



This is in response to your authorized representative's submission dated December 13, 2007, requesting a ruling that the division of a trust into five trusts and the subsequent termination of one of the trusts will not be a transfer under § 2519 of the Internal Revenue Code of any of the property of, or interest in, the four remaining trusts.

On Date 1, Decedent established a revocable trust, Trust, which became irrevocable on Decedent's date of death. Pursuant to Article II(B)(1) of Trust, upon Decedent's death, if Spouse survives him, the trustee shall set aside in Marital Trust an amount equal to fifty percent of Decedent's adjusted gross estate as finally determined for federal estate tax purposes, less the value of any assets passing outside Trust to Spouse by reason of Decedent's death.

Under Article II(B)(1)(c)(i), the net income of Marital Trust shall be paid to Spouse quarterly or more often. Under Article II(B)(1)(c)(iii), upon Spouse's death, Marital Trust shall be added to and pass as part of the Children's Trust, as governed under Article II(B)(3).

Decedent died on Date 2, survived by Spouse, Child 1, Child 2, Child 3, Child 4, and Child 5. On Decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, an election was made to treat Marital Trust as a qualified terminable interest property (QTIP) trust pursuant to § 2056(b)(7)(B)(v). The Co-trustees of Marital Trust are Spouse, X, and Bank.

The assets of Marital Trust consist of marketable securities. Due to different investment philosophies and risk tolerances, Spouse, X, Bank and the presumptive remainder beneficiaries of Marital Trust (Child 1 - Child 5), have disagreed about the investment and management of Marital Trust. Child 1 instituted litigation in State Court against Spouse, X, and Bank, as Co-Trustees of Marital Trust, and the other remainder beneficiaries, Child 2 – Child 5.

In an effort to resolve this litigation, Court directed a mediation which resulted in the interested parties entering into Settlement Agreement. Guardians ad litem were appointed to represent the minor and unborn children for each of Child 1 – Child 5. Court issued an order approving the agreement on Date 3. Settlement Agreement provides that no later than the Effective Date of the agreement, the principal of Marital Trust will be divided into five trusts (Settlement Trusts). All of the Settlement Trusts are trusts for the life benefit of Spouse, with each of Child 1 through 5 being the presumptive remainder beneficiary of one such trust. The Effective Date is the date that the Internal Revenue Service (Service) issues a private letter ruling on this transaction.

The division of Marital Trust is pursuant to State Statute 1. State Statute 1 provides that after notice to the qualified beneficiaries, a trustee may divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trusts or trust, respectively. A

separate trust created by severance must be treated as a separate trust for all purposes from the date on which the severance is effective.

Pursuant to Settlement Agreement, all accrued and accumulated net income in Marital Trust as of the Effective Date will be distributed to Spouse as soon as practicable on or after the Effective Date. Each separate Settlement Trust will be of equal value and funded with a pro rata portion of the assets of Marital Trust. Except as otherwise provided in Settlement Agreement, the Settlement Trusts of which each of Child 2, Child 3, Child 4, and Child 5 are presumptive remainder beneficiaries (collectively, the Surviving Settlement Trusts) will be held and administered pursuant to the same terms and conditions as Marital Trust. Commencing as of Date 4, however, each of the Surviving Settlement Trusts will be converted to a  $y\%$  unitrust pursuant to State Statute 2, with the unitrust amount payable to Spouse in monthly installments.

State Statute 2 provides, in part, that a trustee may, without court approval, convert an income trust to a total return unitrust if: (a) the trustee adopts a written statement regarding trust distributions that provides that: (1) future distributions from the trust will be unitrust amounts rather than net income, and indicates the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the trustee determines the terms of the unitrust under one of the following methods: (1) a disinterested trustee determines (a) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (b) the method to be used in determining the fair market value of the trust; and (c) which assets, if any, are to be excluded in determining the unitrust amount; or (2) the interested trustee or disinterested trustee administers the trust such that: (a) the percentage used to calculate the unitrust amount is 50 percent of the applicable federal rate, as defined in § 7520, in effect for the month the conversion becomes effective and for each January thereafter; however, if the percentage calculated exceeds 5 percent, the unitrust percentage shall be 5 percent and if the percentage calculated is less than 3 percent, the unitrust percentage shall be 3 percent; and (b) the fair market value of the trust shall be determined at least annually on an asset-by-asset basis, reasonably and in good faith.

Upon Spouse's death, the assets held in each of the Surviving Settlement Trusts will be paid to trusts (Children's Trusts) established for the benefit of Decedent's children and their descendants, other than Child 1, and distributed as provided in Trust. Each of Child 2, Child 3, Child 4, and Child 5 shall serve as a trustee of the respective Settlement Trust of which he or she is presumptive remainder beneficiary, along with a corporate trustee to be selected by Spouse, with the approval of Child 2, Child 3, Child 4, or Child 5, as applicable.

Settlement Agreement provides that in the event that Child 2's Settlement Trust is terminated for any reason prior to Spouse's death, Child 2 agrees to execute a new trust, to be administered by her and a corporate fiduciary of her choosing as co-

trustees, with a unitrust payment to Child 2 of  $\underline{z}$ % annually, and to pay the full amount distributed to Child 2, net of all tax liabilities, interest and penalties, to such trust (Child 2's Contingency Trust). If Child 2 survives Spouse, Child 2's Contingency Trust will terminate at Spouse's death, and all assets thereof distributed to Child 2 outright. If Child 2 predeceases Spouse, Child 2's Contingency Trust will continue for Spouse's lifetime, with all income thereon accumulating in such trust, and on Spouse's death, all assets of Child 2's Contingency Trust (including accumulated income) shall be paid in equal shares to Child 3, Child 4, and Child 5's respective Children's Trusts. Settlement Agreement does not contain a similar provision for any of the other Surviving Settlement Trusts.

It is represented that, among other things, compliance with the terms of Child 1's Settlement Trust will defeat or substantially impair a material purpose of the trust, specifically, the preservation and transfer of wealth. Accordingly, Settlement Agreement provides that, within ten days of the Effective Date, Child 1's Settlement Trust will be terminated pursuant to State Statute 3.

State Statute 3 provides that upon application of a trustee of the trust or any qualified beneficiary, a court at any time may amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust, terminate the trust in whole or in part, direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust, or prohibit the trustee from performing acts that are permitted or required by the terms of the trust, if, among other things, due to circumstances not anticipated by the trust settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust.

Upon termination, a portion of the corpus of Child 1's Settlement Trust equal to the actuarial value of Spouse's income interest in such trust will be distributed to Spouse in satisfaction of her life estate and all interest in Child 1's Settlement Trust. In satisfying this distribution to Spouse, the cash, stocks and bonds held in Child 1's Settlement Trust will be distributed pro-rata to Spouse, valued as of the date of distribution. The remaining property of the trust will be distributed to Child 1, as remainder beneficiary of the terminated trust, in satisfaction of his interests in Marital Trust (including any interest in the Survivor's Settlement Trusts and the trusts established pursuant to Trust for the benefit of Decedent's children and their descendants).

The amount distributed to Child 1 upon termination of Child 1's Settlement Trust will be reduced by an amount, to be agreed to by Spouse's and Child 1's attorneys, representing the total transfer tax liability incurred as a result of the termination and distributions under Child 1's Settlement Trust. The amount of such reduction will be held in an escrow account pursuant to an Escrow and Tax Indemnity Agreement which was concurrently executed with Settlement Agreement. Any transfer tax liability as a

result of the termination and distributions under Child 1's Settlement Trust will be paid from the escrow account. Under the terms of Settlement Agreement, if the amount held in the escrow account is insufficient to pay such liabilities, Child 1 will be personally and solely responsible for any such remaining tax liability as a result of the termination of Child 1's Settlement Trust. Spouse will exercise her right of recovery under § 2207A to have the gift tax attributable to the transfer under § 2519 paid by the person receiving the property, as defined in § 25.2207A-1(d) and, which in this case is Child 1.

Spouse will treat the termination of Child 1's Settlement Trust as a result of her receipt of cash in satisfaction of her interest in such trust as a transfer under § 2519 of all of the interests in Child 1's Settlement Trust, other than her qualifying income interest in such trust, in an amount equal to (a) the aggregate value of Child 1's Settlement Trust as of the date that such trust is terminated reduced by the sum of (b) (i) the value of Spouse's qualifying income interest as of such date and (ii) the gift taxes payable from the escrow account and by Child 1, if any, with respect to such transfer.

Court approval of Settlement Agreement is contingent on the issuance of a private letter ruling from the Service to the effect that the termination and distribution of Child 1's Settlement Trust (per the terms of Settlement Agreement) will not trigger § 2519 so as to cause gift tax liability with respect to any property of, or interest in, any of the Surviving Settlement Trusts.

The Co-Trustees, on behalf of Marital Trust, request a ruling that the division of Marital Trust into five Settlement Trusts and the subsequent termination of Child 1's Settlement Trust pursuant to Settlement Agreement will not be deemed to be a transfer under § 2519 of any property of, or interest in, the Surviving Settlement Trusts, and therefore, such division and termination will not give rise to any gift tax liability with respect to any property of, or interest in, any of the Surviving Settlement Trusts.

### Law and Analysis

Section 2056(a) provides that for purposes of the tax imposed by § 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate. Section 2056(b)(1) provides, in pertinent part, that no deduction shall be allowed under § 2056(a) where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, and on such termination, the property passes to a person other than the surviving spouse or the spouse's estate.

Section 2056(b)(7) allows an estate tax marital deduction for qualified terminable interest property. Under § 2056(b)(7)(B)(i), the term "qualified terminable interest

property” means property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which the QTIP election under § 2056(b)(7)(B)(v) applies. Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from 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 during the surviving spouse's life.

Section 20.2056(b)-7(d)(2) of the Estate Tax Regulations provides that the principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust. Section 20.2056(b)-5(f)(1) provides that the surviving spouse's interest shall meet the conditions set forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter. Section 1.643(b)-1 of the Income Tax Regulations provides that an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

Section 2044(a) provides that the value of the gross estate shall include the value of any property in which the decedent had a qualifying income interest for life. Section 2044(b)(2) provides that § 2044(a) applies to any property if § 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

Section 2501(a)(1) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident. Section 2502(c) provides that the tax imposed by § 2501 shall be paid by the donor. Section 2511(a) provides that subject to the limitations of chapter 12, the tax imposed by § 2501 applies 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 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Section 25.2511-2(a) of the Gift Tax Regulations provides that the gift tax is a primary and personal liability of the donor, is an excise upon the donor's act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which this section applies is treated as a transfer of all interests in the property other than the qualifying income interest. Section 2519(b) provides that § 2519(a) applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056(b)(7).

Section 25.2519-1(a) provides that if a donee spouse makes a 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) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of chapters 11 and 12 as transferring all interests in property other than the qualifying income interest.

Section 25.2519-1(c)(1) provides that the amount treated as a transfer under § 2519 upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest 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.

Section 25.2519-1(f) provides that 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.

The term "disposition," as used in § 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. REP. NO. 201, 97<sup>th</sup> Cong., 1<sup>st</sup> Sess. 161 (1981).

Section 2207A(b) provides that if for any calendar year tax is paid under chapter 12 with respect to any person by reason of property treated as transferred by such person under § 2519, such person shall be entitled to recover from the person receiving the property the amount by which the total tax for such year under chapter 12, exceeds the total tax which would have been payable under such chapter for such year if the value of such property had not been taken into account for purposes of chapter 12.

Section 25.2207A-1(a) provides that, if an individual is treated as transferring an interest in property by reason of § 2519, the individual is entitled to recover from the

*person receiving the property* the amount of gift tax attributable to that property. The value of property to which § 25.2207A-1(a) applies is the value of all interests in the property other than the qualifying income interest. There is no right of recovery from any person for the property received by that person for which a deduction was allowed from the total amount of gifts, if no federal gift tax is attributable to the property. The right of recovery arises at the time the federal gift tax is actually paid by the transferor subject to § 2519.

Section 25.2207A-1(c) provides that the amount of federal gift tax attributable to all properties includible in the total amount of gifts under § 2519 made during the calendar year is the amount by which the total federal gift tax for the calendar year (including penalties and interest attributable to the tax) under chapter 12 that has been paid, exceeds the total federal gift tax for the calendar year (including penalties and interest attributable to the tax) under chapter 12 that would have been paid if the value of the properties includible in the total amount of gifts by reason of § 2519 had not been included.

Section 25.2207A-1(d) provides that a person's right of recovery with respect to a particular property is an amount equal to the amount determined in § 25.2207A-1(c) multiplied by a fraction. The numerator of the fraction is the value of the particular property included in the total amount of gifts made during the calendar year by reason of § 2519, less any deduction allowed with respect to the property. The denominator of the fraction is the total value of all properties included in the total amount of gifts made during the calendar year by reason of § 2519, less any deductions allowed with respect to those properties.

Section 25.2207A-1(e) provides that, if the property does not remain in trust, the *person receiving the property* is any person receiving the property prior to the expiration of the right of recovery.

Rev. Rul. 75-72, 1975-1 C.B. 310, holds that if, at the time of the transfer, the gift is made subject to a condition that the gift tax is to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under § 2512(b), the value of the gift is measured by the fair market value of the property passing from the donor minus the amount of the gift tax to be paid by the donee or from the property itself.

Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift, the value of the property transferred is reduced by the gift tax liability assumed by the donee, if the payment of the tax by the donee is a condition of the transfer. The donor's available unified credit must be used to reduce the tax liability that the donee has assumed to the extent the unified credit is available.



Although § 2502(c) provides that the gift tax imposed on a transfer is the liability of the donor, in Rev. Rul. 75-72 and Rev. Rul. 81-223, the burden of the tax was shifted to the donees by agreement. The amount of the gift on which the gift tax was computed was reduced by the amount of gift tax paid by the donees.

In the present case, Spouse has a qualifying income interest for life in Marital Trust, and Child 1, Child 2, Child 3, Child 4, and Child 5 are the presumptive remainder beneficiaries. Pursuant to Settlement Agreement, Marital Trust will be divided into five trusts: specifically, four Surviving Settlement Trusts and Child 1's Settlement Trust. Under State Statute 1, each of the five trusts will be treated as a separate trust for all purposes from the date on which the severance is effective. After the division, Spouse will have a qualifying income interest for life, and Child 2, Child 3, Child 4, and Child 5 will be the remaindermen of the Surviving Settlement Trusts. Child 1's Settlement Trust will be terminated. Accordingly, based on the facts submitted and representations made, we conclude that the division of Marital Trust into five trusts and the subsequent termination of Child 1's Settlement Trust pursuant to Settlement Agreement will not be deemed to be a transfer under § 2519 of any property interest, or interest in, the Surviving Settlement Trusts, and therefore, such division and termination will not give rise to any gift tax liability with respect to any property of, or interest in, any of the Surviving Settlement Trusts.

As stated above, Child 1's Settlement Trust will be terminated. Pursuant to Settlement Agreement, a portion of the corpus of Child 1's Settlement Trust will be distributed to Spouse in satisfaction of her life estate and all interest in Child 1's Settlement Trust and the remaining corpus will be distributed outright to Child 1. Based upon the facts submitted and the representations made, we conclude that the termination of Child 1's Settlement Trust is treated as a transfer under § 2519 of the fair market value of the entire corpus of Child 1's Settlement Trust on the date of the termination, less the value of Spouse's qualifying income interest in that trust.

Spouse is exercising her right of recovery under § 2207A to recover the gift tax attributable to the transfer of corpus in Child 1's Settlement Trust to Child 1. As a condition of Settlement Agreement, the parties have agreed that any gift tax imposed on the termination of Child 1's Settlement Trust will be paid by Child 1 with funds from the escrow account and, to the extent those funds are insufficient, Child 1 will be personally and solely responsible for any such remaining tax liability as a result of the termination of Child 1's Settlement Trust. Based upon the facts submitted and the representations made, we conclude that the amount of the gift made by the Spouse under § 2519 will be equal to the fair market value of the entire corpus of Child 1's Settlement Trust, determined on the date of the termination, less the value of Spouse's qualifying income interest in that trust on the date of the termination, reduced by the amount of the gift tax attributable to that interest paid from the escrow account and by Child 1 under § 25.2207A-1(d).

Further, in the event Child 2's Settlement Trust terminates and Child 2's Contingency Trust is established with the assets from Child 2's Settlement Trust, the termination of Child 2's Settlement Trust would be treated as a transfer under § 2519 of the fair market value of the entire corpus of Child 2's Settlement Trust on the date of the termination, less the value of Spouse's qualifying income interest in that trust. However, the termination of Child 2's Settlement Trust, as provided for in Settlement Agreement, would not be treated as a transfer under § 2519 of the remaining Surviving Settlement Trusts, namely, Child 3's Settlement Trust, Child 4's Settlement Trust, and Child 5's Settlement Trust, assuming the provisions of Trust and Settlement Agreement continue to govern those trusts.

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.

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

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Lorraine E. Gardner  
Senior Counsel, Branch 4  
(Passthroughs & Special Industries)

Enclosures (2)  
Copy for § 6110 purposes  
Copy of this letter