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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-118250-99
Date:
November 28, 2001

Re:

Legend

Decedent =
Spouse =

Son 1 =

Son 2 =

Grandchild 1 =
Grandchild 2 =
Trust =

Agreement =

Initial Corporate Trustee =
Successor Corporate Trustee =
County =
State =
Year 1 =
Year 2 =
Year 3 =

Dear :

This is in response to your letter of March 13, 2001, and prior correspondence, requesting a ruling on the income, gift and generation-skipping transfer (GST) tax consequences of a proposed transaction.

FACTS

Decedent, a resident of State, died testate in Year 1, prior to 1982, survived by his spouse, (Spouse) and two sons, Son 1 and Son 2, from a previous marriage. Son 2 has two children, Grandchild 1 and Grandchild 2. Son 1 and Son 2 are currently over age 40.

Item Fifth of Decedent's will provides that the residue of his estate is to be held in a trust (Trust) for the benefit of Spouse and Decedent's two sons. The general objectives of the Trust are set forth in Paragraph A of Item Fifth. This section provides that the trustee is to pay Spouse all of the Trust's net income during her life. The trustee may also use the corpus for Spouse if the net income is insufficient, when taken with other income available to her from all sources known to the trustee, to support and maintain her in her customary and usual standard of living. Following the death of Spouse, Decedent's children shall receive the balance of the Trust estate. Paragraph B addresses the distribution of income and corpus from Trust and provides that the trustee is authorized and empowered to pay all of the net income (and corpus in the event Spouse is not the trustee at the time of the distribution) to Spouse.

Paragraph C provides that, upon the death of Spouse, the trustee is to divide the trust estate into as many equal shares as there are children of Decedent then living and deceased children of Decedent leaving issue then surviving. One separate trust is established for the benefit of each child of Decedent then living and one for the benefit of the surviving issue of each deceased child.

Paragraph C.1 provides for the distribution of income and corpus of each trust. Until the beneficiary or beneficiaries of each trust attain age twenty-five and complete their education, the trustee shall pay to the beneficiary or beneficiaries or expend on the beneficiary's behalf, so much of the income and corpus as the trustee may deem advisable to provide properly for the beneficiary's maintenance education, welfare, and comfort. After the beneficiary or beneficiaries of each trust has attained the age of twenty-five (25) years and competed his education, the trustee shall pay to the beneficiary the entire share of the net income of the trust until final distribution is made.

At the time the beneficiary attains the age of forty (40), the trust shall terminate and the trustee is to distribute the entire balance of the trust to the beneficiary. If there is more than one beneficiary of a single trust, distribution shall be made at the time designated to each beneficiary of the specified fractional interest in his undivided interest in the trust. If any beneficiary has attained any of the respective ages at the time when the trust is directed to be set apart for such beneficiary, the Trustee is to distribute to such beneficiary such part or parts, or all, as the case may be, of the trust

(instead of holding the property in trust) as is directed to be distributed to such beneficiary upon attaining such respective ages.

Paragraph C.2 provides that, in the event a beneficiary shall die after a separate trust fund has been set apart for the beneficiary's benefit, or beneficiary's benefit and the benefit of another or others, and before the entire share of the trust has been distributed to the beneficiary, the trustee shall distribute the share of the trust (or remainder thereof) to the beneficiary's issue surviving the beneficiary, if any, and if none, then to Decedent's surviving grandchildren and to the issue of any deceased grandchild of Decedent, per stirpes. However, if at the time of distribution any such issue is an income beneficiary of any trust established under the will, the share of the beneficiary shall be added to the corpus of the trust fund as an integral part, to be administered and distributed in accordance with all of the terms, conditions, and limitations applying thereto.

The initial trustees of Trust were Spouse, Decedent's attorney, and Initial Corporate Trustee. Decedent's attorney resigned as co-trustee in Year 2, and under Paragraph D.6 of Article Fifth of the will, Spouse and the Initial Corporate Trustee served as trustees. In Year 3, the Initial Corporate Trustee was acquired by Successor Corporate Trustee and Successor Corporate Trustee became a co-trustee.

