

Internal Revenue Service

Department of the Treasury

Index Number: 671.00-00, 2702.00-00,
1361.00-00

Washington, DC 20224

Number: **200001013**
Release Date: 1/7/2000

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:7-PLR-101742-99
Date:
September 30, 1999

LEGEND:

Taxpayer =

Trust =

Company =

Spouse =

a =

b =

c =

d =

e =

f =

g =

h =

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i =

j =

k =

l =

m =

n =

o =

Dear :

We received your letter, dated January 11, 1999, requesting rulings concerning the federal income, estate, and gift tax consequences of a proposed grantor retained annuity trust. This letter responds to your request.

The facts and representations submitted are summarized as follows: Taxpayer proposes to establish the Trust, an irrevocable trust that will hold stock in Company, an S corporation. Spouse will serve as the trustee of the Trust.

Section I of the Trust will provide that no additional contributions to the Trust under this Agreement may be accepted by the trustee.

Section II.A(1) of the Trust will provide that from the date of the Trust agreement until the earlier of the ath anniversary of the Trust agreement or Taxpayer's death (the Trust term), the trustee is to pay Taxpayer the annuity amount. The annuity amount is to be paid annually on the anniversary date (the day preceding the month and day on which the Trust agreement is executed) for each year during the Trust term and, if the last date of the Trust term is not the anniversary date, on the last day of the Trust term. The annuity amount payable in each calendar year is to be the following percentages (or a pro rata portion thereof to reflect the number of days in a partial year) of the initial fair market value of the assets contributed to fund the Trust as finally determined for federal gift tax purposes:

Year in Which
Anniversary Date Falls

Percentage of Initial
Fair Market Value

b

c percent

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| | |
|----------|------------------|
| <u>d</u> | <u>e</u> percent |
| <u>f</u> | <u>g</u> percent |
| <u>h</u> | <u>i</u> percent |
| <u>j</u> | <u>k</u> percent |
| <u>l</u> | <u>m</u> percent |

Taxpayer represents that the Trust will be funded with n and based on the above scheduled annuity payments, the remainder interest has a value of o.

Section II.A(2) of the Trust provides that during the Trust term, the trustee may pay to taxpayer so much of the net income remaining after the annuity amount as the trustee in its sole discretion determines. Any net income not so paid is to be accumulated and added to principal.

Section II.B of the Trust provides that if Taxpayer is living on the expiration of the Trust term, the trustee is to pay the final annuity amount to Taxpayer and distribute the remaining trust assets to Taxpayer's children who are then living *per capita*, and if none, then to Taxpayer's descendants who are then living *per stirpes*.

Section II.C of the Trust provides that if the Trust term terminates due to Taxpayer's death prior to the expiration of a years, then the remaining Trust assets are to be distributed to, or in trust for, such appointees as Taxpayer may appoint by will. In the absence of such appointment, the remaining trust assets are to be distributed to Taxpayer's estate.

Section III of the Trust provides that if at the termination of the Trust term there is no recipient identified in the Trust agreement to take the Trust principal, the trustee is to distribute the remaining Trust assets outright and free of trust to the persons and in the amounts to the persons who would have received the Trust assets under laws of descent and distribution of State.

Section IV.A(1) of the Trust provides that the trustee is to prorate the annuity amount on a daily basis for any short period (of less than 12 months) of the Trust term, in the manner prescribed by § 25.2702-3(b)(3). Under section IV.A(2), the annuity amount is to be paid first from income, and to the extent income is insufficient, from accumulated income, and to the extent accumulated income is insufficient, from principal.

Section IV.A(3) of the Trust provides that the trustee is not to make any distributions from the Trust to or for the benefit of anyone other than Taxpayer during the Trust term while Taxpayer is living.

Section IV.A(5) of the Trust provides that if the trustee incorrectly determines the initial fair market value of the Trust assets, then within a reasonable period after the

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corrected valuation is finally determined for federal gift tax purposes, the trustee is to redetermine the annuity amount in a manner consistent with § 1.664-2(a)(1)(iii) of the Income Tax Regulations. If the initial value is determined to have been too low, the trustee is to pay the amount of the increase in the annuity amount to Taxpayer. If the initial value is determined to have been too high, Taxpayer is to pay the amount of the decrease in the annuity amount to the trustee. Any payment resulting from incorrect valuation is payable with interest computed at the rate applicable under § 7520 of the Internal Revenue Code on the date the Trust was created.

Section IV.A(6) of the Trust provides that in addition to the payment of the foregoing amounts to Taxpayer, if the total of the net ordinary income and capital gains received by the Trust during the any taxable year exceeds the amounts paid to Taxpayer in respect of such year as provided above, the trustee is to reimburse Taxpayer for any tax (whether federal, state, or otherwise) paid or payable on the excess.

Section VII.A of the Trust provides that at any time during the Trust term, Taxpayer is to have the power, exercisable in a nonfiduciary capacity (either personally or by an attorney-in-fact under a power of attorney expressly referring to this power), without the consent or approval of any person in any capacity, to reacquire any property held by the Trust by substituting other property having the same fair market value (determined without regard to the nature of the assets or the relative value of the asset to any person having an interest in the Trust).

Section VII.B of the Trust provides that commutation of Taxpayer's annuity interest in any trust established under the Trust agreement any time is expressly forbidden.

You requested the following rulings:

(1) Pursuant to §§ 674 and 677 of the Internal Revenue Code, Taxpayer will be considered the owner of the entire trust for purposes of § 671 until the earlier of Taxpayer's death or the termination of the Trust.

(2) No gain or loss will be recognized by Taxpayer or the Trust on Taxpayer's transfer of assets to fund the Trust, on the transfer of any property from the Trust to Taxpayer in payment of any annuity amount, or on Taxpayer's substitution of Taxpayer's assets for assets of the Trust.

(3) By virtue of being a grantor trust under § 671, the trust will be qualified to hold subchapter S stock under § 1362(c)(2)(A)(i).

(4) The periodic payments to Taxpayer will constitute a "qualified interest" and a "qualified annuity interest" under § 2702(b) and § 25.2702-2.

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(5) Pursuant to § 25.2702-3(b)(3), the payment of the annuity amount on the anniversary date of the Trust without proration during the first taxable year of the Trust, does not affect the status of Taxpayer's interest as a qualified annuity interest.

(6) The value of the gift to the remaindermen equals the fair market value of the property transferred to the Trust as finally determined for federal gift tax purposes less the sum of the value of Taxpayer's qualified annuity interest.

(7) If Taxpayer survives the Trust term, the value of the property in the Trust will not be includible in Taxpayer's gross estate.

Rulings 1 and 2:

You requested rulings that Taxpayer will be considered the owner of the entire Trust for purposes of § 671 until the earlier of Taxpayer's death or the termination of the Trust and that no gain or loss will be recognized by Taxpayer or the Trust on Taxpayer's transfer of assets to fund the Trust, on the transfer of any property from the Trust to Taxpayer in payment of any annuity amount, or on Taxpayer's substitution of Taxpayer's assets for assets of the Trust.

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

Section 674(a) provides that the grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 674(b)(3) provides that § 674(a) does not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 1.674(b)-1(b)(3) provides that if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law, capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.

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Section 677(a)(1) provides that the grantor is treated as the owner of any portion of a trust, whether or not he is treated as the owner under § 674, whose income without the approval or consent of any adverse party, is, or, in the discretion of the grantor or an adverse party, or both, may be distributed to the grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, provides that an exchange of assets between a wholly-owned trust and the owner of the trust is not recognized as a sale for federal income tax purposes because the same party is on both sides of the transaction. A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.

Based on the information submitted and the representations made, we conclude as follows:

Under the terms of the of Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under § 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under § 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term. Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of § 671 during the Trust term.

In accordance with the holding in Rev. Rul. 85-13, neither Taxpayer nor the Trust will recognize gain or loss as a result of Taxpayer's transfer of assets to the Trust to fund the Trust, on the Trust's transfer of any property to Taxpayer in satisfaction of any annuity payments due Taxpayer, or the substitution by Taxpayer of assets of Taxpayer for assets of the Trust.

Ruling 3:

You requested a ruling that the Trust will be qualified to hold subchapter S stock under § 1362(c)(2)(A)(i).

Section 1361(b)(B) provides that an S corporation may not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual.

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Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b), a trust all of which is treated (under subpart E of part 1 of subchapter J) as owned by an individual who is a citizen of the United States may be an S corporation shareholder.

Based on the information submitted and the representations made, we conclude that because the Trust will be a wholly-owned grantor trust under § 671, the Trust will be a trust described in § 1361(c)(2)(A)(i). Accordingly, the Trust will be an eligible S corporation shareholder.

Rulings 4 through 6:

You requested rulings that: (1) The periodic payments to Taxpayer will constitute a "qualified interest" and a "qualified annuity interest" under § 2702(b) and § 25.2702-2; (2) the payment of the annuity amount on the anniversary date of the Trust without proration during the first taxable year of the Trust, will not affect the status of Taxpayer's interest as a qualified annuity interest; and (3) the value of the gift to the remaindermen equals the fair market value of the property transferred to the Trust as finally determined for federal gift tax purposes less the sum of the value of Taxpayer's qualified annuity interest.

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) provides that 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 25.2511-1(e) provides that if a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. The tax is applicable, for example, to the transfer of an undivided half interest in property, or to the transfer of a life estate when the grantor retains the remainder interest, or vice versa.

Section 2702(a)(1) provides that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in § 2702(e)(2)) is determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides that

(A) In General.---The value of any retained interest that is not a qualified interest is treated as being zero.

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(B) Valuation of Qualified Interest.---The value of any retained interest that is a qualified interest is determined under § 7520.

Section 2702(b) defines the term "qualified interest" to mean--

(1) any interest that consists of the right to receive fixed amounts payable not less frequently than annually,

(2) any interest that consists of the right to receive amounts that are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

(3) any noncontingent remainder interest if all of the other interests in the trust consists of interests described in § 2702(b)(1) or (2).

Section 25.2702-3(b) sets forth the requirements that must be satisfied for an interest to be a qualified annuity interest. Section 25.2702-3(b)(1)(i) provides that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term.

Section 25.2702-3(b)(1)(ii) provides that a fixed amount means--

(A) A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent that the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or

(B) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically, but not less frequently than annually, but only to the extent that the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

Section 25.2702-3(b)(1)(iii) provides that an annuity interest does not fail to be a qualified interest merely because the trust permits income in excess of the amount required to pay the annuity to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

Section 25.2702-3(b)(2) provides that if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

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Section 25.2702-3(b)(3) provides that the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iv) (relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term). Solely for purposes of § 25.2702-3(b), the governing instrument meets the requirements of § 25.2702-3 with respect to short taxable years, if any, and the last taxable year of the term if the governing instrument provides that the fixed amount or a pro-rata portion thereof must be payable for the final short period of the annuity interest.

Section 25.2702-3(b)(4) provides that the governing instrument must prohibit additional contributions to the trust.

Section 25.2702-3(d)(1) provides that to be a qualified annuity or unitrust interest an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

Section 25.2702-3(d)(2) provides that the governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

Section 25.2702-3(d)(3) provides that the governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified terms of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest.

Section 25.2702-3(d)(4) provides that the governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

Based on the information submitted and the representations made, we conclude that: (1) Only the periodic payments to Taxpayer will constitute a "qualified interest" and a "qualified annuity interest" under § 2702(b) and § 25.2702-2, and the trustee's discretionary distributions in excess of the periodic payments will not constitute a "qualified interest" or "qualified annuity interest"; (2) the payment of the annuity amount on the anniversary date of the Trust without proration during the first taxable year of the Trust, will not affect the status of Taxpayer's interest as a qualified annuity interest; and (3) the value of the gift to the remaindermen equals the fair market value of the property transferred to the Trust as finally determined for federal gift tax purposes less the sum of the value of Taxpayer's qualified annuity interest.

Ruling 7:

You requested a ruling that if Taxpayer survives the Trust term, the value of the property in the Trust will not be includible in Taxpayer's gross estate.

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Section 2036(a) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in effect end before his death--

- (1) the possession or enjoyment of, or the right to the income from, the property,
or
(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

In this case, under the terms of the Trust if Taxpayer survives the Trust term, all of Taxpayer's interest in the Trust will have terminated before Taxpayer's death. Accordingly, based on the facts submitted and the representations made, we conclude that if Taxpayer survives the Trust term, the value of the property in the Trust will not be included in Taxpayer's gross estate for federal estate tax purposes.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions of the Code or any other provision of the Code.

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

Sincerely yours,
Christine E. Ellison

Chief, Branch 7
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)