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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:B04-PLR-132982-01  
Date:

Re:

October 19, 2001

Legend:

Wife =  
Husband =  
Living Trust =

Attorney =  
Date 1 =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
Date 6 =  
County Court =  
Preparer =  
x =  
State A =  
State B =

Dear :

This is in response to your June 13, 2001 letter and other correspondence requesting rulings concerning the gift tax and estate tax consequences of the proposed division of Living Trust.

You have requested the following rulings:

1. Wife will not incur a gift tax liability under section 2501(a) of the Internal Revenue Code, or application of her unified credit under section 2505(a), for the value of Living Trust assets transferred by Wife, as trustee, to the Family Trust.
2. The transfer by Wife, as trustee, of the Living Trust assets to the Family Trust does not constitute a transfer of her property with reserved lifetime benefits, subject to inclusion in Wife's gross estate under section 2036 upon her death.

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3. The Family Trust will not be included in the Wife's gross estate under section 2044(a) and 2044(b)(1)(A).

The facts submitted are as follows:

Husband and Wife executed a joint revocable trust (Living Trust) on Date 1. The Living Trust was drafted by Attorney. Wife and Husband were residents of State A, a separate property state. However, they did own some real property in State B, a community property state, that was transferred to the Living Trust.

Under Article 8, Section 1 of the Living Trust, on the death of the first to die of Husband and Wife, the trustee is to divide the trust property into two separate irrevocable trusts, the Marital Trust and the Family Trust. Article 8, Section 1.a. provides that the Marital Trust is to consist of the surviving spouse's community portion of the trust property, surviving spouse's separate property, and a fractional share of the deceased spouse's property such that the Marital Trust receives the "smallest amount which, if allowed as a marital deduction, would result in the least federal estate tax being payable as a result of the deceased spouse's death after allowing for the unified credit and the credit for state death taxes." Article 8, Section 1.b. provides that the Family Trust is to consist of the balance of the Living Trust assets.

Article 9 of the Living Trust provides that the surviving spouse is to receive monthly payments of all the net income of the Marital Trust. In addition, trustee is to pay to the surviving spouse, during life, such amounts from the principal of the Marital Trust as the surviving spouse may request. On the surviving spouse's death, the surviving spouse is granted a general testamentary power to appoint trust corpus.

Article 10, Section 1 of the Living Trust provides that the trustee may distribute income and principal from the Family Trust to the surviving spouse solely for the spouse's education, health, maintenance, and support. Any income not distributed by the trustee is to be accumulated and added to principal. Article 10, Section 2 states that the surviving spouse has a testamentary nongeneral power to appoint the principal and any undistributed net income of the Family Trust among the Husband's and Wife's descendants. The spouse has the power to appoint in equal or unequal amounts among the descendants, but cannot appoint to the spouse's estate, the creditors of spouse's estate, or in any manner which would result in any economic benefit to spouse.

Article 12 provides that upon the death of the surviving spouse, any remaining principal or undistributed income from the Family Trust, or the Marital Trust, in default of exercise of the spouse's power of appointment, shall be distributed among the descendants of Husband and Wife.

Husband died on Date 2, survived by Wife. Under Article 15, Section 3.d., Wife became the sole trustee of Living Trust on Husband's death.

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Preparer prepared a federal estate tax return (Form 706) on Date 4. On Schedule M of Form 706, the estate claimed an estate tax marital deduction for the value of the entire Living Trust residue passing to both the Marital and Family Trusts. The schedule as filed did not reflect that the Living Trust residue was to be divided into a Marital Trust and a Family Trust, and that only the Marital Trust qualified for an estate tax marital deduction.

Wife has filed a complaint in County Court in State A against Preparer and Attorney for failure to advise Wife on administration matters of the Living Trust subsequent to the death of Husband. The County Court ordered on Date 5, amended by the order on Date 6, that Wife, serving as trustee, fund the Family Trust with \$x in assets as of Date 3, per the values listed on Form 706. The Family Trust is to be funded with assets that are fairly representative of appreciation and depreciation of the entire fund between the date of Husband's death and the date of funding. The order of the County Court is stayed until such time as a favorable ruling is issued here. If a favorable ruling is not issued, the order of the County Court will be null and void.

## LAW AND ANALYSIS

### Ruling 1

Section 2501(a) imposes a tax on the transfer of property by gift. Section 2505(a) allows a unified credit against the tax imposed by section 2501 for the applicable credit amount in effect under section 2010(c).

In the instant case, the court order directs Wife, as trustee of the Trust, to establish and fund the Family Trust and the Marital Trust, in accordance with the terms of the Living Trust. Under the terms of the Living Trust, the assets passing to the Family Trust are to consist solely of Husband's assets that are includible in his gross estate.

Pursuant to the court order, Wife is to fund the Family Trust based on the value of the assets as reported on Form 706 filed for Husband's estate, using assets that are representative of appreciation and depreciation of the entire fund between the date of death and the date of funding. Under these circumstances, we conclude the transfer of Living Trust assets by Wife, as trustee to the Family Trust, pursuant to the Court order, will not constitute a gift for gift tax purposes under section 2501.

### Ruling 2

Section 2036(a) provides that a decedent's gross estate shall include the value of all property with respect to any interest therein that has been transferred by the decedent by trust or otherwise, in which the decedent has retained for life (1) the possession or enjoyment of, or right to the income from, the property, or (2) the right to designate the person who shall possess or enjoy the property or income therefrom. Section 2036 is applicable only with regard to an interest in property that has been

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transferred by the decedent. Transfers by others, which create rights in the decedent, do not invoke the provisions of this section.

In this case, as discussed above, the court order directs Wife, as trustee of the Living Trust, to fund the Family Trust and the Marital Trust in accordance with the terms of the Living Trust. As noted above, as directed by the terms of Living Trust, the property which Wife proposes to transfer to Family Trust is the property of Husband held by the Living Trust. The Family Trust will be funded based on the value of the assets as reported on Form 706, using assets that are fairly representative of the appreciation and depreciation of the entire fund between the date of death and the date of funding. We conclude that the assets transferred to the Family Trust will not be includible in Wife's gross estate under section 2036.

### Ruling 3

Section 2056(a) provides that, except as limited by section 2056(b), the value of a taxable estate is 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 the surviving spouse.

Section 2056(b)(1) denies a marital deduction for an interest passing to the surviving spouse that is a "terminable interest." An interest is a terminable interest if the interest passing to the surviving spouse 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, the interest passes to someone other than the surviving spouse.

Section 2056(b)(7)(A) provides an exception to this terminable interest rule in the case of qualified terminable interest property (QTIP). For purposes of section 2056(a), qualified terminable interest property is treated as passing to the surviving spouse, and no part of the property is treated as passing to any person other than the surviving spouse. Under section 2056(b)(7)(B)(i), QTIP is property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which an election under section 2056(b)(7)(B)(v) applies. Under section 2056(b)(7)(B)(ii), the spouse has a qualifying income interest for life if the spouse is entitled to all the income from the property, payable at least annually, and no person has the power to appoint any part of the property other than the surviving spouse.

Section 2056(b)(7)(B)(v) provides that the election to treat property as QTIP under section 2056(b)(7) is made by the executor on the return of tax imposed by section 2001. This election, once made, is irrevocable.

Section 2044 provides that the value of the gross estate shall include the value of any property with respect to which the decedent had a qualifying income interest for life and a deduction under section 2056(b)(7) was previously allowed.

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In this case, the estate claimed a marital deduction for the entire Living Trust on Schedule M of Form 706 filed for Husband's estate. That portion of the Living Trust assets passing to the Marital Trust representing Husband's property qualifies for the marital deduction under section 2056(b)(5) (life estate coupled with a general power of appointment). Regarding the portion of the Living Trust allocable to the Family Trust, the estate, by claiming a marital deduction for these assets on Schedule M, purported to make a QTIP election with respect to these assets. However, as stated above, under the terms of the Family Trust, income is payable to Wife at the discretion of one trustee. Accordingly, Wife was not entitled, for life, to all the income from the trust, and therefore did not receive a qualifying income interest for life in the Family Trust under section 2056(b)(7)(B)(ii). Accordingly, the Family Trust is not qualified terminable interest property. Under the facts presented in this case, the Family Trust will not be includible in the gross estate of Wife under section 2044. Compare, Estate of Letts v. Commissioner, 109 T.C. 290 (1997).

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

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(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,  
George Masnik  
Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)