Planning with Grantor Trusts

A. Christopher Sega

Mary Ann Mancini
PLANNING WITH GRANTOR TRUSTS

William & Mary 53rd Tax Conference
Tax-Free Planning in a Taxable World

By

Mary Ann Mancini
Bryan Cave LLP

A. Christopher Sega
Venable LLP

Mary Ann Mancini
Bryan Cave LLP
700 13th Street, N.W.
Suite 700
Washington, DC 20005-3960
(202) 508-6000
maryann.mancini@bryancave.com

A. Christopher Sega, Esquire
Venable LLP
575 7th Street, N.W.
Washington, D.C. 20004
(202) 344-8565
acsega@venable.com
http://www.venable.com
Update on Grantor Trusts – Rulings, Rules and Practical Applications

October 15, 2007

1. General Rules

(A) What are Grantor Trusts and why do they exist - a brief history.

(B) Some reasons why Grantor Trust status is desirable.

(1) To avoid recognition on sales or other transfers to the Trust.

(2) To avoid depleting the Trust by the payment of income taxes.

(3) To qualify as a Subchapter S corporation shareholder.

(C) Some reasons to avoid Grantor Trust status.

(1) To reduce the Grantor’s income tax liability.

(2) To avoid State-level income tax.

(3) To recognize gain on sales or other transfers to the Trust.

(D) Which are the favored powers that make a trust a Grantor Trust?

(1) Power to Control Beneficial Enjoyment – Section 674.

   (i) Power to add beneficiaries.

   (ii) Separate share trusts and creditor issues.

(2) Administrative Powers – Section 675.

   (i) Power of substitution

      (A) Insurance Trusts – Estate of Jordahl.

      (B) The Internal Revenue Service 2007-2008 Business Plan.

   (ii) Power to borrow without adequate security versus actually borrowing without adequate security.
(3) Income for the benefit of the Grantor – Section 677.
   (i) The power to use income to pay insurance premiums.
   (ii) The estate tax inclusion risk.

(4) Foreign Trusts with U.S. beneficiaries – Section 679.
   (i) The complexity of a foreign trust.
   (ii) Consequences on termination of grantor trust status – Section 684.
   (iii) Choice of foreign trustee.

(5) Combining Powers.
   (E) The Role of the Grantor’s Spouse and the “Non-Adverse Party”.
      (1) Who is a “Non-Adverse Party”? 
      (2) What if there is a divorce or a marriage?

(F) Additional issues with Grantor Trust powers.
   (1) Can you “toggle” powers on or off?
      (i) Fiduciary implications.
      (ii) Tax issues associated with releasing a power.
      (iii) Notice 2007-73 – The “toggle” power as a “Transaction of Interest”.

   (2) Giving another person the power to add a Grantor Trust power.

(G) Conclusion: There are no risk-free powers!

2. Recent rulings on Grantor Trusts.
   (A) Power was held by the Grantor’s spouse -- PLR 2007-30-011.
   (B) Crummey trusts and Section 678 -- PLR 2006-06-006.
Where the trust is not a Grantor Trust.

(1) Use of Adverse Party distribution committees.


Transfer of ESOP “Rollover Property” to Grantor Trust — PLR 2007-09-011.


3. The “tough issues” involving Grantor Trusts.

(A) When the Grantor Trust status terminates

(1) Treas. Reg. 1.1001-2(c), Example 5; Madorin (84 T.C. 667)

(2) Treatment of basis.

(3) Gain or loss to grantor.

(4) Holding period for assets.

(B) Using Crummey Powers in a Grantor Trust.

(C) The “portion” question.


(A) QPRT Leases.

(B) Grantor Trusts to hold “Seed Money” from terminated GRATs.

(C) Using Grantor Trusts to qualify multiple-member LLCs as S-corporation shareholders. PLR 2004-39-027.

(D) Self-settled “Credit Shelter” Trust as a Grantor Trust.

(E) Grantor Charitable Lead Trusts.

(F) Private Annuities with Grantor Trusts.

Some of the following attachments were obtained from RIA Checkpoint and Westlaw. They are used with permission.
ATTACHMENTS

1. Grantor Trust Rules. IRC §§ 671-679
3. Revenue Ruling 85-13, 1985-1 C.B. 184
7. Notice 2007-73
16. Treas. Reg. § 1.671-4
§ 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

§ 672. Definitions and rules

(a) Adverse party.--For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) Nonadverse party.--For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

(c) Related or subordinate party.--For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is--

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule where power is subject to condition precedent.--A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the...
power.

(e) Grantor treated as holding any power or interest of grantor's spouse.--

(1) In general.--For purposes of this subpart, a grantor shall be treated as holding any power or interest held by--

(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) Marital status.--For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(f) Subpart not to result in foreign ownership.--

(1) In general.--Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

(2) Exceptions.--

(A) Certain revocable and irrevocable trusts.--Paragraph (1) shall not apply to any portion of a trust if--

(i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or

(ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

(B) Compensatory trusts.--Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.

(3) Special rules.--Except as otherwise provided in regulations prescribed by the Secretary--

(A) a controlled foreign corporation (as defined in section 957) shall be treated as a domestic
corporation for purposes of paragraph (1), and

(B) paragraph (1) shall not apply for purposes of applying section 1297.

(4) Recharacterization of purported gifts.--In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

(5) Special rule where grantor is foreign person.--If--

(A) but for this subsection, a foreign person would be treated as the owner of any portion of a trust, and

(B) such trust has a beneficiary who is a United States person,

such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property (other than in a sale for full and adequate consideration) to such foreign person. For purposes of the preceding sentence, any gift shall not be taken into account to the extent such gift would be excluded from taxable gifts under section 2503(b).

(6) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations providing that paragraph (1) shall not apply in appropriate cases.

§ 673. Reversionary interests

(a) General rule.--The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

(b) Reversionary interest taking effect at death of minor lineal descendant beneficiary.--In the case of any beneficiary who--

(1) is a lineal descendant of the grantor, and

(2) holds all of the present interests in any portion of a trust,

the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.
(c) Special rule for determining value of reversionary interest.--For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

(d) Postponement of date specified for reacquisition.--Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

§ 674. Power to control beneficial enjoyment

(a) General rule.--The grantor shall be 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.

(b) Exceptions for certain powers.--Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent.--A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after occurrence of event.--A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(3) Power exercisable only by will.--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.

(4) Power to allocate among charitable beneficiaries.--A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1)).

(5) Power to distribute corpus.--A power to distribute corpus either--
(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporarily.--A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable--

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary.--A power exercisable only during--

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person
has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income.--A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for certain powers of independent trustees.--Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor--

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

§ 675. Administrative powers

The grantor shall be treated as the owner of any portion of a trust in respect of which--

(1) Power to deal for less than adequate and full consideration.--A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of
the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security.--A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds.--The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

(4) General powers of administration.--A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

§ 676. Power to revoke

(a) General rule.--The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) Power affecting beneficial enjoyment only after occurrence of event.--Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.
§ 677. Income for benefit of grantor

(a) General rule.--The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be--

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) Obligations of support.--Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

§ 678. Person other than grantor treated as substantial owner

(a) General rule.--A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.
(b) **Exception where grantor is taxable.**—Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) **Obligations of support.**—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) **Effect of renunciation or disclaimer.**—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) **Cross reference.**—

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).

§ 679. Foreign trusts having one or more United States beneficiaries

(a) **Transferor treated as owner.**—

(1) **In general.**—A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

(2) **Exceptions.**—Paragraph (1) shall not apply—

(A) **Transfers by reason of death.**—To any transfer by reason of the death of the transferor.

(B) **Transfers at fair market value.**—To any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property. For purposes of the preceding sentence, consideration other than cash shall be taken into account at its fair market value.

(3) **Certain obligations not taken into account under fair market value exception.**—

(A) **In general.**—In determining whether paragraph (2)(B) applies to any transfer by a person
described in clause (ii) or (iii) of subparagraph (C), there shall not be taken into account--

(i) except as provided in regulations, any obligation of a person described in subparagraph (C), and

(ii) to the extent provided in regulations, any obligation which is guaranteed by a person described in subparagraph (C).

(B) Treatment of principal payments on obligation.--Principal payments by the trust on any obligation referred to in subparagraph (A) shall be taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(C) Persons described.--The persons described in this subparagraph are--

(i) the trust,

(ii) any grantor, owner, or beneficiary of the trust, and

(iii) any person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner, or beneficiary of the trust.

(4) Special rules applicable to foreign grantor who later becomes a United States person.--

(A) In general.--If a nonresident alien individual has a residency starting date within 5 years after directly or indirectly transferring property to a foreign trust, this section and section 6048 shall be applied as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.

(B) Treatment of undistributed income.--For purposes of this section, undistributed net income for periods before such individual's residency starting date shall be taken into account in determining the portion of the trust which is attributable to property transferred by such individual to such trust but shall not otherwise be taken into account.

(C) Residency starting date.--For purposes of this paragraph, an individual's residency starting date is the residency starting date determined under section 7701(b)(2)(A).

(5) Outbound trust migrations.--If--

(A) an individual who is a citizen or resident of the United States transferred property to a trust which was not a foreign trust, and

(B) such trust becomes a foreign trust while such individual is alive,
then this section and section 6048 shall be applied as if such individual transferred to such trust on the date such trust becomes a foreign trust an amount equal to the portion of such trust attributable to the property previously transferred by such individual to such trust. A rule similar to the rule of paragraph (4)(B) shall apply for purposes of this paragraph.

(b) Trusts acquiring United States beneficiaries.--If--

(1) subsection (a) applies to a trust for the transferor's taxable year, and

(2) subsection (a) would have applied to the trust for his immediately preceding taxable year but for the fact that for such preceding taxable year there was no United States beneficiary for any portion of the trust,

then, for purposes of this subtitle, the transferor shall be treated as having income for the taxable year (in addition to his other income for such year) equal to the undistributed net income (at the close of such immediately preceding taxable year) attributable to the portion of the trust referred to in subsection (a).

c) Trusts treated as having a United States beneficiary.--

(1) In general.--For purposes of this section, a trust shall be treated as having a United States beneficiary for the taxable year unless--

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and

(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.

(2) Attribution of ownership.--For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and--

(A) in the case of a foreign corporation, such corporation is a controlled foreign corporation (as defined in section 957(a)),

(B) in the case of a foreign partnership, a United States person is a partner of such partnership, or

(C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

(3) Certain United States beneficiaries disregarded.--A beneficiary shall not be treated as a United States person in applying this section with respect to any transfer of property to foreign trust if such beneficiary first became a United States person more than 5 years after the date of
such transfer.

(d) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.
United States Court of Appeals, Second Circuit.


Executors of taxpayer's estate and taxpayer's wife paid income tax deficiency assessment and then filed with Internal Revenue Service a claim for refund with interest. Upon denial of claim, action for refund was brought. The United States District Court for the District of Connecticut, 574 F.Supp. 19, Warren W. Eginton, J., dismissed the action, and appeal was taken. The Court of Appeals, Friendly, Circuit Judge, held that taxpayer's purchase, on credit, of shares of corporation from irrevocable trust he established for benefit of his children was, at least indirectly, a "borrowing" within meaning of statute directing that grantor of trust shall be treated as owner, for income tax purposes, of any portion of a trust which grantor has directly or indirectly borrowed; however, such finding did not require complete recharacterization for income tax purposes of the transaction, and thus taxpayer was entitled to an interest deduction on his payments to trust. 26 U.S.C.A. §§ 671, 675(3).

*704 Ira B. Grudberg, New Haven, Conn. (Jonathan Katz, Charles B. Price, Jr., and Jacobs, Grudberg & Belt, P.C., New Haven, Conn.), for plaintiffs-appellants.


Reversed and remanded.

Feinberg, Chief Judge, concurred and dissented with opinion.

Oakes, Circuit Judge, dissented with opinion.
executors of the estate of Alexander Rothstein, and Reba Rothstein, his widow, appeal from a judgment of the District Court for Connecticut, which dismissed their action for a tax refund after trial before Judge Eginton and an advisory jury, 574 F.Supp. 19. Appellants urge two grounds for reversal. One involves the interpretation of § 453, 671 and 675 of the Internal Revenue Code ("IRC"); the other relates to the judge's having sua sponte stricken from the jury panel eleven veniremen solely because they had some experience with rental property or connection with closely held corporations. In the view we take of the case only the first requires statement and discussion.

The district court found the facts to be as follows: In 1951 decedent Alexander Rothstein ("taxpayer") and Abraham Savin formed a real estate holding company known as Industrial Developers, Inc. ("IDI"). They purchased, at a cost of $30,000 each, a parcel of land in East Hartford, Connecticut, which they conveyed to the corporation, each receiving 300 shares of IDI stock. The corporation constructed, at a cost not disclosed in the record, warehouses which were used as rental property.

On February 18, 1957, taxpayer contributed his 300 shares of IDI to an irrevocable trust he established for the benefit of his three children, Harold, David and Edna. Taxpayer's wife Reba was the trustee. Although the trust was required to distribute any dividends received on the IDI stock, which was its sole asset, to the beneficiaries at least semi-annually, no dividends were ever paid.

In October 1964, taxpayer bought Savin's 300 shares of IDI for $500,000, agreeing to pay the purchase price at a later date. On November 13, 1964, he purchased from his wife as trustee the trust's 300 shares for $320,000. Payment was made by an unsecured promissory note bearing an interest rate of 5% per annum, payable semi-annually beginning May 13, 1965. These payments were duly made. Principal payments were scheduled to be made as follows: $25,000 on or before November 13, 1969; $25,000 on or before November 13, 1970; $50,000 on or before November 13, 1971; and $50,000 on or before November 13 of each calendar year thereafter until the full sum of $320,000 had been paid.

In January 1965, taxpayer, having become owner of all of IDI's stock as a result of the transactions with Savin and the trust, dissolved IDI and had all its assets transferred to himself. He then refinanced the property, replacing an existing mortgage of less than $200,000 with a new $700,000 mortgage to Equitable Life Insurance Company and using the approximately $500,000 excess of the new mortgage over the old to discharge his debt to Savin. On February 8, 1965, he gave a second mortgage of $320,000 to his wife as trustee to secure the promissory note of that amount given in exchange for the trust's IDI shares three months before.

In their joint federal income tax return for 1965 taxpayer and his wife claimed deductions for (1) $16,000 in interest paid to the trust on the promissory note, and (2) a short-term capital loss of $33,171 on the liquidation of IDI, determined as follows:

**fair market value of**
The Commissioner, however, asserted a deficiency of $56,664 based on his disallowance of the interest deduction and his determination that taxpayer had in fact realized a substantial gain on the liquidation of IDI. As now presented by the Government, the Commissioner's theory was that, under IRC § 75(3) [FN1], the taxpayer was to be treated as the "owner" of the trust assets and that this crucially affected the tax consequences of the events described above. On this view, transactions involving trust assets were to be reanalyzed after substituting the taxpayer (as the "owner" of those assets) for the trust. Thus, the Commissioner disallowed the $16,000 interest deduction, since the taxpayer was not entitled to deduction for amounts paid to himself as "owner" of the promissory note held by the trust. Similarly, in computing taxpayer's gain on the liquidation of IDI, the Commissioner reduced taxpayer's basis in the shares acquired from the trust from $320,000 to $30,000. His rationale, apparently, was that the taxpayer could not claim a full "cost" basis in stock acquired in a sale that involved nothing more than a transfer of the property from the taxpayer as "owner" of the stock) to himself. [FN2]

FN1. This provides: § 675. Administrative powers
The grantor shall be treated as the owner of any portion of a trust in respect of which--
(3) Borrowing of the trust funds
The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

FN2. The $30,000 basis asserted by the Commissioner seems to reflect either a carry-over of the trust's basis in the shares or perhaps, as suggested in the Government's brief, taxpayer's original basis in the shares that he transferred to the trust--the two being here identical by virtue of IRC § 1015(a). Using this reduced figure as taxpayer's basis and an appraisal that the property received was
worth $950,000, the Commissioner determined that the taxpayer had realized a capital gain of approximately $152,000 on the liquidation of IDI. The Commissioner's gross adjustment--some $184,000--represents the recomputed gain plus the allegedly erroneously computed loss that appeared on taxpayer's return. After the 50% allowable deduction, this yielded a net increase in taxable income of approximately $92,000, to which was added $16,000 representing the disallowance of the deduction for interest paid to the trust. The resultant deficiency was $56,664, plus interest.

In July 1967, taxpayer paid the asserted deficiency, together with interest of $2,470. In February 1969 Mr. and Mrs. Rothstein filed a claim for a refund in the amount of $57,942.12. After this was denied, the Rothsteins filed a protest, which the IRS held for more than five years, during which time Alexander Rothstein died. The protest was finally disallowed and Rothstein's executors and widow brought this refund suit against the United States under 28 U.S.C. § 1346(a)(1).

Although both sides were entitled to a jury trial, 28 U.S.C. § 2402, the case was tried by the judge with an advisory jury. After denying motions by both sides for a directed verdict, the judge put four interrogatories to the jury. The questions and answers were as follows:

1. Was the sale by the Trustee, Reba Rothstein, to the grantor, Alexander Rothstein of 300 shares of IDI stock for $320,000 for adequate consideration?
   Yes.

2. Was the trustee, Reba Rothstein, subservient to the grantor, Alexander Rothstein, when she accepted a note from Alexander Rothstein in the amount of $320,000 in exchange for the 300 shares of IDI stock from the trust?
   Yes.

3. Was adequate security provided by Alexander Rothstein for the $320,000 note given by him in November, 1964 to Reba Rothstein as trustee?
   No.

4. Did the note for $320,000 from Alexander Rothstein to Reba Rothstein, as trustee for the children, provide for an adequate rate of interest?
   Yes.

*707 The judge then made findings of fact and conclusions of law pursuant to F.R.Civ.P. 52(a). He ruled that the 1964 sale of the IDI stock involved a borrowing of trust funds under the first sentence of IRC § 675(3) and, in accordance with the advisory jury's answers with respect to lack of adequate security and subservience, that it did not fall within the exception created by the second sentence. Without further discussion, the judge entered judgment for the Government, presumably because he agreed with the Commissioner that, if § 675(3) applied, this would entail disallowance of taxpayer's interest deduction and reduction of his basis in the shares of IDI acquired from the trust.

DISCUSSION

Taxpayer's principal argument on the merits is that his purchase, on credit, of the 300 shares of IDI did not involve a "borrowing" from the trust and therefore did not come within IRC § 675(3), which applies only when the grantor "has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year". The image most immediately conveyed by the statutory language is that of a grantor who has obtained an asset from the trust, whether money or otherwise, in exchange for a promise to return the same asset at some future time. Taxpayer is
correct in noting that a transaction like that here in question--a sale of a trust asset on credit--involves no borrowing of the asset sold. However, the Commissioner's argument is that what was "directly or indirectly borrowed" was not the IDI stock but money in the amount of the purchase price. On the Commissioner's view, the trust's extension of credit was a "loan" within the meaning of § 675(3), notwithstanding that the loan "proceeds" were immediately used to pay for the shares.

Whether an extension of credit in a sale should be deemed a "loan" for purposes of § 675(3) is not easily answered on the basis of the language of the statute alone. On the one hand, Black's Law Dictionary 844 (5th ed. 1979) defines "loan" quite narrowly as the "[d]elivery by one party to and receipt by another party of [a] sum of money upon agreement, express or implied, to repay it with or without interest". This definition suggests that an extension of credit is not a loan unless there is actual delivery of loan proceeds to the obligor. A similar distinction appears to underlie the numerous decisions holding that, for purposes of a usury statute, a sale on credit is not a loan. See, e.g., Bartholomew v. Northampton Nat'l Bank, 584 F.2d 1288, 1295 (3 Cir.1978) (Pennsylvania law). On the other hand, it is common enough to conceive of a credit sale as involving a loan, as witness the many statutes referred to as "truth-in-lending" laws, see, e.g., Consumer Credit Protection Act, 15 U.S.C. § 1601 et seq. ("Truth in Lending Act"), although one hardly says that the purchaser has borrowed the property purchased. [FN3]

FN3. It could be further contended on behalf of the taxpayer that Congress dealt with the subject of purchases from a trust in § 675(1) (regarding certain powers "to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration"). thus arguing for a narrower interpretation of § 675(3). Against this is the fact that § 675(1) applies only to powers permitting purchases for inadequate consideration, whereas § 675(3) applies, irrespective of a previously existing power, where the loan is either inadequately secured or made by "a related or subordinate trustee subservient to the grantor".

More important in deciding whether § 675(3) should apply in the instant case is the object which the statute was intended to serve. As is well known, the purpose of IRC §§ 671-79 and the regulations that preceded them was to bring order out of the chaos that has been created by the decision in Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788 (1940), that a grantor's continued domination of a trust might render trust income taxable to him. This led to over a hundred decisions in the courts of appeals, some holding Clifford to be applicable and others holding the contrary, with little difference in the facts, see 1 Surrey & Warren, Federal Income Taxation *708 1340 (1972 ed.). The purpose of the regulations, originally issued in 1945, amended in 1947, and codified in 1954, was "to establish a definite line separating 'Clifford trusts' where income is taxable to the grantor from trusts falling under the general trust sections [where income is taxable to the trust or its distributees]." Id. at 1341. The statute directs that the grantor shall be treated as "owner" of a portion of a trust not only when a reversionary interest "will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust," § 673(a), but in many other instances where, although the trust was expected to have a longer duration, the grantor's powers or acts were thought by the Commissioner and later by Congress to indicate that he remained in effective control.
Section 675, entitled "Administrative powers", is a subset of the many provisions dealing with the retention of substantial interests in and powers over a trust. Broadly speaking, it requires that the grantor be treated as "owner" of a trust when he could engage or has engaged in certain transactions with the trust without providing adequate consideration. In particular, § 675(3) addresses those situations in which the grantor has exercised "dominion and control" over a trust by borrowing from it at less than an adequate rate of interest or without giving adequate security for his promise to repay the loan. Indeed, § 675(3)'s determination to prevent a grantor's treating a trust as his private bank without paying the tax consequences is so strong that the grantor is to be treated as "owner" even if the rate of interest and the security are adequate, unless the loan is made by a trustee other than the grantor or "a related or subordinate trustee subservient to the grantor".

There can be no doubt that the extension of credit in the present case, made without adequate security by a subservient trustee, would fall within the scope of the statute should we deem it a "borrowing" or "loan" under § 675(3). We think it is consistent with the overall purpose of Congress to do so. First, in view of the fact that the statute is to apply to any grantor who has "borrowed" from the trust, whether "directly or indirectly" (emphasis supplied), we cannot attach much weight to the distinction, mentioned above, between (1) an extension of credit in which the proceeds are actually delivered to and received by the obligor, and (2) one in which they are immediately applied to the purchase of an asset from the obligee. Second, we must consider the consequences of a decision that an extension of credit like this is not within the scope § 675(3). A grantor wishing to obtain a loan from a trust while steering clear of the statute could always do so by arranging for the trust to purchase, for example, marketable securities with a value equal to the amount of the contemplated loan, which the grantor would then purchase from the trust in exchange for his note. The grantor could then sell the securities on the market, leaving him with cash and the trust with his note-- just as if it had made him a conventional loan. The only difference would be that § 675(3) would not apply, since the extension of credit in the sale did not involve actual delivery of loan proceeds to the grantor. Accepting taxpayer's argument would in effect largely annul § 675(3). We therefore adopt the district court's conclusion that the extension of credit here was, at least "indirectly", a "borrowing" within the meaning of the statute. [FN3a]

FN3a. Our ruling does not rest on any conclusion that the transaction here in question was a "sham", as Chief Judge Feinberg seems to suggest. We do not question the authenticity of the sale by the trust but adhere to the not very novel proposition that the trust's extension of credit to enable Rothstein to finance the sale was a "borrowing" for purposes of § 675(3). We also note that the hypothetical in the text, which Chief Judge Feinberg would dispose of as a "sham", describes only the most egregious case. One can readily imagine situations in which the asset in question would be one already held by the trust or something other than a marketable security, but would nonetheless be an item of value for which the grantor would gladly give his unsecured note. It is unclear how such cases would be dealt with under Chief Judge Feinberg's proposal, notwithstanding that they are as much the target of § 675(3) as the example in the text.
*709 While we thus agree with the Government that the taxpayer's purchase of the IDI stock in exchange for his installment note involved a "loan" under § 675(3), we disagree with its contention that this requires a complete recharacterization for tax purposes of transactions involving the taxpayer and the trust. If § 675(3) stood alone, we might agree that taxpayer's "ownership" of trust assets should prevent his claiming a deduction for interest paid on the note or a full cost basis in the shares acquired from the trust. However, § 675 is only one of a battery of provisions, see §§ 673-74, 676-79, requiring that the grantor or another person be treated as the "owner" of trust assets. All of these provisions are subject to § 671, in which Congress expressly stated the consequences of such "ownership":

Where it is specified in this subpart [§§ 671-79] that the grantor ... shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor ... those items of income, deductions, and credits against tax which are attributable to that portion of the trust to the extent such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D [§§ 641-68].

Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/"owners" be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself. [FN4] Rather, the statute envisions (1) that the income and deductions of the grantor and the trust will be computed in the normal fashion, the trust being treated as a fully independent tax-paying entity, and (2) that the relevant "items of income, deductions, and credits against tax" that would ordinarily appear on the trust's return will instead "be included in computing the taxable income and credits of the grantor". Nowhere does § 671 direct that the grantor's basis in property purchased from the trust be deemed any different from what it would otherwise be, namely, his cost in acquiring it—in this case $320,000, the amount of taxpayer's note. Nor does the statute contain anything authorizing the Commissioner to disallow an interest deduction on the ground that grantor's payments were made to the trust. Consistently with the objective of Clifford to prevent high-bracket taxpayers from shifting income to low-bracket trusts over which they retain or exercise excessive controls, § 671 dictates that, when the grantor is regarded as "owner", the trust's income shall be attributed to him—this and nothing more.

FN4. It should be observed that most of the provisions of §§ 673-79 mandate "ownership" treatment in circumstances in which there may have been no transaction between the grantor and the trust. In those instances, § 671 must operate by imputing tax items to the grantor, not by recharacterizing his dealings with the trust.

In some instances the result of applying § 671 as written will be identical with what would have obtained under the Government's approach of recharacterizing the transaction. Here, for example, application of § 671 would mean that the trust's $16,000 annual interest income on the promissory note would be included in computing taxpayer's gross income, but would be offset by an equivalent deduction for the interest paid—with the same net result as under the Government's approach, where the taxpayer would be neither entitled to the deduction nor required to treat as income the payments received. But in other instances, the two approaches can yield quite different results. Here, for example, if the full amount of the note had been paid in 1965, the trust would have
realized a gain in the amount of $290,000 (the excess of $320,000 over the trust's $30,000 carry-over basis in the shares transferred to it in 1957, see § 1015(a)). Under § 671 this gain would be includible in the taxpayer's income, whereas under the Government's approach, which would "disregard" the sale for tax purposes, no one would realize taxable income unless and until the taxpayer sold the stock.

The Government's grievance apparently derives from the fact that, here, in contrast to the hypothetical where the precise application of § 671 would work to its advantage in the year 1965, neither the taxpayer nor the trust had reported a capital gain on the sale of the IDI shares in 1964. [FN5] This, however, is simply a consequence of the provisions of § 453, governing installment sales. We disagree with the district court's contention that § 453 supplies little aid to the taxpayer here because it was "designed to alleviate a hardship on the seller by permitting an installment seller to report a proportionate share of the gain during each year in which he receives proceeds from the sale" (emphasis in original). Under § 671 the income of the seller (the trust) is to be computed as in the case of an individual, and as the Government concedes in its brief "the transaction under consideration in this case may properly be characterized as an installment sale, and ... the seller, here the trust, may elect to recognize its income proportionately over the period of the payment schedule" (emphasis in original). It is that income, if any there be in the taxable year, which § 671 directs shall be imputed to the grantor in cases where, under other sections, he is to be treated as owner of a portion of the trust. Because the trust had no reportable gain in 1965, application of § 675(3) to the taxpayer should not increase his tax liability on account of the trust's sale of IDI stock. The reason why taxpayer realized no gain in the liquidation of IDI is not, as the dissent argues, that we are allowing him "to take advantage of the trust's prior election to receive a portion of its proceeds from the taxpayer/grantor on an installment basis", but that the taxpayer obtained a new basis of $320,000 as a consequence of his purchase from the trust and that this resulted in his realizing a loss on his subsequent disposition of the IDI shares. Nothing in § 671 says that a grantor shall not be entitled to his usual cost basis in property purchased from a trust of which other sections direct he shall be treated as "owner"; it says only, so far as here relevant, that if his purchase results in taxable gain to the trust, he is taxable on the gain. But here the trust, having properly taken advantage of the opportunity to account for its gain on the installment basis, had no reportable income on the sale to the taxpayer that could be imputed to him under § 671. The dissent simply refuses to recognize that the consequences of violating § 675(3) are those and only those specified in § 671. It is immaterial whether the statutory scheme envisioned by Judge Oakes would achieve better results; we are governed by the statute as it is. Congress specified the consequences of violating § 675(3) and similar provisions in § 671; we are not at liberty to enlarge upon it.

FN5. The record does not show whether the trust paid capital gains tax beginning in 1969 when principal payments became taxable under the installment sale provision, IRC § 453(b). Neither the taxpayer's nor the Government's counsel was able to respond to our inquiries at argument on this score. The Government's brief tells us only that "[t]he Government has not made any assertions whatever regarding the realization of gain by the seller in this case."

The judgment dismissing taxpayer's claim is reversed and the cause remanded to the district
court for the entry of a judgment in favor of the taxpayer consistent with this opinion.

