

## Internal Revenue Service

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Department of the Treasury

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Third Party Communication: None

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Person To Contact:

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PLR-136850-04

Date:

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### Legend

Trust =

Decedent =

Date 1 =

Date 2 =

Date 3 =

X =

Son =

Grandchild 1 =

Y =

Grandchild 2 =

Grandchild 3 =

Date 4 =

Date 5 =

Date 6 =

Court =

Date 7 =

Z =

Date 8 =

Dear :

This is in response to your representative's letter, dated July 7, 2004, and subsequent correspondence requesting rulings regarding the income, estate, gift, and generation-skipping transfer (GST) tax consequences of two beneficiaries' renunciation of their interests in Trust.

The facts submitted and the representations made are summarized as follows: Decedent executed her Last Will and Testament on Date 1 and a codicil to the will on Date 2. Decedent died on Date 3.

Item III of Decedent's Will established Trust. Section 9(d) of Item III directs the trustee to pay \$x each to Son and to Grandchild 1 per month. In addition, the trustee is directed to pay \$y each to Grandchild 2 and to Grandchild 3 per month. Section 9(f) generally provides that after Son's death and when the youngest grandchild reaches the age of forty years, the trustee shall distribute: one-third of the assets to Grandchild 1. The remaining assets shall continue in trust and Grandchild 2 and Grandchild 3 shall each continue to receive \$y per month during their lives. Upon the death of either Grandchild 2 or Grandchild 3, one-half of the assets in Trust shall be distributed equally to Grandchild 1's children. Upon the death of the survivor of Grandchild 2 and Grandchild 3, Trust shall terminate and the remaining Trust assets shall be distributed equally among Grandchild 1's children.

Son died on Date 4. The youngest grandchild reached age forty on Date 5. After the distribution of one-third of the Trust assets in accordance with Section 9(f), Trust was modified by an agreement on Date 6. A corresponding judgment was entered by Court on Date 7. Date 7 is prior to September 25, 1985.

The Date 7 Court order required the distribution of all but \$z of the Trust assets. Paragraph 1 of the order provides that \$z of the Trust assets shall continue to be held in Trust. Paragraph 1(a) of the order provides that Grandchild 2 and Grandchild 3 shall each receive \$y per month. In addition, the remaining net income from Trust shall be distributed among Grandchild 1's children. Paragraph 1(b) of the order provides that upon the death of the first to die of Grandchild 2 and Grandchild 3, one-half of the Trust principal shall be distributed equally among Grandchild 1's children. Upon the death of the survivor of Grandchild 2 and Grandchild 3, the remaining Trust assets shall be distributed equally among Grandchild 1's children.

There have been no additions (actual or constructive) to the corpus of Trust since September 25, 1985.

Grandchild 2 and Grandchild 3 propose to renounce their interests in Trust. In accordance with a Date 8 order by Court, the renunciation by both grandchildren of their interests in Trust will terminate Trust and the remaining Trust principal will be distributed to Grandchild 1's children. The trustee of Trust has requested a ruling that the proposed renunciation of the grandchildren's interests will constitute "present interest" gifts for purposes of the gift tax annual exclusions under § 2503(b). The trustee further requests a ruling that the proposed renunciations will not affect Trust's status as exempt from the GST tax. Finally, the trustee requests a ruling that the renunciations will not have any income tax consequences to Grandchild 2, Grandchild 3, or the residuary beneficiaries.

### Characterization of Gifts

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 the year.

Section 25.2503-3(a) of the Gift Tax Regulations provides that the term “future interest” includes reversions, remainders, and other interests 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 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, 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.

In this case, each grandchild will renounce their interests in Trust. Each grandchild’s renunciation of these interests constitutes a gift for gift tax purposes under § 2501 of the value of the renounced interests. Under the terms of the Trust agreement and in accordance with the Date 8 Court order, after both grandchildren’s renunciation of their interests, Trust will terminate and the interests renounced by each grandchild will pass to the residuary beneficiaries. Accordingly, the value of the renounced

interests will qualify for the gift tax annual exclusion under § 2503(b) as gifts of present interests.

### Trust's Status as Exempt from the GST Tax

Section 2601 imposes a tax on every generation-skipping transfer.

Section 2611(a) defines the term "generation-skipping transfer" to include a taxable distribution, taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions do not apply to any GST under a trust (as defined in § 2652(b)) 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).

Section 26.2601-1(b)(1)(ii)(A) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

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) provides rules for determining the pro rata portion of a GST 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, 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 GST tax, the lapse of S's power of appointment is treated as if \$750,000 had been distributed to S and then transferred back to the trust. Thus, S is considered to have added \$750,000 to the trust at the date of S's death. Because this constructive addition occurred after September 25, 1985, fifty percent of the corpus of the trust became subject to chapter 13 at S's death.

In this case Trust is a GST trust because it provides for distributions to more than one generation of beneficiaries below the grantor's generation. Trust was last modified on Date 7, prior to September 25, 1985, and Trust was irrevocable on September 25, 1985. Prior to the grandchildren's renunciation of their interests, therefore, Trust is exempt from the GST tax pursuant to § 26.2601-1(b)(1)(i).

As discussed above, each grandchild, by renouncing his interests, is making a gift that is subject to the gift tax under chapter 12. Further, by declining to accept trust payments they are otherwise entitled to receive, each grandchild is making a constructive addition to Trust that is similar to the constructive addition illustrated in § 26.2601-1(b)(1)(v)(D), Example 1. Accordingly, each grandchild is treated as making a constructive addition to Trust after September 25, 1985, of an amount equal to the value of the interests in Trust that each grandchild is renouncing. As a result of the proposed renunciation by Grandchild 2 and Grandchild 3, a pro rata portion of 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). Each grandchild is treated as the transferor for GST tax purposes of such pro rata portion under § 2652. However, provided the subsequent distributions made from Trust will be made to individuals who are not 2 or more generations below the generation assignment of the transferor (each grandchild with respect to the pro rata portion), the distributions will not be taxable events for GST tax purposes. The remaining pro rata portion of Trust and terminations

with respect to Trust will remain exempt from the provisions of chapter 13, in accordance with § 26.2601-1(b)(1)(iv)(A).

#### Income Tax Consequences to Annuitants

Section 61(a)(15) provides, in part, that gross income means all income from whatever source derived including income from an interest in an estate or trust.

Under Lucas v. Earl, 281 U.S. 111 (1930), income must be taxed to the one who earns it, and income may not be avoided by assignment to another. The crucial question in assignment of income cases is whether the assignor relinquishes sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat the assignee as the recipient of the income for tax purposes. See Commissioner v. Sunnen, 333 U.S. 591, 605 (1948).

In Blair v. Commissioner, 300 U.S. 5 (1937), 1937-1 C.B. 175, the Supreme Court holds that a life beneficiary's assignment of specified annual amounts of trust income to his children was not an assignment of income because the taxpayer had assigned not merely the right to receive the income but the taxpayer's entire interest in the trust corpus. See Rev. Rul. 55-38, 1955-1 C.B. 389 (generally holding that in the case of an irrevocable assignment, valid under local law, of trust income for a period of not less than 10 years, such income will be taxable to the assignee rather than the assignor).

In the present case, each grandchild proposes to renounce his respective interests in Trust, and in effect, make an absolute irrevocable assignment of income of their entire interest to residuary beneficiaries. Therefore, assuming the proposed renouncement will be valid under local law, the transaction will satisfy the conditions of Blair, and the post-renunciation income will not be taxable to Grandchild 2 or Grandchild 3.

#### Income Tax Consequences to Primary Beneficiaries

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

Section 102, in general, excludes from gross income 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) 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.

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 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.

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

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

In order for a transaction to be a realization event under § 1001, the transaction must be (1) a sale, exchange or other disposition, and (2) if an exchange, the exchange must result in the receipt of property that is “materially different” from the relinquished property. Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991).

In the present case, there will be no sale or exchange because the residuary beneficiaries did not obtain the grandchildren’s renunciation and the accelerated distribution of Trust in return for any consideration or relinquishing any of their trust interests. Cf. Helvering v. Flaccus Oak Leather, 313 U.S. 247 (1941)(holding that without the reciprocal transfer of property, there can be no exchange under § 1001). Instead, the residuary beneficiaries will receive the trust distributions upon termination of the trust by virtue of their status as heirs. See § 102(a). Because there will be no sale, exchange or other disposition of property, the grandchildren’s renunciation and the accelerated distribution of the Trust termination will not result in a realization event to the residuary beneficiaries for purposes of § 1001.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, we express or imply no opinion on the value of each grandchild’s gift to Trust.

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

Pursuant to the Power of Attorney on file with this office, this letter is being sent to the taxpayer's representative.

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman  
Branch Chief, Branch 9  
(Passthroughs & Special Industries)

Enclosure

Copy of this letter for § 6110 purposes

cc: