

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-111539-99/CC:DOM:P&SI:B2

Chief, Technical and Support Branch,

District

Taxpayer's Name:

Taxpayer's Address:

TIN:

Years Involved:

Dates of Conferences:

LEGEND:

X =

A =

B =

C =

D =

Company =

Trust 1 =

Trust 2 =

Trust 3 =

D1 =

D2 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

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Year 5 =

Year 6 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

ISSUES:

1. Is the amount of the liability incurred by Trust 2 which was secured by the property in Trust 2 included in X's amount realized upon the termination of Trust 2 and the transfer of the assets and liabilities of Trust 2 to the remainder trusts?

2. If the Service rules adversely to X on Issue 1, will the Service grant X's request to apply this technical advice memorandum on a nonretroactive basis under § 7805(b)(8) of the Internal Revenue Code?

CONCLUSION:

1. Since Trust 2 is a grantor trust, X is treated as the owner of the property of Trust 2 for federal income tax purposes. Therefore, the amount of debt incurred by Trust 2 which was secured by the property of Trust 2 is included in X's amount realized when Trust 2 terminates and the assets and liabilities of Trust 2 are transferred to the remainder trusts.

2. X's request to apply this technical advice memorandum on a nonretroactive basis under § 7805(b)(8) is denied.

FACTS:

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X owned a shares of common stock in Company, a closely held corporation. X had originally acquired an interest in the stock in Year 1, when A, X's father, created Trust 1 and funded it with the stock for the benefit of X. Trust 1 terminated in Year 2, and X owned the stock individually until X transferred it to Trust 2 on D1 of Year 2. Prior to the transfer of the stock to Trust 2, X had expressed an interest in redeeming or selling the stock. At the time of the transfer of the stock to Trust 2, X's basis in the stock was approximately \$b, a nominal amount, and the reported value of the stock, used by X for gift tax purposes, was approximately \$c.

Trust 2 names X as the grantor and B as the trustee. B is the brother of X, the father of C and D, and the president of Company.

Section 1.2 of Trust 2 provides that the trustee shall divide all trust property into two equal shares and that these shares shall be administered as two separate trusts for X's benefit and shall be designated by X's name, one followed by the initials of X's nephew, C, and one followed by the initials of X's nephew, D. Each separate share shall be administered under the provisions of Trust 2 as a separate and distinct trust the assets of which may be jointly administered but shall be separately accounted for at all times. All references in Trust 2 to nephews of X shall refer only to C and D, notwithstanding that X may have other nephews.

Section 2.1 of Trust 2 provides that the purpose of Trust 2 is to establish two grantor retained annuity trusts (GRATs) whereby a "qualified interest" within the meaning of § 2702(b)(1) is retained by X for a term of two years, and, upon their termination, to provide for the creation of two separate remainder trusts to continue thereafter for the respective benefit of X's nephews, C and D.

Section 2.2 of Trust 2 provides that X shall be the sole beneficiary of the GRATs during the two year term of the retained qualified interest and distributions from the GRATs to or for the benefit of any other person during the term of the qualified interest are prohibited.

Section 2.3 of Trust 2 provides that the trustee shall pay to X an annuity equal in value to 94.06 percent of the net fair market value of the property (as finally determined for federal gift tax purposes) transferred to the GRATs. On the date the GRATs are established, and on the first anniversary of that date, the trustee shall pay to X an annuity amount equal to 36.77 percent of the value determined in the immediately preceding sentence. Upon the date the GRATs terminate, the trustee shall

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pay to X an annuity amount equal to the amount required to result in a present value on the date the GRATs are established of all annuity amounts paid to X equal to the total amount of the annuity retained by X. The present value of such annuity amounts shall be determined in the manner prescribed by the Code. The annuity amounts shall be paid from income and, to the extent income is not sufficient, from principal. Any income of the GRATs for a taxable year in excess of the annuity amount shall be added to principal. The initial value of the trust property for federal gift tax purposes (based upon appraisal) is \$c. If the net fair market value of the trust property is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee of the GRATs or the trustee of the remainder trusts established under Article 3 of Trust 2, if after termination of the GRATs) shall pay (from income, or principal if income is insufficient, of such GRAT or remainder trust) to X (in the case of an undervaluation) or receive from X (in the case of an overvaluation) an amount equal to the difference between the annuity amounts properly payable and the annuity amounts actually paid in the manner provided in § 1.664-2(a)(1)(iii) of the Income Tax Regulations.

Section 2.9 of Trust 2 provides that all provisions of Trust 2 shall be construed and applied so that each GRAT shall qualify as a grantor retained annuity trust whereby one or more "qualified interests" are retained within the meaning of § 2702(b)(1). The trustee (a) shall not take any action or have any power that would disqualify and (b) shall have all additional powers necessary to qualify each GRAT as a grantor retained annuity trust whereby "qualified interests" are retained within the meaning of § 2702(b)(1).

Section 3.1 of Trust 2 provides, in part, that each GRAT established under Trust 2 shall terminate two years after the date of the establishment of Trust 2. At such time, the trustee shall distribute the remaining GRAT income and principal (other than any amounts required to be distributed to X or X's estate and including any amounts required to be received from X or X's estate under the provisions of Article 2) as follows: (A) each separate GRAT shall be held and administered by the trustee as a separate trust for the benefit of X's nephew whose initials are appended thereto, if he is then living, and if not, for such nephews' descendants.

Section 5.3 of Trust 2 provides, in part, that B shall serve as trustee of the trusts established in Trust 2, and if, for any reason, B shall fail or cease to serve as trustee of any trust established in Trust 2, then the person or persons (including corporations) B shall designate by written instrument during B's life or in B's will shall succeed them as trustee of such trusts.

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Section 6.1 of Trust 2 provides that Trust 2 shall be irrevocable and may not be altered, amended, revoked or terminated by X. X acknowledges that X has no right or power, whether alone or in conjunction with others, in whatever capacity, to alter, amend, revoke or terminate Trust 2, or any of the terms of Trust 2, in whole or in part, or designate the persons who shall possess or enjoy the trust property, or the income therefrom. Further, X absolutely and forever relinquishes all possession and enjoyment of, and right to the income from, the trust property, whether directly, indirectly or constructively, and every interest of any nature, present or future, in the trust property.

The reported value, for gift tax purposes, of the Company stock transferred to Trust 2 was \$c. X retained an annuity interest in the GRATs for the two year term which was equal to 94.06 percent of the net fair market value of the property. Thus, the present value of the retained payment equaled \$d. The terms of Trust 2 as adjusted for present value provided that X received following annuity payments: on D2 of Year 2, \$e; on D1 of Year 3, \$f; and on D1 of Year 4, \$g. The total annuity payments in Year 2, Year 3, and Year 4 equaled \$h.

Trust 2's only asset was the Company stock, which has never paid dividends. To make the annuity payments to X, Trust 2 borrowed funds from Trust 3. The beneficiaries of Trust 3 are C and D and the trustee of Trust 3 is B. Trust 3 did not have sufficient cash to fund the entire amount of the payments, and in turn borrowed from B. Of the amounts paid by Trust 3 to Trust 2, approximately \$i, approximately 64%, was originally borrowed by Trust 3 from B.

As each annuity payment became due from the GRATs established under Trust 2 to X, a loan document with Trust 3 was drawn. The loans were due in one year with stated interest. Neither principal nor interest was ever repaid. As each note became due, it was extended for another year and the current year's borrowing was added to it.

By the terms of Trust 2, the GRATs terminated on D1 of Year 4 when the final annuity payment was made to X. At that time, the GRATs had not made any payment of principal or interest on the loans from Trust 3. The remainder trusts established under Trust 2 succeeded to the assets and liabilities of the GRATs. When the note again became due on D1 of Year 5, another extension was executed, extending the due date on the payment of the principal and interest an additional five years, to D1 of Year 6.

Two years after X transferred X's Company stock to Trust 2, X has the full value of the stock in cash and has reported no

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gain. X is not exposed to any liability regarding the loans used to pay the annuity amounts.

LAW AND ANALYSIS:

Nothing in the analysis provided below is intended to state or imply that the facts described above do not constitute a sale of the Company stock by X or Trust 2 to Trust 3.

Section 1.1001-2(a) of the Income Tax Regulations provides that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property."

In Rev. Rul. 85-13, 1985-1 C.B. 184, an individual, A created an irrevocable trust, T, and funded T with 100 shares of stock in Corporation Z in 1980. A's basis in the shares was \$20x. On December 27, 1981, when the fair market value of the Corporation Z shares was \$40x, W, as trustee, transferred the 100 shares to A in exchange for A's unsecured promissory note with a face amount of \$40x, bearing an adequate rate of interest. On January 20, 1984, A sold the 100 shares to an unrelated party for \$50x. The Revenue Ruling concludes that A's acquisition of the entire corpus of T in exchange for an unsecured note was, in substance, the economic equivalent of borrowing trust corpus, and therefore A is treated as the owner of the trust under § 675(3), and is considered to be the owner of the trust assets for federal income tax purposes. Furthermore, the ruling concludes that the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets.

Under § 1.1001-2(c) Ex. 5, C, an individual creates T, a grantor trust. C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. When C renounces the powers that initially resulted in T being classified as a grantor trust, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. Since prior to the renunciation, C was the owner of the entire trust, C was considered the owner of all the trust property for federal income tax purposes and C was considered to be the partner in P during

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the time T was a grantor trust. When T no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity. At that time C's share of P's liabilities is \$11,000. On the transfer, C's share of partnership liabilities is considered as money received.

Similarly, in the present case, X has created a grantor trust and is treated as the owner of the entire trust and the owner of all the trust property. Thus, although X has nominally transferred a shares of Company stock to Trust 2, X remains the owner of the trust property for federal income tax purposes. Therefore, when Trust 2 terminates and transfers a shares of Company stock to the remainder trusts for C and D, X is considered to have disposed of the Company stock to the remainder trusts, along with the associated liability assumed by the remainder trusts, and X's amount realized includes the amount of liabilities from which X is discharged as a result of the disposition.

X argues that this case is distinguishable from Example 5 in § 1.1001-2(c) because, in that example, T purchased an interest in P and C deducted the distributive share of partnership losses attributable to the partnership interest held by T, while, in the present case X did not deduct losses attributable to debt incurred by Trust 2. Therefore, X argues that X should not be considered the owner of all the trust property for federal income tax purposes, and X should not be considered to have transferred ownership of the stock, subject to the liability, to the remainder trusts. X argues that instead, Trust 2 should be treated as the owner of the stock, and Trust 2 should be treated as the transferor of the stock, subject to the liability, to the remainder trusts. In addition, X argues that the debt is incurred by reason of Trust 2's acquisition of the stock, and since under Rev. Rul. 85-13, the amount of the debt did not increase Trust 2's basis in the stock, the liability should not be included in Trust 2's amount realized under § 1.1001-2(a)(3).

However, although X did not deduct losses attributable to debt incurred by Trust 2, X received an annuity payment from Trust 2 that was not includible in X's income, and thus, X benefitted from the debt incurred by Trust 2. Therefore, we conclude that the present case is not distinguishable from Example 5 of § 1.1001-2(c). Because X was considered the owner of the stock for federal income tax purposes, the exception in § 1.1001-2(a)(3) does not apply to the present case. X, not Trust 2, is the transferor of the stock on termination of Trust 2 and X did not incur the indebtedness in order to acquire the stock within the meaning of § 1.1001-2(a)(3).

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In addition, X argues that the language of § 1.1001-2(a)(3) does not require that the debt be incurred by reason of the transferor's acquisition of the property, but merely be incurred by reason of any acquisition of the property. Therefore, X states that regardless of whether X or Trust 2 is treated as the transferor of the stock to the remainder trusts, the amount of the liability should not be included in X's amount realized because the debt was incurred by reason of Trust 2's acquisition of Company stock. Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property." We believe this language can only be reasonably read to refer to the transferor's acquisition of the property. We believe this case is substantially identical to Example 5 in § 1.1001-2(c).

SECTION 7805(b) ISSUES:

A technical advice memorandum ordinarily is applied retroactively. See § 17.02 of Rev. Proc. 99-2, 1999-1 I.R.B. 73 at 96. Relief under § 7805(b)(8) usually is granted only if a taxpayer relied to its detriment on a published position of the Service or on a letter ruling or technical advice memorandum issued to that taxpayer.

X's arguments for favorable § 7805(b)(8) treatment are that (a) there has been no misstatement or omission of material facts by X, (b) the facts related to the transactions described above are not materially different from the facts on which § 1.1001-2(a)(3) and Rev. Rul. 85-13 are based, (c) there has been no change in the applicable law since the transactions described above, and (d) X acted in good faith in relying on § 1.1001-2(a)(3) and Rev. Rul. 85-13, and the retroactive application of an unfavorable holding would be to X's detriment.

No ruling was issued to X, nor did X reasonably rely on specific language in the cited regulation and revenue ruling. X relies on a literal application of § 1.1001-2(a)(3) taken out of context. As discussed above, X did not incur the indebtedness in order to acquire the stock within the meaning of the regulation; thus, as there was no acquisition by X, X could not rely on § 1.1001-2(a)(3). A reading of the entire regulation clearly indicates a result adverse to X's position. The facts described above resemble those described in Example 5 in § 1.1001-2(c), not those described in Rev. Rul. 85-13. Consequently, X's arguments do not support granting its request for § 7805(b)(8) relief.

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A copy of this technical advice memorandum is to be given to X. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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