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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:04
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Date: JANUARY 10, 2006

Legend:

Decedent =
Spouse =
Residence =

Decedent's QPRT =

Spouse's QPRT =

Daughter 1 =
Daughter 2 =
Daughter 3 =
Daughter 4 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

Cite 1 =

Cite 2 =

State =

Dear :

This letter is in response to a letter dated August 14, 2005 and prior correspondence from your authorized representative requesting rulings concerning the income and gift tax consequences of the transaction described below.

The facts and representations submitted are summarized as follows:

On Date 1, Decedent and Spouse each created a qualified personal residence trust (Decedent's QPRT and Spouse's QPRT). Decedent and Spouse each conveyed a one-half undivided interest in their principal residence (Residence) to their respective trusts.

The trusts were intended to qualify as qualified personal residence trusts described in section 25.2702-5(c) of the Gift Tax Regulations. The terms of each trust are identical, except that Decedent is the grantor, trustee and primary beneficiary of Decedent's QPRT and Spouse is the grantor, trustee, and primary beneficiary of Spouse's QPRT. Under Article 2, if the grantor is unable to serve as trustee of the respective trust, then Decedent or Spouse, as the case may be, is appointed as the successor trustee. If the Decedent or Spouse is unable to serve, then Daughter 1 is appointed as trustee.

Article 4.1 of each QPRT provides that until the first to occur of 8 years after the date the trust is established or the earlier death of the grantor (the "trust term"), the grantor is to be paid the net income at least annually, as required by Treas. Reg. § 25.2702-5(c), is entitled to the exclusive use of Residence held in the trust, and is to pay all expenses relating to Residence. Article 4.4 provides that the trust will cease to be a qualified personal residence trust (1) if the residence ceases to be used or held for use as a personal residence by the grantor, or (2) as to proceeds of sale or insurance proceeds, as provided in Treas. Reg. § 25.2702-5(c)(7)(ii). If damage or destruction renders the residence not usable as a residence, Treas. Reg. § 25.2702-5(c)(7)(iii) is to apply. If the trust ceases to be a qualified personal residence trust as to Residence, then within thirty days, the trust corpus is to be held in a separate share and the grantor's interest is to be converted into a qualified annuity interest (as

defined by Treas. Reg. § 25.2702-3) with the smallest fixed payment permitted by Treas. Reg. § 25.2702-5(c)(8) for the balance of the trust term.

Under Article 4.5, upon the expiration of the trust term, the trustee is to distribute the principal of the trust, if the grantor is then living, in equal shares to the grantor's then living daughters or, if no such daughter is then living, to the legal representatives of the estate of the last to die of such daughters. If the grantor is not living, the corpus is to be distributed to the grantor's personal representative, to be disposed of as part of the grantor's estate.

Article 7 of Decedent's QPRT and Spouse's QPRT provide, respectively, that the trust shall be irrevocable and that the grantor shall have no right or power, whether alone or in conjunction with others, in whatever capacity, to alter, amend, revoke or terminate the trust.

Decedent and Spouse each timely filed United States Gift (and Generation-Skipping Transfer) Tax Returns, Forms 709, reporting their respective transfer of a one-half interest in Residence to their respective trusts.

At the time Decedent's QPRT and Spouse's QPRT were established, Decedent and Spouse had four daughters: Daughter 1, Daughter 2, Daughter 3, and Daughter 4. In Year 1, the year the trusts were established, Decedent informed Daughter 1 that Decedent and Spouse had created Decedent's QPRT and Spouse's QPRT. Decedent also informed Daughter 1 that she was named as the successor trustee of the QPRTs in the event Decedent and Spouse could no longer serve as trustee.

Subsequent to the creation of the trusts, during Year 2, Spouse developed severe health problems and became distressed regarding the loss of Residence on the termination of the QPRTs. In Year 3, on Date 2, eight months prior to Date 3, the expiration date of the eight year term of each QPRT, and notwithstanding Article 7 of each trust, the Decedent and Spouse executed deeds conveying the interests in Residence held in their QPRTs to revocable trusts established by Decedent and Spouse.

It is represented that Daughters 1-4 were not consulted, advised of, or aware of the Decedent's and Spouse's actions in transferring Residence to the revocable trusts. Further, it is represented that Daughters 1-4 did not become aware of the conveyances until Year 4, several years after Date 3, when the parties began the process of selling Residence. Daughters 1-4, at the advice of counsel, made a demand against Decedent and Spouse for the sale proceeds based on fraud, breach of fiduciary duties, and tortious interference with their interest in the Residence.

Subsequent to the closing of the sale of Residence and the demand, the proceeds have been held in escrow pending the determination of the rights of the parties and resolution of this conflict. Decedent died on Date 4. Decedent's estate

and Spouse, to avoid the costs of litigation with Daughters 1-4, offered in settlement of the matter, to deliver all of the proceeds of the sale to Daughters 1-4, equally. In exchange, Daughters 1-4 agree to accept the sales proceeds in full settlement of all claims against Decedent's estate and Spouse.

Decedent's estate, Spouse, Daughter 1, Daughter 2, Daughter 3, and Daughter 4 request the following rulings:

1. The payment of the sales proceeds of Residence to Daughters 1-4 will not constitute a taxable gift by Spouse or the beneficiaries of Decedent's revocable trust or the beneficiaries of his estate.

2. Daughters 1-4 did not make a taxable gift upon the transfer of Residence from Decedent's QPRT and Spouse's QPRT to Decedent's and Spouse's revocable living trusts.

3. Daughters 1-4 are the proper parties for reporting the gain from the sale of the Residence.

4. Daughters 1-4 will determine the basis of Residence in determining the gain from the sale under § 1015 and the holding period of the Residence under § 1223(2).

Ruling Requests 1 and 2

Section 2501(a)(1) provides for the imposition of a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax applies to a transfer by way of gift 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 25.2511-2(a) of the Gift Tax Regulations provides that the gift tax is an excise on the donor's act of making the transfer, and is measured by the value of the property passing from the donor. Section 25.2511-2(b) provides that a gift of property is complete to the extent the donor has so parted with dominion and control as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state.

In view of Estate of Bosch, whether an agreement settling a dispute is effective for transfer tax purposes, depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. Ahmanson Foundation v. United States, 674 F.2d 761, 774-775 (9th Cir. 1981).

In the instant case, the terms of each QPRT provided that on termination of the term of the trust, the trust corpus was to be distributed to Daughters 1-4. The trusts contained no provision whereby the trust corpus would become distributable to Decedent and Spouse, as grantors, for example, as provided in §25.2702-5(c)(8)(A). Further, Article 7 of each QPRT provided that the trust was irrevocable and that the grantor had no right or power, whether alone or in conjunction with others, in whatever capacity, to alter, amend, revoke or terminate the trust. Thus, Decedent's and Spouse's action in withdrawing Residence from the QPRTS was not authorized under the terms of the trusts. Further, it is represented that Daughters 1-4 were not aware of, and did not consent to, Decedent's and Spouse's actions in transferring Residence to the revocable trusts. Under these circumstances Daughters 1-4 did not relinquish or otherwise transfer their respective remainder interests in the corpus of the QPRTs upon the transfer of Residence from Decedent's QPRT and Spouse's QPRT to Decedent's and Spouse's revocable living trusts. Accordingly, Daughters 1-4 did not make taxable gifts upon the transfer of Residence from the QPRTs to the revocable living trusts.

Further, under the terms of the trusts and applicable State law, Daughters 1-4, as remainder beneficiaries of the QPRTs, possessed enforceable claims with respect to Residence that had not been otherwise relinquished. See Cite 1; Cite 2. Accordingly, the payment of the sales proceeds of Residence to Daughters 1-4 in settlement of their claims to Residence will not constitute a taxable gift by Spouse or the beneficiaries of Decedent's revocable trust or the beneficiaries of his estate. Ahmanson Foundation v. United States, cited above.

Ruling Request 3

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as

otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

Section 121(a) provides that a taxpayer's gross income will not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. The full exclusion is available only once every two years.

Section 121(b) provides that the amount of gain excluded from gross income will not exceed $250,000 or $500,000 (for married taxpayers filing jointly provided certain requirements are met).

As discussed above, at the time of the sale, Daughters 1-4 possessed an enforceable claim to Residence as the remainder beneficiaries under the terms of the QPRTs. Because Daughters 1-4 were the owners of Residence, the sale of Residence should be reported by Daughters 1-4. Daughters 1-4 should report the gain on the sale of Residence in Year 4. Additionally, Daughters 1-4 have also represented that they do not meet the requirements of § 121 and accordingly can not exclude any gain on the sale of Residence.

Ruling Request 4

Section 1015(b) provides that if property is acquired by a transfer in trust (other than a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased by the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that in determining the period for which a taxpayer has held property, however acquired, there is included the period for which such property was held by any other person, if the property has, for the purpose of determining gain

or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of that other person.

Under § 1015, the basis of Residence in the hands of Daughters 1-4 was determined by reference to its basis in the hands of the trust grantors, Decedent and Spouse, and was used in determining the gain on the sale of the residence. Under § 1223(2), therefore, the holding period of Residence in the hands of Daughters 1-4 included the holding period of Decedent and Spouse.

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. In addition, we express or imply no opinion regarding the value of the property transferred to the trust.

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.

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

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

Sincerely,

George L. Masnik
Chief, Branch 4
(Passthroughs & Special Industries)

Enclosures
Copy for section 6110 purposes
Copy of this letter

cc: