result of labored negotiations among the parties involved. Assuming that the sale is one made in the ordinary course of business, in that it is bona fide, at arm's length, and free from any donative intent, it will be considered a transfer made for an adequate consideration in money or money's worth, and it will not constitute a gift under section § 2511.

Ruling #6. Section 2519 provides that any disposition of all or a part of a qualifying income interest for life in property for which an election had been made under § 2056(b)(7) is treated as the transfer of all interests in the property other than the qualifying income interest.

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 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 the disposition. (The gift tax consequences of the disposition of the qualifying income interest are determined separately under

§ 2511 as discussed above in #5).

Section 25.2511-2(a) 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 2207A(b) provides that if a gift tax is paid with respect to any person because of a transfer made by that person under § 2519, then that person shall be entitled to recover the tax attributable to the transfer from the person receiving the property.

Rev. Rul. 75-72, 1975-1 C.B. 110, holds that gift tax imposed on a transfer that is paid by the donee may be deducted from the value of the transferred property in determining the amount of the gift, if it is established that the payment of the tax by the donee or from the property is a condition of the transfer. If, at the time of the transfer, the gift is made subject to the 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 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.

Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift, the gift tax liability assumed by the donee may be deducted from the value of the transferred property, if the payment of the tax by the donee is a condition of the transfer. The donor’s available unified credit must be used to reduce the tax liability that the donee has assumed to the extent the unified credit is available.

In a case like the present one, where the gift tax will be imposed as a result of a transfer under § 2519, § 2207A(b) statutorily shifts the tax burden, but not the liability, for paying the gift tax to the donee. In 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.

Accordingly, we conclude that upon Spouse’s disposition of Spouse’s qualifying income interest for life, Spouse will be treated as making a gift under § 2519. Under § 2519, the gift tax will be imposed upon on the entire value of the QTIP Trust as of the date that the actual transfer occurs, reduced by: 1) the value of the Spouse’s qualifying income interest for life on the transfer date; 2) the amount paid to Spouse for the release of her interest in trust principal under the settlement agreement; and 3) the amount of gift tax that Spouse recovers under § 2207A(b) as limited under the terms of the settlement agreement.

Ruling #7. Section 2601 imposes a tax on every generation-skipping transfer (GST). Under § 1431(a) of the Tax Reform Act of 1986 and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the tax generally applies to any generation-skipping transfer made after October 22, 1986. A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless (A) immediately after such termination a non-skip person has an interest in such property; or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2612(b) provides that the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Under § 2612(c), the term "direct skip" means a transfer subject to a tax imposed under the gift tax or estate tax provisions of an interest in property to a skip person. Section 2613(a) provides that a "skip person" means (1) a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or (2) a trust - (A) if all interests in the trust are held by skip persons, or (B) if there is no person holding an interest in such trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Section 2652(a)(1) provides that except as provided in § 2653(a), the term "transferor" means - (A) in the case of property subject to the estate tax, the decedent, and (B) in the case of property subject to the gift tax, the donor. An individual will be treated as transferring any property with respect to which such individual is the transferor.

Section 2652(a)(3) provides that in the case of any trust with respect to which a deduction is allowed to the decedent under § 2056 by reason of subsection (b)(7) thereof, the estate of the decedent may elect to treat all of the property in such trust for purposes of the generation-skipping transfer tax (GSTT) as if the election to be treated as qualified terminable interest property had not been made.

In the present case, Decedent's estate made the election under § 2652(a)(3) on Decedent's estate tax return to treat the property in the QTIP Trust as if the QTIP election had not been made. As a result, Decedent is considered the transferor of the property in the QTIP Trust. Upon Spouse's sale of Spouse's qualifying income interest for life in the QTIP Trust, Spouse will be treated under § 2519 as transferring all interests in the trust property other than the qualifying income interest. However, as a result of the § 2652(a)(3) election, the Decedent is treated as the transferor for GSTT purposes, and the sale of Spouse's income interest in the QTIP Trust will not result in Spouse being treated as the transferor of the QTIP Trust. Accordingly, we conclude that no GSTT will be imposed on Spouse as a result of her disposition of the qualifying income interest and the resultant transfer under § 2519.

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.

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,

Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

By_______________________
Katherine A. Mellody
Senior Technician Reviewer
Branch 4

Enclosure
Copy for section 6110 purposes