

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

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Date:

November 01, 2006

LEGEND

Taxpayer =

Company =

Year Y =

Year Z =

Dear :

This responds to your letter dated , which was submitted on your behalf by your authorized representative concerning whether the transfer of qualified replacement property to and from a grantor retained annuity trust would result in a disposition under section 1042(e) of the Internal Revenue Code.

Taxpayer participated as a significant shareholder in the establishment of an employee stock ownership plan (ESOP) for Company. Taxpayer represents that the ESOP satisfied the requirements under section 4975(e)(7). The ESOP was established prior to the retirement of Taxpayer's spouse and purchased Company shares from Taxpayer and other existing shareholders in Year Y.

In Year Z, Taxpayer and other individual shareholders again sold Company shares to the ESOP. Taxpayer represents that the sale of Taxpayer's Company shares to the ESOP met the requirements for the sale of qualified securities under section 1042(b) and that the Company shares constituted qualified securities under section 1042(c)(1).

After both the Year Y and Year Z sale of Taxpayer's Company shares, the Taxpayer represents that she elected to defer recognition of long term capital gain on the sale of Company shares to the ESOP under section 1042(a) and purchased qualified replacement property (QRP) (as defined in section 1042(c)(4)) within the replacement period (as defined in section 1042(c)(3)). Taxpayer represents that she intends to transfer the QRP to a trust intended to be a grantor retained annuity trust (GRAT) within the meaning of section 2702. The trust provides that the Taxpayer shall have the power, solely in a nonfiduciary capacity and without the approval of any person in a fiduciary capacity, to reacquire the trust principal by substituting other property of equivalent value.

You have requested the following rulings:

- (1) That the transfer of QRP to a GRAT does not constitute a disposition under section 1042(e);
- (2) That the exercise of Taxpayer's power held during the term of the GRAT in a non-fiduciary capacity to substitute cash or other QRP assets of at least equal value does not constitute a disposition under section 1042(e);
- (3) That the transfer of QRP to the Taxpayer as a periodic annuity payment does not constitute a disposition under section 1042(e);
- (4) That the transfer of QRP at the termination of the GRAT to the trust beneficiaries does not result in a disposition under section 1042(e).
- (5) That, if the Taxpayer dies while the GRAT is still in existence, an interim or final annuity payment in the form of QRP made to the Taxpayer's successor in interest, that is, an estate or inter-vivos trust, does not constitute a disposition under section 1042(e).

Since you have not requested a ruling concerning whether the sale of securities to the ESOP or the election by the Taxpayer to defer recognition of gain satisfied the requirements of section 1042 or section 1.1042-1T of the Temporary Income Tax Regulations, we express no opinion on that issue. For purposes of your ruling request we will assume that the property purchased by the Taxpayer constitutes QRP as defined in section 1042(c)(4) and that section 1042(e) applies to such property.

Under section 1042(a), a taxpayer or executor may elect in certain cases not to recognize long-term capital gain on the sale of "qualified securities" to an ESOP (as defined in section 4975(e)(7)) or eligible worker owned cooperative if the taxpayer purchases "qualified replacement property" (as defined in section 1042(c)(4)) within the

replacement period of section 1042(c)(3) and the requirements of section 1042(b) and section 1.1042-1T are satisfied.

Section 1042(d) provides that a taxpayer's basis in QRP purchased during the qualified replacement period will be reduced by the amount of gain not recognized by reason of the application of section 1042(a). If more than one item of QRP is purchased, the basis of each item of QRP shall be reduced by an amount determined by multiplying the total gain not recognized by reason of the application of section 1042(a) by a fraction the numerator of which is the cost of such item of QRP, and the denominator of which is the total cost of all items of such property.

Section 1042(e)(1) provides that "[i]f a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property."

The legislative history of section 1042(e) indicates that it was added to the Internal Revenue Code as part of the Tax Reform Act of 1986 to coordinate the requirement that deferred gain be recognized on the disposition of any QRP with other nonrecognition provisions of the Code. "Effective for dispositions made after the date of enactment, the Act overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time." S. Rep. 99-313, 99th Congr., 2nd Sess., 1032 (1986), 1986-3 C.B. v. 3, 1032. Limited exceptions to this rule are provided in section 1042(e)(3). Thus, gain realized from the disposition of any QRP by a taxpayer who made an election under section 1042 must be recognized at the time of the disposition regardless of any other nonrecognition provisions of the Code that may otherwise have applied.

Section 1042(e)(3) provides that the recapture rules of section 1042(e)(1) shall not apply to any transfer of QRP that occurs: (1) in any reorganization (within the meaning of section 368) unless the person making the election under section 1042(a)(1) owns stock representing control of the acquiring or acquired corporation and such property is substituted basis property in the hands of the transferee; (2) by reason of the death of the person making the election; (3) by gift; or (4) in any transaction to which section 1042(a) applies.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Sections 673 through 677 specify the circumstances under which the grantor is treated as the owner of a portion of a trust.

Section 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1.675-1(a) of the Income Tax Regulations provides, in general, that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.

Section 1.675-1(b)(4)(iii) provides that the circumstances which may cause administrative controls to be considered exercisable primarily for the benefit of the grantor include the existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term "powers of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that if a grantor is treated as the owner of any portion of an entire trust, the grantor is the owner of the trust's assets for federal income tax purposes.

The circumstances surrounding the administration of the trust will determine whether the power of administration is exercisable in a fiduciary or nonfiduciary capacity. 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 Internal Revenue Service office where the returns are filed. Therefore, we cannot determine at this time whether the Taxpayer will be treated as the owner of the trust under § 675(4)(C). Provided that the circumstances indicate that the power of administration is exercisable in a nonfiduciary capacity, the Taxpayer will be treated as the owner of the trust under §§ 671 and 675.

We assume for purposes of this ruling that the Taxpayer is treated as the owner of the QRP transferred to the purported GRAT under the rules of sections 671 and 675. The Taxpayer represents that she will not relinquish any powers during the term of the

trust that would cause the GRAT to fail to be a trust in which the Taxpayer is the owner of the trust under sections 671 and 675 of the Code.

Therefore, based on the facts presented and representations made, we conclude the following:

- (1) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of the transfer, the transfer of QRP to the grantor retained annuity trust does not constitute a disposition of the QRP under section 1042(e);
- (2) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of exercise, the exercise of Taxpayer's power held during the term of the GRAT in a non-fiduciary capacity to substitute cash or other QRP assets of at least equal value does not constitute a disposition of the QRP under section 1042(e);
- (3) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of any annuity payments under the trust, the transfer of QRP to the Taxpayer as a periodic annuity payment does not constitute a disposition of the QRP under section 1042(e);
- (4) Provided that the funding of the GRAT with QRP constituted a completed gift of the remainder interest for Federal transfer tax purposes, the transfer of QRP to the trust beneficiaries pursuant to the terms of the trust does not result in a recapture of gain deferred under section 1042(a) because of the operation of section 1042(e)(3)(C).
- (5) If the Taxpayer dies while the GRAT is still in existence, an interim or final annuity payment in the form of QRP made to the Taxpayer's successor in interest, (an estate or inter-vivos trust) will not result in a recapture of gain deferred under section 1042(a) because of the operation of section 1042(e)(3)(B).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling does not express an opinion as to validity of the grantor retained annuity trust under section 2702 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.

The rulings contained in this letter are based upon information and representations 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.

Sincerely yours,

Robert D. Patchell
Chief, Qualified Plans Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:
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