Prior to the corporate acquisition of the Initial Corporate Trustee, Spouse informed the Initial Corporate Trustee, Son 1, and Son 2 that she desired to renounce her right to receive any further income or corpus distributions from the Trust. Spouse, however, specified that she would do so only if: (1) the renunciation of her right to receive income or corpus from the Trust would not result in any tax liability or other costs to her; and (2) the contingent interests of Son 2's children would be protected.

It is unclear under the terms of the Trust and applicable State law how the Trust should be administered and disposed of if Spouse renounces her lifetime right to receive trust income and corpus. Arguably, as a result of Spouse's renunciation, the Trust would terminate immediately and the corpus would be distributed outright to Son 1 and Son 2. On the other hand, under the terms of Trust, Son 1 and Son 2 are to receive the Trust corpus only if they survive Spouse. If either fails to survive, their share of corpus is to pass to or for the benefit of their descendants. Arguably, after Spouse's renunciation, the Trust would continue until Spouse dies at which time the corpus would be distributed to Son 1 and Son 2, if living, and if not, to or for the benefit of their descendants.

The parties have entered into an agreement (Agreement) providing for the administration and disposition of the Trust after Spouse's renunciation and for the payment of taxes incurred by Spouse as a result of the transaction. The parties to the Agreement have filed a petition with the local probate court requesting a deviation from the terms of Decedent's will and a modification and construction of the Trust in a manner consistent with the terms provided in the Agreement. An attorney ad litem has been appointed to represent the minor and unborn beneficiaries.

Paragraph 4 of the Agreement provides for the creation of a separate trust (Grandchildren's Trust) for the benefit of existing descendants of Son 1 and Son 2 and all unborn or unascertained beneficiaries of Trust. Paragraph 4(a) provides that, during the life of Spouse, the Successor Trustee shall pay to any then living issue of Son 1 and Son 2, or expend on such issue's behalf so much of the income and corpus as the Successor Trustee may deem advisable to provide properly for the issue's maintenance, education, welfare, and comfort as provided for in Section C.1 of Article Fifth of the will. Paragraph 4(b) provides that, upon the death of Spouse, the trust shall be distributed, or continued in trust, in accordance with Section C of Article Fifth of the will, as if both Son 1 and Son 2 had predeceased Spouse. Paragraph 4(c) provides that all other provisions of the will applicable to a trust created under Section C of Article Fifth of the will shall apply to the Grandchildren's Trust.

Under Paragraph 4, the Grandchildren's Trust is to be funded with assets from Trust having a fair market value at the date of funding equal to the then present value of the interests of these beneficiaries. The parties have represented that they have engaged a recognized authority to determine the actuarial value of these interests.

Paragraph 6 of the Agreement provides for the administration of the balance of Trust. Under Paragraph 6(c), the term of the trust is revised. As revised, the Trust is to continue until one year after the death of Spouse. The trustee is required to distribute all of the net income of the Trust, in equal shares, to Son 1 and Son 2 from the period beginning on the first day of the month following the final order of the local probate court or, at the election of the trustee, the last day of the month in which the local probate court enters the final order and ending on the date that is one year after the death of Spouse. Paragraph 6(a) provides that the trustee shall distribute the sum of $500,000 in equal shares of $250,000 each to Son 1 and Son 2 within thirty days after the local probate court issues a final order. Paragraph 6(b) provides that the trustee is to distribute the sum of $500,000 in equal shares of $250,000 each to Son 1 and Son 2 within thirty days after the expiration of three years from the date the court enters the final order.

Paragraph 6(d) provides that, if either Son 1 or Son 2 dies during Spouse's lifetime, then from and after the date of death of either of them and during the remainder of the revised term, the share of the income of the Trust that would otherwise have been distributed to the deceased beneficiary shall instead be held in trust for, or distributed to, his descendants, per stirpes, as provided in Section C.1 of Article Fifth of the will. However, if he should leave no descendants, then his share of the Trust income shall be paid to his brother, or, if his brother is not then living, shall instead be held in trust for, or distributed to, the descendants of his brother, per stirpes.

Paragraph 6(e) provides that, at the end of the revised term, the balance of Trust shall be distributed in equal shares to Son 1 and Son 2. However, if either of them has died before Spouse's death, then his share shall be held in trust for, or distributed to, his descendants, per stripes, as provided in Section C.1 of Article Fifth of the will. If the deceased individual leaves no descendants who are living at the end of the revised

term, his share shall pass to his brother. If his brother is not living, the share shall instead be held in trust for, or distributed to, the descendants of his brother, per stirpes. In the event neither Son 1 or Son 2 are living at the end of the revised term, then the balance of the trust shall be distributed to the then living persons who would have constituted the heirs of Decedent (determined according to the laws of descent and distribution of State) if Decedent had died, unmarried, immediately after the end of the revised term without leaving any surviving descendants.

Paragraph 6(f) provides that, if either Son 1 or Son 2 dies during the revised term but after Spouse's death, the successor trustee shall, during the remainder of the revised trust term, distribute his share of the undistributed income of the trust that shall accrue during the remainder of the revised term and shall, at the end of the revised term, distribute his entire share of the trust as then constituted, each in such amounts and manner, outright or in lesser estate, in trust or otherwise, as he shall validly appoint by his last will and testament. This power shall include the power to appoint by his last will and testament his entire share of the trust, outright, and free of any trust, in favor of his own estate, his own creditors, or the creditors of his estate, or any appointee or appointees without limitation, and shall be exercisable by him alone and in all events, with no power in any other person to appoint any part of his share of the Trust. If he does not fully exercise the power of appointment, then, to the extent he has not exercised that power of appointment, the Successor Trustee shall hold or distribute his share of the Trust in accordance with the preceding subparagraphs (d) and (e).

Paragraph 7 deals with the tax consequences of the transaction. Paragraph 7(a) provides that Son 1 and Son 2 shall pay all federal gift and income taxes incurred by Spouse that are attributable to Spouse's renunciation of her Trust interests such that the gift will be treated as a "net gift" for gift tax purposes. Not later than March 15 of the year following the year in which the gift is deemed made, Spouse shall furnish to the Successor Trustee, Son 1 and Son 2 a calculation of the additional gift and income taxes payable by her as a result of the transaction. On behalf of Son 1 and Son 2, the Trust shall remit to her the total of the additional taxes. If it is finally determined that the additional gift taxes paid by the Trust, Son 1, or Son 2 exceed the amount due, Spouse shall promptly submit to the Internal Revenue Service a claim for refund and promptly pay the refund, including interest, to the person or persons who paid the excess. The income tax component of the amount paid will be a liquidated amount and no subsequent adjustments of the liquidated amount are provided for under the Agreement.

Paragraph 7(b) provides that Son 1 and Son 2 shall pay Spouse's estate all additional federal estate taxes and state estate or inheritance taxes to which the estate is subject that are attributable to the transaction. Not later than 8 months following the death of Spouse, the personal representative of her estate shall furnish the Successor Trustee, Son 1, and Son 2 a calculation of the additional estate and inheritance taxes payable by the estate as a result of the transaction. On behalf of Son 1 and Son 2, the Trust shall remit to the personal representative of Spouse's estate, the total of such additional taxes. If following the payment of such amounts, it is finally determined that

additional estate or inheritance taxes are due by Spouse's estate as a result of the proposed transaction, Son 1 and Son 2 shall pay the additional amount to the personal representative of Spouse's estate upon demand. If it is finally determined that the additional estate or inheritance taxes paid by the Trust, Son 1, or Son 2 exceed the amount due, Spouse's estate shall promptly submit to the Internal Revenue Service a claim for refund and promptly pay the refund, including interest, to the person or persons who paid the excess. In addition to the distributions referred to under Paragraphs 6(a) and 7(a), the Trust shall distribute for the benefit of Son 1 and Son 2 all amounts needed to discharge their obligation under Paragraph 7(b) to reimburse the estate of Spouse for all additional estate and inheritance taxes incurred by it. The failure of the Trust to make the distributions shall not affect the liability of Son 1 and Son 2.

To the extent that any payment by or on behalf of Son 1 and Son 2 under Paragraph 7(b) gives rise to a right to a refund of any tax in favor Spouse's estate, her personal representative shall take such reasonable steps as may be necessary to seek such refund, provided that satisfactory arrangements are made with Son 1 and Son 2 to have Son 1, Son 2, and Trust pay for all costs (including attorney's fees) incident to such refund. Upon collection of such refund, the personal representative shall remit same to the Successor Trustee or, if the Trust has terminated, to Son 1 and Son 2, or to their successors in interest.

The parties to the Agreement have requested the following rulings:

1. The gift that Spouse will make under the proposed renunciation and Agreement is the present value of her life income interest in the Trust, calculated under § 7520 of the Internal Revenue Code, plus the value of her right to receive trust corpus, less the gift tax (i.e., gift tax paid net of any refund as provided in Paragraph 7(a) of the Agreement) and income taxes to be paid under Paragraph 7(a) of the Agreement.

2. The gifts to Son 1 and Son 2 in the proposed transaction will qualify for the gift tax exclusion under § 2503(b) as a gift of a present interest to Son 1 and Son 2.

3. Neither Son 1 or Son 2 will be treated as making a gift for federal gift tax purposes as a result of the proposed transaction.

4. No part of the value of the Trust or the Grandchildren's Trust will be included in Spouse's gross estate for federal estate tax purposes, except for the amount, if any, owed to her estate as reimbursement for estate, inheritance, or income taxes under Paragraphs 7(a) and 7(b) of the Agreement.

5. If either Son 1 or Son 2 predeceases Spouse, no part of the value of Trust will be included in that son's gross estate for federal estate tax purposes, other than unpaid income and the amounts of Trust corpus, if any, then due under Paragraphs 6(a) and 6(b) of the Agreement.

6. No part of the value of the Grandchildren's Trust will be included in the gross estate of either Son 1 or Son 2 for federal estate tax purposes.

7. The current federal income tax imposed on Spouse as a result of the proposed transaction will be calculated by treating the amount of the gift and income taxes to be paid pursuant to Paragraph 7(a) of the Agreement (net of any gift tax refunds paid pursuant to Paragraph 7(a) of the Agreement) as gain from the sale of a capital asset.

8. Spouse will not be treated as the owner of any part of the Trust or the Grandchildren's Trust for income tax purposes.

9. The proposed transaction will not cause Trust or any distributions from Trust to be subject to § 2601.

10. The Grandchildren's Trust will be treated as a trust that was created before September 25, 1985, and therefore will not be subject to the generation-skipping transfer tax under chapter 13 of the Code.

Ruling Requests 1, 2, and 3

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2502(c) provides that the payment of the gift tax is the liability of the donor.

Section 2503(a) provides that the term "taxable gifts" means the total amount of gifts made during the calendar year, less the deductions provided in subchapter C.

Section 2503(b)(1) provides, generally, that in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $ 10,000 (adjusted for inflation as provided in § 2503(b)(2)) of such gifts to such person shall not be included in the total amount of gifts made during such year.

Section 25.2503-3(a) of the Gift Tax Regulations provides that the term "future interest" includes reversions, remainders, and other interest or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. Section 25.2503-3(b) defines a present interest in property as an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain).

Section 2511 provides that the 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 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall 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, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

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 25.2512-5(d)(2) provides that, in general, if the donor assigns or relinquishes an annuity, life estate, remainder, or reversion that the donor holds by virtue of a transfer previously made by the donor or another, the value of the gift is the value of the interest transferred.

Under § 7520(a)(1), the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined under tables prescribed by the Secretary. See § 25.7520-1(c).

In Diedrich v. Commissioner, 457 U.S. 191 (1982), the Court held that, if a donor makes a gift transfer of appreciated property that is conditioned upon the transferee's payment of the resulting gift tax, the donor realizes gross income to the extent that the gift tax is paid by the donee exceeds the donor's adjusted basis in the transferred property. The Court reasoned that, when a donor makes a gift to a donee, a debt to the United States for the amount of the gift tax is incurred by the donor. When the donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In Estate of Weeden v. Commissioner, 658 F.2d 1160 (9th Cir. 1982), the court held that the resulting income is realized by the donor at the time the donee pays the donor's gift tax liability rather than in the year of the gift transfer.

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 § 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.

In this case, Spouse will renounce her right to receive Trust income and corpus. Spouse's relinquishment of these interests constitutes a gift for gift tax purposes under § 2501 of the value of the relinquished interests. The present value of the relinquished income interest is determined under § 7520. The value of the relinquished right to receive Trust corpus is a factual determination with respect to which we decline to rule. See § 7.01 of Rev. Proc. 2001- I, 2001-1 I.R.B. 1, 19.

Under the terms of the Agreement, the interests relinquished by Spouse will pass to or for the benefit of Son 1, Son 2, Grandchild 1, and Grandchild 2. Under Paragraph

7(a) of the Agreement, as a condition for Spouse's transfer, a fixed amount will be remitted to Spouse, determined by March 15th of the year following the year the gift is deemed made, representing the gift tax and additional income tax imposed on Spouse as a result of her gift. (See discussion in Ruling Request 7, below.) This amount remitted to Spouse under the terms of the Agreement will constitute consideration passing to Spouse for the transfer. Therefore, based on the facts submitted and representations made, we conclude that the value of Spouse's gift resulting from the relinquishment of her income and corpus interests is the value of these interests in Trust relinquished by Spouse (determined as discussed above) reduced by the net amount remitted to Spouse under Paragraph 7(a) of the Agreement.

As discussed above, after Spouse renounces her income and corpus interests in Trust, a bona fide issue will be presented regarding the disposition of the trust corpus. The Agreement, inter alia, settles this dispute between Son 1 and Son 2 on one side and Grandchild 1, Grandchild 2, and the unborn heirs on the other side. Whether an agreement settling a dispute is effective for estate and gift tax purposes, depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-775 (9th Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

We have examined the Agreement in the context of the state court decisions that address the issue presented. We have concluded that the proposed Agreement pertaining to the disposition of the trust corpus after Spouse's renunciation, is a product of arm's length negotiation and fairly reflects the relative merits of the claims made by the parties to the dispute. We believe that the Agreement provides an allocation of the trust assets that is within a range of reasonable settlements considering the state court decisions that address the issues. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) are consistent with the relative merit of the claims asserted by the parties.

As discussed above, under the terms of the Agreement, a separate trust will be established for the benefit of Grandchild 1 and Grandchild 2. Further, $250,000 will be distributed immediately (within 30 days after the issuance of a final court order) to Son 1 and Son 2, and Trust income will be payable to Son 1 and Son 2 during Spouse's life. In view of our determination above regarding the bona fides of the issues presented and the Agreement settling the controversy, we conclude that Son 1 and Son 2 will not be treated as making a gift as a result of the proposed transaction. We further conclude that the interests received by Son 1 and Son 2 as a result of Spouse's gift to the Trust will qualify for the gift tax annual exclusion under § 2503(b) as gifts of present interests.

Ruling Requests 4, 5, and 6

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 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death. Section 2033 applies generally to property that is owned outright by the decedent and that may be passed by the decedent's will to the beneficiaries of the probate estate. The section does not apply to property interests that are extinguished at death.

Section 2036 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period that does not in fact end before his death: (1) the possession or enjoyment of, or the right to the income from, the property; or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038 provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In this case, Spouse will relinquish all of her interests in Trust. As discussed above, we have concluded that the Agreement constitutes the settlement of a bona fide controversy between Son 1 and Son 2, on the one hand, and Grandchild 1, Grandchild 2, and the unborn heirs on the other, regarding the disposition of the Trust corpus. The Agreement was the product of arm's length negotiation and reflects the merits of the parties' claims. Son 1 and Son 2 will possess no interest with respect to Grandchildren's Trust. Accordingly, based on the information submitted and representations made, we conclude that no part of the value of the Trust or the Grandchildren's Trust will be included in Spouse's gross estate for federal estate tax purposes, except for the amount, if any, owed to her estate as reimbursement for estate, inheritance, or income taxes under Paragraphs 7(a) and 7(b) of the Agreement. Further, if either Son 1 or Son 2 predeceases Spouse, no part of the value of Trust will be included in that son's gross estate for federal estate tax purposes, other than unpaid

income and the amounts of Trust corpus, if any, then due under Paragraphs 6(a) and 6(b) of the Agreement. Finally, no part of the value of the Grandchildren's Trust will be included in either Son 1's or Son 2's gross estate for federal estate tax purposes.

Ruling Request 7

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. Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Section 1001(c) provides that, except as otherwise provided in Subtitle A, the entire amount of gain determined under § 1001 on the sale or exchange of property shall be recognized.

The character of the gain will depend on the nature of the asset sold. Section 1222 provides that long-term capital gain is gain from the sale or exchange of a capital asset held for more than one year. Section 1221 provides that the term "capital asset" means property held by the taxpayer, excluding certain types of property not apparently at issue in this case.

Rev. Rul. 72-243, 1972-1 C.B. 233, 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 and that the life tenant's basis attributable to his life interest at the time of the sale is considered to be zero, pursuant to § 1001(e). See §§ 1.1001-1(f) and 1014-5(b) and (c) of the Income Tax Regulations.

In Diedrich v. Commissioner, cited above, the Supreme Court held that a donor who makes a gift of property on the condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property. The situation here is similar to that in Diedrich, except that, in this case, as well as donor's gift taxes, the donor's income taxes, and incremental estate and inheritance taxes will be paid by the donees or on the donees' behalf.

Under the facts presented here, the amount realized by Spouse, under § 1001(b), will be the fair market value of the property she will receive (i.e., the Sons' promise to pay her taxes and the undertaking by the Trust to pay, on Sons' behalf, any incremental estate and inheritance tax liability).

Because, under § 1001(e), Spouse's adjusted basis in the property she is transferring (i.e. her life tenancy) is to be considered to be zero, the gain from Spouse's

disposition of the property will be equal to the amount realized. Under § 1001(c), the entire amount of gain will be recognized.

Under Rev. Rul. 72-243 and Diedrich, Spouse's gain from the transfer of her entire interest in the Trust to the remaindermen will be treated as an amount realized from the sale or exchange of a capital asset under § 1222.

We conclude that the current federal income tax imposed on Spouse as a result of the proposed transaction will be calculated by treating the amount of the gift and income taxes to be paid pursuant to Paragraph 7(a) of the Agreement (net of any refunds of such taxes paid pursuant to Paragraph 7(a) of the Agreement), plus the value of the undertaking by the Trust to pay, on Sons' behalf, any incremental estate and inheritance tax liability imposed on Spouse's estate as a result of the transaction, pursuant to Paragraph (7)(b) of the Agreement, as gain from the sale of a capital asset.

Ruling Request 8

Section 671 provides that, where it is specified in subpart E of part I of subchapter J of chapter 1 that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D.

Section 673 through 677 specify the circumstances under which the grantor is regarded as the owner of a portion of a trust.

Section 678 provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Based solely on the facts and representations submitted, we conclude that the modification of Trust pursuant to the application to modify Trust made to the court will not cause Spouse to be treated as the owner of any part of Trust or the Grandchildren's Trust under §§ 671 though 678.

Ruling Requests 9 and 10

Section 2601 imposes a tax on every generation-skipping transfer (GST) (within the meaning of § 2611 and § 2612) made by a transferor defined in § 2652(a) to a skip person defined in § 2613.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the GST tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Under § 26.2601-1(b)(1)(iv)(A), if an addition is made after September 25, 1985, to an irrevocable trust that is excluded from chapter 13 under § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in § 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in § 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio is zero. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under § 2642(a)(1). The regulation further provides that a constructive addition under § 26.2601-1(b)(1)(v) is treated as an addition. Section 26.2601-1(b)(1)(iv)(B) and (C) provide rules for determining the pro rata portion of a generation-skipping transfer that is subject to GST tax where a post-September 25, 1985 addition is made to a trust that was irrevocable on or before September 25, 1985.

Section 26.2601-1(b)(1)(v) discusses constructive additions to trusts. Section 26.2601-1(b)(1)(v)(A) provides that where any portion of a trust remains in the trust after the release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed will be treated as an addition to the trust. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. In the latter case, the transferor for purposes of chapter 11 or chapter 12 is the transferor for purposes of chapter 13.

Section 26.2601-1(b)(1)(v)(D), Example 1, considers a situation where a pre-1985 trust provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to T and S's grandchild, GC. S also possesses a general power of appointment over one-half of the trust assets. On December 21, 1989, when the value of the trust corpus is $1,500,000, S died without having exercised the general power of

appointment. The value of one-half of the trust corpus, $750,000 ($1,500,000 x .5) is included in S's gross estate under § 2041(a) and is subject to estate tax under chapter 11. Because the value of one-half of the trust corpus is subject to tax under chapter 11 with respect to S's estate, S is treated as the transferor of that property for purposes of chapter 13 (see § 2652(a)(1)(A)). For purposes of the generation-skipping transfer tax, the lapse of S's power of appointment is treated as if $750,000 ($1,500,000 x .5) had been distributed to S and then transferred back to the trust. Thus, S is considered to have added $750,000 ($1,500,000 x .5) to the trust at the date of S's death. Because this constructive addition occurred after September 25, 1985, 50 percent of the corpus of the trust became subject to chapter 13 at S's death.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1) will not cause the trust to lose its exempt status. The regulation provides that these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Under § 26.2601-1(b)(4)(i)(B), a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if the settlement is the product of arm’s length negotiations and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties’ assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 2652(a)(1)(B) provides that the term “transferor” means, in the case of any property subject to the tax imposed by chapter 12, the donor. An individual shall be treated as transferring any property with respect to which the individual is a transferor.

In this case, as discussed above, Spouse by renouncing her right to receive distributions of trust income and corpus is making a gift that is subject to the gift tax under chapter 12 of the Code. Further, by declining to accept trust income and corpus she is otherwise entitled to receive, Spouse is making a constructive addition to the Trust that is similar to the constructive addition illustrated in § 26.2601-1(b)(1)(v)(D), Example 1. Accordingly, Spouse is treated as making a constructive addition to Trust after September 25, 1985, of an amount equal to value of the interests in Trust relinquished by Spouse. Thus, the transfer will cause a portion of the Trust to become subject to chapter 13, in accordance with the rules contained in § 26.2601-1(b)(1)(iv). Spouse will become the transferor of that portion of the Trust. Section 2652(a)(1)(B).

Therefore, based on the information submitted and representations made we conclude that:

1. As a result of Spouse's transfer by renunciation, a pro rata portion of Trust and distributions from Trust (including the distribution establishing the Grandchildren's Trust) and terminations of interests in property held in the Trust, will be subject to the provisions of chapter 13. Such pro rata portion is determined in accordance with § 26.2601-1(b)(1)(iv)(A), (B), and (C). Spouse is treated as the transferor for GST tax purposes of such pro rata portion under § 2652. Accordingly, a pro rata portion of the distribution to the Grandchildren's Trust will constitute a direct skip under § 2611.

2. The remaining pro rata portion of Trust and distributions and terminations with respect to Trust will remain exempt from the provisions of chapter 13, in accordance with §26.2601-1(b)(4)((i)(B).

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

Sincerely yours,
Associate Chief Counsel
(Passthroughs and Special Industries)
By: George Masnik
Chief, Branch 4

Enclosure (1)
Copy for 6110 purposes

CC: