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Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:PSI:4 - PLR-121389-03
Date: MARCH 26, 2003

Re:

Legend:

Taxpayers =
=

Decedent =
Spouse =
Date 1 =
Bank A =
Court =

Date 2 =
Date 3 =
State Statute 1=
State Statute 2 =

Dear :

This is in response to your letter dated October 28, 2002, and prior correspondence, submitted on behalf of the Taxpayers, requesting rulings regarding the federal gift and income tax consequences of a modification of a trust and division of trust assets as described below.

Facts

The facts submitted and representations made are as follows: Decedent died on Date 1, survived by his Spouse and three sons.

In Article Fifth of his will, Decedent bequeathed and devised the rest, residue and remainder of his estate to a residuary trust (Residuary Trust). Article Fifth provides

that the Trustee shall pay to Spouse during her lifetime, in monthly installments, the net income of the trust, together with so much of the principal as the Trustee deems proper and necessary to reasonably provide for her maintenance and support, taking into account her other assets and sources of income. At Spouse's death, the remainder of the Residuary Trust (after the payment of any federal estate tax imposed upon Spouse's estate due to the inclusion of the value of the trust in her estate) is to be distributed to Decedent's children, in equal shares, or to the lineal descendants of any child who may be deceased, by right of representation.

Paragraph 4 of Article Fifth provides as follows:

The interest of any beneficiary in the principal or income of any trust created hereunder shall not be subject to claims of creditors or others, or liable to attachment, execution, or other process of law, and no beneficiary shall have the right to assign, encumber or otherwise alienate his interest in these trusts in any manner whatsoever.

In Article Sixth of his will, Decedent named a bank as Trustee of the Residuary Trust and as Executor of his estate. Bank A, the successor in interest of the named bank, is currently serving as Trustee.

Decedent's federal estate tax return, Form 706, was timely filed. On Schedule M of the return, the Executor elected to treat the Residuary Trust as qualified terminable interest property (QTIP). The Residuary Trust included Decedent's residence, cash, marketable securities, limited partnership interests, and a promissory note.

It is represented that after Decedent's death, two of his sons developed health problems that were not anticipated by Decedent and Spouse before Decedent's death. Due to these changed circumstances, Spouse petitioned Court for an order, contingent on a favorable letter ruling by the Internal Revenue Service, authorizing the division of the Residuary Trust pursuant to State Statute 1, and the modification of the terms of Article Fifth of Decedent's will as applicable to one of the new trusts, pursuant to State Statute 2.

State Statute 1 relates to the division of trusts. It provides as follows:

On petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries.

State Statute 2 relates to the modification or termination of a trust due to changed circumstances. It provides as follows:

(a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.

(b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.

On Date 2, Court issued a conditional order (Conditional Order) with respect to the Residuary Trust (hereinafter referred to as the "Residuary QTIP Trust"). Under paragraph 2(a) of the Conditional Order, the Residuary QTIP Trust is to be divided into two separate trusts, Trust One and Trust Two. One-tenth of the value of the Residuary QTIP Trust is to be allocated to Trust One, and nine-tenths of the value of the Residuary QTIP Trust is to be allocated to Trust Two. Paragraph 2(a) of the Conditional Order further provides that assets allocated to either Trust One or Trust Two may be satisfied in cash or in kind, in undivided interests, or partly in each, using the values of assets as of the date of distribution to the trusts.

Paragraph 2(b) of the Conditional Order provides that Trust One and Trust Two shall be held, managed and distributed under the same terms and conditions as the original Residuary QTIP Trust in accordance with Articles Fifth and Sixth of Decedent's will, except as provided in paragraph 2(c).

On Date 3, Court issued a nunc pro tunc order (Nunc Pro Tunc Order) which modifies the Conditional Order by deleting paragraph 2(c) of the Conditional Order. The Nunc Pro Tunc Order modifies paragraph 4 of Article Fifth of Decedent's will by deleting that paragraph in its entirety and replacing it with the following language:

4. The interest of any beneficiary in the principal or income of any Trust created hereunder shall not be subject to claims of creditors or others, or liable to attachment, execution, or other process of law, and no beneficiary may assign, encumber or otherwise alienate his interest in these trusts in any manner whatsoever, except the surviving spouse, [Spouse], may assign her income interest in [Trust One] to her issue at any time.

Following the division of the Residuary QTIP Trust, Spouse intends to transfer her income interest in Trust One in equal shares to her three sons, who are the remaindermen of the Residuary QTIP Trust.

It is represented that the assets of the Residuary QTIP Trust presently consist of cash, marketable securities, and Decedent's residence. The Trustee proposes to allocate cash and marketable securities to Trust One and to allocate Decedent's residence and the balance of the cash and securities to Trust Two. The Trustee will apportion the date of distribution basis and value of the assets of the Residuary QTIP Trust between Trust One and Trust Two, so that each trust will share proportionately in the appreciation or depreciation in the value of the assets of the Residuary QTIP Trust between Decedent's date of death and the date of distribution.

You have asked that we rule as follows:

1. The division of the Residuary QTIP Trust into Trust One and Trust Two under the terms of the Conditional Order as modified by the Nunc Pro Tunc Order will not be deemed to be a gift or other disposition of the Residuary QTIP Trust under § 2519.
2. The modification of the terms of Trust One pursuant to the Nunc Pro Tunc Order and Spouse's transfer of her income interest in Trust One, as permitted under the modification, will not be a gift or other disposition of Trust Two.
3. The division of the Residuary QTIP Trust into Trust One and Trust Two on a fractional basis and the funding of Trust One and Trust Two on a non-pro rata basis will not cause the Residuary QTIP Trust to realize gain or loss under § 1001.

Law and Analysis

Rulings 1 and 2

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 2056(a) provides that, except as limited by § 2056(b), the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(1) denies the marital deduction for an interest in property passing to the surviving spouse that is a "terminable interest." An interest passing to the surviving spouse is a terminable interest if it will terminate or fail on the lapse of time or on the occurrence of an event or contingency or on the failure of an event or

contingency to occur and, on termination, an interest in the property passes to someone other than the surviving spouse.

Section 2056(b)(7) provides an exception to the terminable interest rule in the case of qualified terminable interest property (QTIP). Under § 2056(b)(7)(A), qualified terminable interest property is treated as passing to the surviving spouse for purposes of § 2056(a), and no part of the property is treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1). Section 2056(b)(7)(B)(i) provides that the term "qualified terminable interest property" means property: (i) which passes from the decedent; (ii) in which the surviving spouse has a qualifying income interest for life; and (iii) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2501 imposes a tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by section 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 2519 provides that for gift tax purposes any disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under § 2056(b)(7) is treated as a transfer of all interests in such property other than the qualifying income interest. The transfer of the qualifying income interest is a transfer subject to gift tax under § 2511.

Section 25.2519-1(a) of the Gift Tax Regulations provides that a transfer of all or a portion of the income interest of a spouse in QTIP property is a transfer by the spouse under section 2511. Section 25.2519-1(c) provides that the amount treated as a transfer under section 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.

In the present case, Spouse has a qualifying income interest for life in the Residuary QTIP Trust, and the three sons of Decedent and Spouse are the remaindermen. Following the division of the Residuary QTIP Trust into Trust One and Trust Two, Spouse will have a qualifying income interest for life in both Trust One and Trust Two, and the three sons will be the remaindermen of both Trust One and Trust Two. The division of the Residuary QTIP Trust into Trust One and Trust Two will not affect the beneficial interests in the Residuary QTIP Trust. Therefore, based on the facts submitted and representations made, we conclude that the division of the Residuary QTIP Trust into Trust One and Trust Two will not be deemed to be a gift or other disposition of the Residuary QTIP Trust under § 2519.

Pursuant to the Conditional Order, as modified by the Nunc Pro Tunc Order, Trust One and Trust Two will be governed by the same terms as the Residuary QTIP Trust with one exception. Under the Nunc Pro Tunc Order, the spendthrift clause in paragraph 4 of Article Fifth of Decedent's will has been modified to allow Spouse to assign her income interest in Trust One to her issue. The modification was made under the authority of State Statute 2. Spouse intends to assign her income interest in Trust One in equal shares to her three sons, who are the remaindermen of the trust. It is represented that Spouse will pay the gift tax under § 2519 on the fair market value of the property in Trust One (minus the value of her qualifying income interest for life) on the date of disposition, and that she will pay the gift tax under § 2511 on the transfer of her qualifying income interest in Trust One. Therefore, based on the facts submitted and representations made, we conclude that the modification of the terms of Trust One pursuant to the Nunc Pro Tunc Order and Spouse's transfer of her income interest in Trust One will not be a gift or other disposition of Trust Two.

Ruling 3

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

Section 1001(a) provides that gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and loss is the excess of the adjusted basis provided in § 1011 over the amount realized. Under § 1001(c), except as otherwise provided in Subtitle A, the entire amount of 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, generally, the gain or loss realized from a conversion of property into cash, or from an exchange of property for other property differing materially either in kind or extent, is treated as income or as loss sustained.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Supreme Court held that an exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. There is a material difference when the exchanged properties embody legal entitlements "different in kind or extent" or if they confer "different rights and powers." Id. at 565.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a severance by partition of jointly owned property is not a sale or other disposition if there is no new or additional interest acquired as a result of the severance.

In the present case, the division of the Residuary QTIP Trust into Trust One and Trust Two does not involve an exchange of property for other property differing materially either in kind or extent. The property in the Residuary QTIP Trust is not

being exchanged for other property; it is being divided and placed into two new trusts. The beneficial interests in the property will not change in kind or in extent, and no new interests will be created. Therefore, based on the facts submitted and representations made, we conclude that the division of the Residuary QTIP Trust into Trust One and Trust Two on a fractional basis and the funding of Trust One and Trust Two on a non-pro rata basis will not cause the Residuary QTIP Trust to realize gain or loss under § 1001.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers 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 specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely yours,

Katherine A. Mellody
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes

cc: