

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04 - PLR - 141280-02

Date:

JULY 29, 2003

Re:

### Legend

H	=
W	=
Trust	=
Contract	=
Company	=
\$ <u>m</u>	=
\$ <u>n</u>	=
Date 1	=
Date 2	=
Date 3	=
Year 1	=
Year 2	=
State	=
State Statute 1	=
State Statute 2	=
State Statute 3	=
State Statute 4	=
State Statute 5	=

Dear :

This responds to a letter dated July 22, 2002, and subsequent correspondence, submitted by your authorized representative requesting rulings under section 1014 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: In Year 1, H and W were married. H and W resided in State, a community property law state. On Date 1, H and W used community property funds to purchase a deferred variable

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annuity contract (Contract) issued by Company, an insurance company, by making a single purchase payment of \$m. No additional premium payments were made to Company under Contract. H was designated as the annuitant under Contract.

Under the terms of Contract, prior to the start of the annuity payments, Contract may be surrendered for its total accumulation value or may be partially surrendered for any portion of its fixed or variable accumulation value.

The original beneficiary of Contract was W. Pursuant to Contract, the interest of any beneficiary who fails to survive the annuitant shall terminate at the death of the beneficiary. W, the beneficiary, failed to survive H, the annuitant. Accordingly, W's beneficiary interest under the annuity contract terminated at her death.

On Date 2, H and W (Trustors) established Trust which is governed under the laws of State. Trust was funded with Contract, other community property, and separate property of H and W. The trustees of Trust prior to W's death were H and W. Article II provides that Trust shall be subject to the full and unrestricted power in the Trustors to alter, amend, or revoke Trust, in whole or in part. The revocation of Trust as it relates to the community property in Trust shall be accomplished by written instrument signed by Trustors, in accordance with State Statute 1 and State Statute 2. State Statute 3 provides that all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in State is community property. State Statute 4 provides that unless the trust instrument or the instrument of transfer expressly provides otherwise, community property that is transferred in trust remains community property during the marriage, regardless of the identity of the trustee, if the trust, originally or as amended before or after the transfer, provides that the trust is revocable as to that property during the marriage and the power, if any, to modify the trust as to the rights and interests in that property during the marriage may be exercised only with the joinder or consent of both spouses. H and W used community funds to purchase Contract; accordingly, Contract is community property. H and W are treated as owning a one-half interest in Contract under State law.

Article III provides that the trustees shall pay the entire income from Trust to or for the benefit of the Trustors, at least annually. Until written instructions to the contrary, the trustees shall pay any income from the Trustors' community property to the Trustors jointly; pay any income from the separate property of H to H; and any income from the separate property of W to W. The trustees shall pay the Trustors such amounts of principal of Trust as Trustors may specify.

Article V provides that at any time within nine months from and after the death of the first of Trustors to die, Trust shall be divided by the trustee into two shares, Trust A and Trust B. Trust A shall consist of an amount equal to the value of the surviving Trustor's interest in community property, all of the surviving Trustor's separate property, and a fractional share of other property that passes to the surviving Trustor that qualifies for the marital deduction.

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Article VI provides that the trustee of Trust A shall pay all of the net income to the surviving spouse for life, at least annually, and such amounts of principal as the surviving Trustor specifies in writing. Article VI further provides that the surviving Trustor shall have the power to revoke Trust A at any time or alter or amend Trust A, or remove all or any part of the property comprising Trust A from the trust, at his or her unrestricted option.

In Year 2, Trustors requested and received a distribution from Trust in the amount of \$m, which was distributed as a lump sum premium payment on Contract. There have been no subsequent distributions from Trust with respect to Contract.

W died testate on Date 3. In her will, W bequeathed personal and household effects to her husband and bequeathed the remainder of her estate to Trust. W did not revoke Trust in her will. State Statute 5 provides that community property held in a revocable trust described in State Statute 4 is governed by the provisions, if any, in the trust for disposition in the event of death. Pursuant to Trust, both W's one-half interest and H's one-half interest in Contract were allocated to Trust A.

At the date of W's death, Contract was valued at \$n. The executor of W's estate included one-half of the value of Contract in W's gross estate on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.

Taxpayer, H, requests rulings that the basis in W's interest in Contract should be "stepped-up" to its fair market value at the date of W's death under section 1014(b)(9) under Rev. Rul. 70-143, 1970-1 C.B. 167, pursuant to the relief granted under Rev. Rul. 79-335, 1979-2 C.B. 292; and that the basis in H's interest in Contract should be "stepped-up" to its fair market value at the date of W's death under section 1014(b)(6).

## LAW AND ANALYSIS

Section 2038(a) 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, 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.

Contract retained its character as community property in Trust. Trust was revocable and, therefore, for federal estate tax purposes, W's one-half interest in Contract was includible in her estate under section 2038.

Section 1014(a) provides, in part, that, except as otherwise provided in this

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section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the fair market value of the property at the date of the decedent's death.

Section 1014(b)(6) provides that, in the case of persons dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, is considered, for purposes of section 1014(a), to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate.

Section 1014(b)(9) provides in the case of persons dying after December 31, 1953, that property acquired from the decedent by reason of death, form of ownership, or other conditions (if by reason thereof the property is required to be included in determining the value of the decedent's gross estate) shall, for purposes of section 1014(a), be considered to have been acquired from or to have passed from the decedent. However, section 1014(b)(9)(A) provides that the foregoing shall not apply to annuities described in section 72.

Section 72 prescribes the tax treatment of amounts received under an annuity contract. Contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company. Section 1.72-2(a)(1) of the Income Tax Regulations.

The Internal Revenue Service (Service) issued two revenue rulings addressing the application of section 1014(b)(9) to a beneficiary's right to receive a lump sum payment under a variable annuity contract following the annuitant's death. In Rev. Rul. 70-143, 1970-1 C.B. 167, husband purchased a variable annuity contract from an insurance company naming his wife as the principal beneficiary. The contract provided that, in the event of the contract owner's (husband) death prior to the annuity starting date, the beneficiary (or the contract owner's estate if the beneficiary predeceases the owner) has the right to surrender the contract for the then value of the contract owner's interest in the accumulation fund of the insurance company.

In the revenue ruling, husband, the annuitant, died prior to the starting date of the annuity and the value of his right to the accumulated value under the annuity contract is includible in determining the value of the decedent's gross estate. Accordingly, under section 1014(b)(9), the right that passes to the beneficiary by reason of her surviving the decedent is considered to have been acquired from or to have passed from the decedent. After consideration of section 1.72-2(b)(2) which provides, in part, that amounts subject to section 72 are considered amounts received as an annuity only in the event they are received on or after the "annuity starting date," the

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Service concluded that the right to the accumulated value under the annuity contract prior to the annuity starting date would not be an annuity described in section 72. Accordingly, the Service held that the basis of the right to the accumulated value is its fair market value at the date of decedent's death under section 1014, i.e., the beneficiary's basis in the right to the accumulated value, is stepped-up to the fair market value of the right at the date of the contract owner's death.

Rev. Rul. 79-335, 1979-2 C.B. 292, revoked Rev. Rul. 70-143. In Rev. Rul. 79-335, the Service states that the contract in question is considered to be an annuity contract in accordance with the customary practice of life insurance companies. The phrase in section 1014(b)(9)(A) "annuities described in section 72" refers to annuity contracts taxable under that section generally and not merely to "amounts received as an annuity." Therefore, the property acquired by the beneficiary is an interest in the benefits provided under the annuity contract. Those benefits accord to the contract owner, or in the event of the owner's death, the named beneficiary, the right to surrender the contract at any time before the annuity starting date and to receive in return an amount equal to the accumulated value under the contract. Further, the fact that the beneficiary may elect to receive a lump-sum payment in return for the accumulated value does not render the property acquired from the decedent an interest in something other than an annuity contract. The Service held that since the contract is subject to the provisions of section 72, the exclusion under section 1014(b)(9)(A) applies. Accordingly, the beneficiary's basis in the right to the lump sum payment is not stepped-up to its fair market value at the date of the annuitant's death. Rev. Rul 79-335 does not apply to deferred variable annuity contracts purchased prior to October 21, 1979, including any contributions applied to such contracts pursuant to a binding commitment entered into before that date.

A revenue ruling "represents the conclusion of the Service regarding the application of law to the entire statement of facts involved". Therefore, "parties are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same." Rev. Proc. 2003-1, sec. 2.05, 2003-1 I.R.B. 1, 7 (January 6, 2003); see also, Rev. Proc. 89-14, sec. 7.01(1), 1989-1 C.B. 814 ("The conclusion expressed in a revenue ruling will be directly responsive to, and limited in scope by, the pivotal facts stated in the revenue ruling.")

The facts in Rev. Rul. 70-143 and this request are not substantially the same because the ruling and this request involve different interests in the annuity. Accordingly, relief under Rev. Rul. 79-335 is not available. The Contract, an annuity described in section 72, is subject to the exclusion under section 1014(b)(9)(A), and, therefore, the basis in W's one-half interest in Contract is not entitled to a stepped-up basis under section 1014(a).

Further, H's one-half interest in Contract is not entitled to a stepped-up basis under section 1014(b)(6). Section 1014(b)(6) allows the beneficiary to step-up his one-half interest in community property where at least one-half of the whole of the community interest in such property was includible in determining the value of the

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decendent's gross estate. In the instant case, one-half of Contract was included in determining the value the W's gross estate. However, the basis in H's one-half interest in Contract is not entitled to be stepped-up under section 1014(b)(6) where the other half which passes from the deceased spouse does not get a stepped-up basis under sections 1014(b)(1) through (9). See Murphy v. Commissioner, 342 F.2d 356 (9<sup>th</sup> Cir. 1965); Collins v. United States, 318 F. Supp. 382 (C.D. Cal. 1970).

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, we express or imply no opinion on the Federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under any other provisions of the Code.

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

In accordance with the power of attorney on file with the office, we are sending a copy of this letter to your authorized representative.

Sincerely,

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

Enclosures

Copy for section 6110 purposes  
Copy of this letter

cc: