

Internal Revenue Service

Department of the Treasury

Index No.: 2519.00-00
Number: **199915052**
Release Date: 4/16/1999

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Person to Contact:

Telephone Number:

Refer Reply to:
CC:DOM:P&SI:4/PLR-122588-97
Date:January 20, 1999

Re:

Legend:

Decedent =

Spouse =

Trust 1 =

Trust 2 =

TIN:

X =

Y =

date 1 =

year 2 =

State =

Dear :

This is in response to a letter dated July 6, 1998, and prior correspondence submitted on your behalf by your authorized representative requesting a ruling under § 2519 of the Internal Revenue Code.

Decedent died on date 1. Pursuant to his will, a trust was established for which Decedent's executors filed a QTIP election under § 2056(b)(7). The executors further elected to treat the trust as two trusts: Trust 1, which is a generation-skipping transfer tax (GSTT)-exempt trust, and Trust 2.

Under the terms of Decedent's will, the net income of the Trusts is payable to Spouse at least annually. The principal may be distributed to her in the discretion of the trustees for her education, support, and maintenance, including health. Spouse has an annual, noncumulative power to withdraw from the principal of the Trusts up to the lesser of \$10,000 multiplied by the number of Decedent's descendants and their spouses or 5 percent of the aggregate value of the assets out of which such withdrawals can be made. Spouse also has a testamentary special power to appoint the assets of the Trusts among a class of persons consisting of Decedent's descendants.

Virtually all of the assets originally funding the Trusts consisted of common and preferred stock of X, a closely-held corporation. In year 2, following a tax-free section 368(a)(1) reorganization, X became a wholly-owned subsidiary of Y, a publicly traded company. As part of the reorganization, Trusts 1 and 2 exchanged their X stock for Y stock. Spouse continues, and will continue, to receive all of the income of the Trusts for her life.

Prior to the reorganization, the income generated by the assets of the Trusts, although adequate for the needs of Spouse, had been less than an average of 1 percent per year of the inventory value of the assets.

State trust law provides that a portion of the net proceeds of sale of any part of principal which has not produced an average net income of at least 1 percent per year of its inventory value for more than a year (including as income the value of any beneficial use of the property by the income beneficiary) shall be treated as delayed income to which the income beneficiary is entitled. The net proceeds of sale are the gross proceeds received, including the value of any property received in substitution for the property disposed of, less the expenses, including capital gains tax, if any, incurred in disposition and less any carrying charge paid while the property was underproductive.

Under the same provision of State law, the sum allocated as delayed income is the difference between the net proceeds and the amount which, had it been invested at simple interest at 5 percent per year while the property was underproductive, would have produced the net proceeds. This sum, plus any carrying

charges and expenses previously charged against income while the property was underproductive, less any income received by the income beneficiary from the property and less the value of any beneficial use of the property by the income beneficiary, is income, and the balance is principal.

The trustees of the Trusts petitioned the local court of State for a determination of whether the State statute referenced above applies to a transaction which is a tax-free corporate reorganization described under § 368(a)(1) of the Internal Revenue Code and for a determination of whether the term "proceeds of sale" as used in the statute encompasses a nominal amount of cash (in lieu of fractional shares) and readily marketable stock of a publicly traded corporation received in exchange for stock of a closely held company pursuant to a § 368(a)(1) tax-free reorganization. The court issued an order construing the State statute as applying to a tax-free corporate reorganization under § 368(a)(1) and construing the term "proceeds of sale" as encompassing a nominal amount of cash and stock received in a tax-free reorganization under § 368(a)(1).

The trustees now propose to make a lump sum payment to Spouse in the amount of the "delayed income."

Section 2056(a) provides that the value of a decedent's taxable estate shall 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.

Under § 2056(b), a deduction is not allowed for terminable interests that pass to the surviving spouse; i.e., interests in property that may terminate or fail on the occurrence of an event, after which an interest in the same property passes to a person other than the surviving spouse.

Section 2056(b)(7)(A) provides that qualified terminable interest property (QTIP) shall be treated as passing to the surviving spouse and no part of such property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B) defines qualified terminable interest property as property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and with respect to which an election is made to treat the property as QTIP under § 2056(b)(7)(B)(v).

Section 2056(b)(7)(B)(ii) provides that a surviving spouse has a qualifying income interest for life if the surviving

spouse is entitled to all the income of the property, payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 2519(a) provides that for purposes of the federal gift and estate tax, any disposition of all or part of a qualifying income interest for life in property shall be treated as a transfer of all interests in such property other than the qualifying income interest.

Section 2519 applies to any property if a deduction was allowed with respect to the transfer of such property to the donee under § 2056 by reason of subsection (b)(7) thereof, or under § 2523 by reason of subsection (f) thereof.

Section 25.2519-1(f) provides that the conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not treated as a disposition of the qualifying income interest. Thus, the sale and reinvestment of assets of a trust holding qualified terminable interest property is not a disposition of the qualifying income interest, provided that the donee spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment. Similarly, the sale of real property in which the spouse possesses a legal life estate and thus meets the requirements of qualified terminable interest property, followed by the transfer of the proceeds into a trust which also meets the requirements of qualified terminable interest property, or by the reinvestment of the proceeds in income producing property in which the donee spouse has a qualifying income interest for life, is not considered a disposition of the qualifying income interest. On the other hand, the sale of qualified terminable interest property, followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest.

In Example 1 of § 25.2519-1(g), the decedent devised a personal residence valued for estate tax purposes at \$250,000 to his surviving spouse for her life, with the remainder interest passing at her death to his children. Decedent's executor made a valid election to treat the property as QTIP. At a later date, when the fair market value of the property was \$300,000 and the value of the surviving spouse's life interest in the property is \$100,000, the surviving spouse makes a gift of her entire interest in the property to the decedent's children. Pursuant to § 2519, the surviving spouse makes a gift in the amount of \$200,000 (i.e., the fair market value of the property

of \$300,000 less the fair market value of her life interest in the property of \$100,000). In addition, under § 2511, the surviving spouse makes a gift of \$100,000 (i.e., the fair market value of her income interest in the property).

The reason for this rule is that under § 2056(b)(7)(A), the entire value of the property that went into the QTIP trust is treated as passing to the surviving spouse even though, in fact, the surviving spouse received only a life estate in the property. Thus, the entire value of the property qualified for the estate tax marital deduction, and no part of the property was subject to the estate tax. Congressional intent in enacting the marital deduction was that marital property be taxed upon its transfer outside of the marital unit only once. Thus, under § 2044, the entire value of the property that was not taxed in the estate of the first spouse to die because of the QTIP marital deduction is subject to the estate tax upon the surviving spouse's death. If the property is transferred by the surviving spouse during her life, the entire value of the property is taxed under § 2519.

In the present case, the amount to be distributed to Spouse is delayed income required to be distributed to her under State law. Thereafter, she will continue to receive all of the net income of both Trusts for her life. We therefore conclude that, based on the facts submitted and representations made, the distribution of the delayed income payment to Spouse will not constitute a disposition of her qualifying income interest within the meaning of § 2519 of the Code.

Except as we have ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

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

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
Katherine A. Mellody
Assistant to the Branch
Chief, Branch 4

Enclosure
Copy for § 6110 purposes