

Internal Revenue Service

Department of the Treasury

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2511.05-00, 1014.01-00, 2036.00-00 Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2 - PLR-118576-99

Date:

July 31, 2000

A =

Trustees =

D1 =

D2 =

Beneficiary =

Trust =

State =

Dear :

This letter responds to your letter dated November 16, 2000, submitted on behalf of Trust, requesting rulings concerning whether A will be treated as the owner of any portion of the principal of Trust for purposes of §§ 671 through 678, whether transfers to the Trust are completed gifts for purposes of § 2511, and whether the basis of the assets of Trust in the hands of the beneficiaries of Trust will be the fair market value of Trust's assets as of the date of A's death for purposes of §§ 1014(a)(1) and 1014(b)(9), as the result of the inclusion of the Trust's assets in A's gross estate for purposes of § 2036(a).

The information submitted states that on D1, A created Trust, an irrevocable trust for the benefit of himself and other

designated beneficiaries. Trust is administered under the laws of State. On D2, A transferred the majority of his assets to Trust. Pursuant to the terms of Trust, during his life, A is entitled to receive all of the net income from Trust and an amount of Trust principal equal to the gift and generation-skipping transfer taxes attributable to any transfer to Trust by A. Upon A's death, his estate is entitled to an amount of Trust principal equal to the estate, inheritance, and generation-skipping transfer taxes generated by property passing under Trust which is included in A's estate. Trustees have no authority to make any distributions to, or for the benefit of A, beyond the amounts described above.

Article II, Section 2.1 of Trust provides that Trust is irrevocable and shall not be revoked, altered, or amended in any manner whatsoever by the Settlor, the Trustees, or any other person or persons.

Article III, Section 3.3 of Trust provides that during A's lifetime, Trustees shall distribute to A, or expend for A's benefit, all of the net income from Trust. Any portion of the net income not expended for A's benefit shall be distributed at least annually to A.

Article III, Section 3.4 provides that neither A nor his estate shall have any right to receive, nor shall Trustees distribute, any portion of the principal of Trust, except for payment of estate, gift, and generation-skipping transfer taxes as set forth in Article IV of the Trust Agreement.

Article IV, Section 4.1 provides that during A's lifetime, all gift and generation-skipping transfer taxes incurred by A with respect to any and all gifts, contributions, and transfers to Trust shall be paid from Trust principal.

Article IV, Section 4.2 provides, generally, that upon A's death, A's estate is entitled to a portion of the Trust principal equal to the amount of estate, inheritance, and generation-skipping transfer taxes that, by reason of A's death, are generated by property passing under Trust which is included in A's gross estate.

Article V, Section 5.1 provides that after all taxes as set forth in Article IV are paid, the balance of Trust, together with any undistributed or accumulated income, shall be distributed as follows: one-fifteenth of the Trust Estate outright to B, provided that he survives Taxpayer; and the balance of Trust to A's nieces and nephew, per stirpes. If none of A's nieces or nephews survive A, Trust shall be divided, per stirpes, among A's grandnieces and grandnephews. Article V, Section 5.1.4 provides

that upon A's death, Trust will be distributed to the designated beneficiaries outright and free of trust, unless the respective beneficiary is under the age of 21.

Article XI, Section 11.1 provides that Trust and the trusts created pursuant to the terms of the Trust Agreement shall be governed and interpreted in accordance with the laws of State.

Article VIII, Section 8.1 provides that while in the hands of the Trustees, neither the principal nor the income of Trust shall be liable for the debts of any beneficiary of Trust, nor shall the same be subject to seizure or attachment by any creditor of any beneficiary, under any writ or proceeding at law or in equity, and no beneficiary of Trust shall have any power to sell, transfer, assign, encumber, or in any manner anticipate or dispose of his or her interest in Trust.

Section 671 of the Code provides, in general, that if the grantor of a trust or another person is treated as the owner of any portion of the trust, that person's taxable income and credits shall include the income, deductions, and credits of the trust attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits of an individual.

Sections 673 through 677 specify the circumstances under which the grantor will be regarded as the owner of a portion of a trust. Our examination of Trust reveals none of the circumstances that would cause A to be treated as the owner of any portion of the principal of Trust under §§ 673, 674, or 676.

Under § 675 and applicable regulations, the grantor is treated as the owner of any portion of a trust if under the terms of the trust agreement or circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust.

Our examination of Trust reveals none of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of A under § 675. Thus, the circumstances attendant on the operation of Trust will determine whether A will be treated as the owner of any portion of Trust under § 675. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director with which the parties file their tax returns.

Section 677 provides that the grantor shall be treated as the owner any portion of a trust, whether or not the grantor is

treated as the owner under § 674, whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse, or applied to the payment of premiums on policies of insurance for the life of the grantor or the grantor's spouse.

Section 1.677(a)-1(d) provides that under § 677, the grantor shall be treated as the owner of the portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in the discharge of a legal obligation of the grantor. Trust provides that A is entitled to receive an amount of Trust principal equal to the gift and generation-skipping transfer taxes attributable to any transfer to Trust by A. Our examination of Trust reveals that based on all the facts and circumstances, as A's payment of the gift tax will be treated as a discharge of indebtedness, through a part gift and part sale of the gift property transferred, A will not be treated as the owner of any portion of the principal of Trust under § 677. Our examination of Trust reveals no other circumstances that would cause A to be treated as the owner of any portion of the principal of Trust under § 677.

In Diedrich v. Commissioner, 457 U.S. 191 (1982), individual taxpayers made a gift of property subject to the condition that the donee pay the gift tax. The Court chose to treat the donee's payment of the gift taxes as a discharge of indebtedness through a part gift and part sale of the gift property transferred. The Court reasoned that, "the donor realizes an immediate economic benefit by the donee's assumption of the donor's legal obligation to pay the gift tax." (457 U.S. 191, 194). In Diedrich, the Court held that the taxpayers realized taxable income to the extent the gift taxes paid by the donees exceeded the donors' adjusted bases in the property transferred. According to the Court, the transfer is treated as if the donor sells the property to the donee for less than its fair market value. The "sale" price is the amount necessary to discharge the gift tax indebtedness. The balance of the value of the transferred property is treated as a gift. The gain thus derived by the donor is the amount of the gift tax liability less the donor's adjusted basis in the entire property. Therefore, to the extent that the gift tax exceeds the donor's adjusted basis in the property, income is realized. (457 U.S. 191, 199).

Article III, Section 3.3 of Trust states that during A's lifetime, Trustees shall distribute to A, or expend for A's benefit, all of the net income from Trust. Any portion of the net income not expended for A's benefit shall be distributed at least annually to A. Therefore, A will be treated as the owner

of the income portion of Trust.

Section 2501 imposes a tax on the transfer of property by any individual. Section 25.2511-1(a) of the Gift Tax Regulations provides that the gift tax applies to every kind of transfer by

way of gift, whether direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(e) states that if a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. The tax is applicable, for example, to the transfer of an undivided half interest in property, or to the transfer of a life estate when the grantor retains the remainder interest, or vice versa.

Section 2502(c) states that the tax imposed by section 2501 shall be paid by the donor. Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee at the time of the transfer. The tax is a primary and personal liability of the donor, is an excise upon the act of making the transfer, is measured by the value of the property passing from the donor, and attaches at the time the property passes, regardless of the fact that the identity of the donee may not then be known or ascertainable.

Section 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.

Section 25.2511-2(c) provides that a gift is incomplete to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries.

Section 2512 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.

Rev. Rul. 75-72, 1975-1 C.B. 310, states that if, at the time of the transfer, the gift is made subject to a condition that the gift tax be paid by the donee or out of the transferred property, the value of the gift is measured by the fair market

value of the property or property right passing from the donor, minus the amount of the gift tax to be paid by the donee.

In this case, A transferred property to Trust for the benefit of himself and designated beneficiaries. Under Article III, Section 3.3 of Trust, A retained the right to receive all of the net income from Trust, annually, during his lifetime. Trustees have no authority to make any distributions to, or for the benefit of, A beyond the amounts described above. Therefore, the portion of the property transferred to Trust over which A has retained an interest, A's right to receive all of the net income from Trust during his lifetime, is an incomplete gift for Federal gift tax purposes. The remaining portion of the transfer, however, is a completed gift in the year the transfer is made.

A also retained the right to receive an amount of Trust principal equal to the gift and generation-skipping transfer taxes attributable to any transfer to Trust by A. When valuing the amount of the gift to Trust, we conclude that any gift tax required to be paid out of Trust property by virtue of Article IV of the Trust will reduce the amount of the gift for Federal gift tax purposes. The value of the gift will be measured by the fair market value of the property or property right passing from A to Trust reduced by the amount of the gift tax required to be paid from Trust principal.

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 2036(a) provides that the value of a decedent's 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 the 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.

In the present case, although A has transferred property to an irrevocable inter vivos trust, he has retained for his life the right to the net income from the trust property. Therefore, pursuant to § 2036, the value of Trust will be included in A's gross estate upon his death.

Section 1014(a)(1) provides that 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 will, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person be the fair market value of the property at the date of the decedent's death.

Section 1014(b)(9) provides that in the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate, shall be considered to have been acquired from or to have passed from the decedent for purposes of § 1014(a).

Therefore, upon A's death, as Trust's assets, pursuant to § 2036, will be included in A's gross estate, the basis of the assets in the hands of beneficiaries of Trust will be the fair market value of Trust's assets as of the date of A's death pursuant to § 1014.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Trust.

Sincerely yours,

J. THOMAS HINES
Acting Branch Chief
Branch 2
Office of the Associate
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
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