FEINBERG, Chief Judge (concurring and dissenting):

I feel compelled to write a separate opinion because my view of the transaction in question is entirely different from that of my colleagues. In my judgment, the crucial issue is whether IRC § 675(3) applies at all to the trust's installment sale of stock to Rothstein. This issue turns on whether that transaction is a "borrowing" within the meaning of § 675(3) or a sale. Although they disagree on the consequences flowing therefrom, both Judges Friendly and Oakes agree that § 675(3) applies because *711 they apparently view the installment sale as either a "borrowing" of the purchase price of the stock or an extension of credit equal to the purchase price. I disagree.

The transaction was not a sham sale. There was a mutual exchange of consideration that made both parties better off and that had genuine economic substance. For over seven years prior to the sale, the trust's asset was stock in a closely held corporation, which had paid no dividends to stockholders and for which there was apparently no market. After the sale, the trust held an asset, Rothstein's promissory note, that paid interest and that conceivably could be discounted for cash. It is significant that the advisory jury and the district judge found that the $320,000 installment note was adequate consideration for the stock. For his part, Rothstein received full title to the stock to do with whatever he pleased (which, incidently, is the reason no one is arguing the stock was borrowed). This, and the coordinate purchase of Savin's stock, enabled Rothstein to liquidate the company, reorganize and refinance it and continue the enterprise, another factor suggesting economic substance to the transaction rather than an attempt to evade the Clifford regulations. The government makes much of the fact that Rothstein did not give security for the promissory note until after the end of the taxable year. Yet Savin gave full title to his stock to Rothstein in October 1964, but was not paid until after Rothstein liquidated the company and took out a mortgage on its former assets in January 1965. Surely, that was not a loan of Savin's stock, nor do I view it as a loan of the purchase price, but simply a deferred payment date. Whatever risk Savin incurred by accepting a deferred payment date without interim security was apparently offset in his view by the economic gain to him from the deal. The same is true for the trust.

In this case, the Commissioner seeks to recharacterize the transaction because he apparently does not like the favorable tax consequences for Rothstein. In a case analogous to this one and also involving the Clifford Regulations, the Ninth Circuit was presented with a sale of stock and other property to a grantor trust in return for a lifetime annuity. The court found that the sale had genuine substance and was not a disguised conduit for distribution of the trust income. The annuity was fixed and was not an attempt to approximate the income production of the trust assets. The taxpayer-annuitant bore the risk of early death or appreciation of the trust assets; the trust bore the risk of late demise or depreciation of the trust assets. The court concluded that "[i]n these circumstances, Taxpayer's formal characterization of the transaction as a sale in exchange for an annuity should not be disregarded for tax purposes." Id. at 850. Similarly, because of the economic substance behind the transaction at bar, I do not believe it should be recharacterized as a
"borrowing" within § 675(3).

The sham sale analysis that I would apply in determining the applicability of § 675(3) does not produce the undesirable consequences suggested by Judge Friendly's hypothetical case in which "[a] grantor wishing to obtain a loan from a trust while steering clear of the statute could always do so by arranging for the trust to purchase, for example, marketable securities with a value equal to the amount of the contemplated loan, which the grantor would then purchase from the trust in exchange for his note." Supra at ----. The hypothesized transaction would be patently a sham. There would be no reason for the trust to engage in such a transaction. Why would the trust give up freely marketable securities it had just purchased for a promissory note? Alternatively, if a promissory note was attractive to the trust for some reason, why wouldn't it simply give cash for the promissory note? Because of the lack of economic substance, the government *712 would be permitted to recharacterize the two steps of the hypothetical transaction as a loan of money with which the taxpayer happened to purchase marketable securities.

The real objection that the Commissioner and Judge Oakes appear to have is to the use of the installment sale device between a grantor and a trust to produce favorable tax consequences in addition to accomplishing whatever other economic objectives the parties may have. However, as long as the transaction is not a sham, the choice is one Congress has made. The taxpayer is free to structure his transactions, and specifically may choose to employ the installment sale device, to minimize his tax consequences. See Roberts v. C.I.R., 643 F.2d 654 (9th Cir.1981) (installment sale of stock to grantor trust, which resold stock on open market; grantor's use of § 453 to defer taxation upheld).

Having concluded that § 675(3) does not apply, I have no need to consider the scope of § 671. Under my approach, the appreciation of the stock is taxed to the trust as it receives installment payments. In this respect, my approach produces the same result as Judge Friendly's. However, since § 671 does not come into play at all under my approach, the interest income on the installment note is also taxed to the trust and is not attributed to Rothstein. Hence he would get a corresponding deduction, which probably would not be a wash because his tax rates for the relevant years are likely to be higher than the trust's. For the purpose of the remand, my position in regard to the interest income is a minority one; both Judges Friendly and Oakes would attribute the trust's interest income to Rothstein. However, were I to view the transaction as a borrowing, as do my colleagues, I would agree with Judge Friendly's interpretation of the consequences under § 671.

OAKES, Circuit Judge (dissenting):

Judge Friendly and I agree that under section 675(3), the taxpayer is to be treated as the "owner" of the trust assets because of the "dominion and control" he exercised in borrowing from a trustee who is related and subservient. His opinion also takes the position, with which I am in complete accord, that the trust's carryover basis in the stock was $30,000, i.e., the grantor's basis under section 1015(a) (see parenthetical in opinion at 13; see also n. 2). Thereafter, however, we differ. In particular, we do not agree that after application of section 675(3) the grantor's basis in the IDI shares which he had transferred to the trust and "bought" back from it was $320,000, the trust's "selling price" to him. True, Judge Friendly's approach does avoid the potential danger that nobody would be taxed on the difference between the grantor's original basis of $30,000 (which became the trust's basis) and the sum of
$320,000; it does so by providing that the grantor pay tax on that gain as if he--like the trust--had elected installment treatment under § 453. But the problem with this approach is that it simply does not treat the grantor/taxpayer as if he were the "owner," which is what the statute requires. The difference is, of course, substantial. Were the taxpayer in this case, for example, truly treated as the owner of the stock, his basis would be that of the trust, i.e., the "old" owner, or $30,000.

I would accordingly frame the ultimate question as follows: whether the grantor of a Clifford trust who is deemed the owner of the trust assets by virtue of section 675(3), who sells those assets in the taxable year and realizes the proceeds of such sale (directly or indirectly), can take advantage of the trust's prior election to receive a portion of its proceeds from the taxpayer/grantor on an installment basis, or whether the taxpayer must report the entire gain in the year he in fact realizes it. Thus stated, the question seems to me to answer itself. A taxpayer must report a gain when he realizes it. The taxpayer did not realize his gain on an installment basis and is therefore disentitled to benefit from an installment election on the part of the trust.

*713 In stating the question, I use the word "portion" advisedly. Suppose that the amount the taxpayer received on liquidation (attributable to the trust's shares) was in excess of $320,000. Even under Judge Friendly's proposed result, which would permit the grantor to treat the difference between the $320,000 received and the $30,000 basis as an installment sale, the amount over and above $320,000 would surely be taxable to him as immediate, short-term capital gain.

But of course the gain on the difference between $30,000 and $320,000 is identical in kind to the gain between $320,000 and the amount ultimately received, once the benefits of the Clifford trust have been denied the taxpayer. After all, had the taxpayer never established a trust, he would have been required to report the entire difference as capital gain. He could not have elected to treat the sale on an installment basis for the simple reason that he did not receive the proceeds on an installment basis. Does it make any difference, then, that he did establish a trust which did not comply with the Clifford trust regulations, non-compliance with which triggered the statutory requirement that he be treated as the "owner" of the assets? In my view the answer has to be in the negative irrespective of the language in section 671 relied on by Judge Friendly as the sole basis for his conclusion.

I submit that the language of section 671, insofar as it includes in the grantor's taxable income "those items of income ... which are attributable to that portion of the trust," simply does not bear on, indeed it has nothing whatsoever to do with, the trust's election to treat gains on an installment basis. The "item of income" attributable to the grantor under section 671 is the difference between $30,000 and $320,000. How it is to be treated on his tax return is dependent on whether he realized it in the taxable year or deferred it by realizing it on an installment basis and taking the installment election. The fact that the taxpayer did not realize that gain in its entirety (as turned out to be the case) simply means that he only has to report it to the extent that he did in fact realize it, not that he is entitled, as Judge Friendly's opinion would inconsistently hold, to treat the entire amount on an installment basis and to deduct the unrealizable portion in the year of his sale.

The grantor, Rothstein, was not himself an installment seller; nor is he to be deemed such by virtue of section 671. Yet under Judge Friendly's analysis, following a transaction after
which Rothstein is to be treated as the owner of the assets in question, he is nevertheless allowed to take advantage of the trust's now meaningless election. Nothing in the statute, legislative history, regulations, or cases supports this anomalous result. In fact, the parties themselves did not even propose this result, which helps explain why nobody knew (or cared) on argument how the trust treated the transaction. From the trust's point of view and against any conceivable suggestion of "double taxation," I would simply point out that once the grantor is treated as the owner and the income or gain thus made attributable to him, there are no tax consequences to the trust, and any election it has made is purely moot. Judge Friendly's opinion does not, as I read it, suggest otherwise.

There is no problem with the grantor's payment of interest to the trust. Whether that payment is treated as a wash, as the Commissioner probably treated it, or whether the trust is perceived as receiving income, which is then functionally offset by allowing the grantor a deduction for interest paid to the trust, as Judge Friendly would have it, there are no tax consequences to the trust, and any election it has made is purely moot. When, by virtue of the grantor's failure to comply with the Clifford trust regulations, he is treated as the owner of the assets involved.

While to affirm I would have to address the second or jury issue in this case, for a lone dissenter to address that question seems to me an academic exercise the usefulness of which cannot be great. To my mind, in any event, appellant's counsel acquiesced in the trial court's treatment of the jury as an advisory one only.
GRANTOR OWNED TRUSTS

Published: February 19, 1985

Section 675.-Administrative Powers, 26 CFR 1.675-1: Administrative powers. (Also Section 671; 1.671-3.)

Grantor owned trusts. A grantor who acquires the corpus of a trust in exchange for the grantor's unsecured promissory note will be considered to have indirectly borrowed the trust corpus. As a result, the grantor will be treated as the owner of the trust and the grantor's acquisition of the trust corpus will not be viewed as a sale for federal income tax purpose. The Service will not follow the Rothstein decision.

ISSUES

(1) Whether a grantor's receipt of the entire corpus of an irrevocable trust in exchange for an unsecured promissory note given to the trustee, the grantor's spouse, constituted an indirect borrowing of the trust corpus which caused the grantor to be the owner of the entire trust under section 675(3) of the Internal Revenue Code.

(2) To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.

FACTS

In 1980, A, an individual, created an irrevocable trust, T. W, A's spouse, is the trustee of T. The trust instrument of T provides that all income of T is to be paid semiannually to C, A's child, for a term of 15 years. Upon expiration of the trust term, or if C dies before the trust term expires, the corpus of T will be distributed to C's child or to the estate of C's child. Neither A nor any other person has a power over or an interest in T that would cause A to be treated as the owner of T under the grantor trust provisions of the Code, section 671 and following.

A funded T with a contribution of 100 shares of stock in Corporation Z. The 100 shares represented all of the outstanding stock of Corporation Z. When A funded T, A's basis in the shares was $20x.

On December 27, 1981, when the fair market value of the Corporation Z shares was $40x, W, as trustee, transferred the 100 shares to A. In exchange, A gave W A's unsecured promissory note with a face amount of $40x, bearing an adequate annual rate of interest, payable semiannually, beginning six months following the date on which the shares were transferred to A. Principal payments on the note were scheduled to be paid in 10 equal annual installments, the first installment being due 3 years
following the date on which the 100 shares were transferred to A, December 27, 1984.

On January 20, 1984, A sold the 100 shares to an unrelated party for $50x. Corporation Z did not make any distributions with respect to the 100 shares at any time before the sale of those shares to the unrelated party.

LAW AND ANALYSIS

Under section 675(3) of the Code, a grantor will be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the trust corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year, unless the loan (1) provides for adequate interest, (2) is adequately secured, and (3) is not made by the grantor or by a related or subordinate trustee who is subservient to the grantor.

Section 1.675-1 of the Income Tax Regulations explains that, in effect, section 675 of the Code treats the grantor as the owner of a trust if under the terms of the trust instrument, or the circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Section 675(3) differs from the other provisions of section 675 which provide rules for determining grantor ownership of a trust, because it requires an affirmative act (borrowing) rather than a retained power, before it applies. Nevertheless, the same theme underlies section 675(3) as underlies the other provisions of section 675 which treat the grantor as owning the trust. In all of these cases the justification for treating the grantor as owner is evidence of substantial grantor dominion and control over the trust.

Section 1.671-3(a)(1) of the regulations states that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner. If the grantor is treated as the owner of a portion of a trust and that portion consists of specific trust property and its income, section 1.671-3(a)(2) provides that all items directly related to that property are to be taken into account in computing the grantor's income tax liability.

In this case, A has acquired control over and use of the entire trust corpus, the 100 shares of Corporation Z stock, in exchange for A's unsecured note. If A, instead of giving W a note in exchange for the 100 shares, had made a cash payment of $40x to W and subsequently borrowed that cash, giving W the unsecured note to evidence the borrowing, section 675(3) of the Code would be applicable and A would be the owner of T. Although A did not engage in this kind of direct borrowing, A's acquisition of the entire corpus of T in exchange for an unsecured note was, in substance, the economic equivalent of borrowing trust corpus. Accordingly, under section 675(3), A is treated as the owner of the portion of T represented by A's promissory note. Further, because the promissory note is T's only asset, A is treated as the owner of the entire trust.

Because A is treated as the owner of the entire trust, A is considered to be the owner of the trust assets for federal income tax purposes. See Ringwalt v. United States, 549 F.2d 89 (8th Cir. 1977), cert. denied, 432 U.S. 906 (1977); Estate of O'Connor v. Commissioner, 69 T.C. 165 (1977); Example 5, section 1.1001-2(c) of the regulations; Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 78-175, 1978-1 C.B.
Rev. Rul. 85-13, 1985-1 C.B.184

144; Rev. Rul. 77-402, 1977-2 C.B. 222; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 72-471, 1972-2 C.B. 201; Rev. Rul. 70-376, 1970-2 C.B. 164; Rev. Rul. 66-159, 1966-1 C.B. 162; but cf. Rev. Rul. 74-243, 1974-1 C.B. 106. In this case, A is considered to be the owner of the promissory note held by the trust. Therefore, the transfer of the Corporation Z shares by T to A is not recognized as a sale for federal income tax purposes because A is both the maker and the owner of the promissory note. 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. See Dobson v. Commissioner, 1 B.T.A. 1082 (1925).

A's basis in the shares received from T will be equal to A's basis in the shares at the time he funded T because the basis of the shares was not adjusted during the period that T held them. See Rev. Rul. 72-406, 1972-2 C.B. 462, a ruling involving the determination of a grantor's basis in property upon reversion of that property to the grantor at the expiration of a trust's term.

In Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), the court considered a transaction that is in substance identical to the facts described in this ruling. The court held that the grantor was the owner of a trust under section 675(3) of the Code because by exchanging an unsecured note for the entire trust corpus, the grantor had indirectly borrowed the trust corpus. The court held further, however, that although the grantor must be treated as the owner of the trust, this means only that the grantor must include items of income, deduction, and credit attributable to the trust in computing the grantor's taxable income and credits, and that the trust must continue to be viewed as a separate taxpayer. The court held, therefore, that the transfer of trust corpus to the grantor in exchange for an unsecured promissory note was a sale and that the taxpayer acquired a cost basis in the assets.

In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service. Accordingly, the Service will not follow Rothstein.

HOLDINGS

(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust
under section 675(3) of the Code.

(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets. Accordingly, when A sold the shares of Corporation Z stock on January 20, 1984, A recognized gain of $30x (amount realized of $50x less adjusted basis of $20x). Further, this holding would apply even if the trust held other assets in addition to A's promissory note if A, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because A would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction. See section 1.671-3(a)(2) of the regulations.
Respondent determined a deficiency of $27,618 in petitioners' Federal income tax for the taxable year 1978. The issues for decision are: (1) Whether section 1.1001-2(c), EXAMPLE (5), Income Tax Regs., should be declared invalid as an unwarranted extension of sections 671, 674 and 1001; (2) if the regulation is valid, whether the regulation should be applied retroactively; and (3) if the regulation is applied retroactively against petitioners, whether the gain recognized by petitioners should be treated as ordinary income or long-term capital gain.

This case was submitted fully stipulated pursuant to Rule 122. The stipulation of facts and the attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Petitioners Bernard and Joyce Madorin were residents of Chicago, Illinois at the time they filed their petition in this case. On December 19, 1975, Bernard Madorin (petitioner), as grantor, established four separate irrevocable trusts: the Miles Trust; the Mark Trust; the Melanie Trust; and the Bernard Descendant's Trust. The trust agreement designated Richard Coen (Coen) as the trustee of each of the four trusts. Coen was at all times a 'nonadverse party' as defined by section 672(b), Further, he was not a 'related or subordinate' party as defined by section 672(c). A provision in the trust agreement gave the trustee the power to add one or more section 501(c)(3) charitable organizations as beneficiaries to any of the trusts. As a result of this provision,
petitioner, the grantor, was treated as the owner of the four trusts pursuant to the provisions of section 674(a).

On or about December 19, 1975, petitioner funded each of the trusts with $5,075 in cash. Petitioners filed United States Quarterly Gift Tax Returns (Forms 709) with respect to the gifts. The $5,075 gift to each trust was its only funding.

On December 19, 1975, each of the four trusts contributed $5,010 to Metro Investment Company (Metro), an Illinois partnership. The trusts each acquired a one-ninth interest in Metro. On or about December 22, 1975, Metro contributed $45,000 to Saintly Associates (Saintly), a partnership involved in servicing the production of motion pictures. Of the $45,000 invested, approximately $20,000 was attributable to the contributions made by the four trusts. On October 17, 1975, Saintly had entered into an agreement with Warner Bros., Inc., to perform all services necessary to produce a motion picture. To finance the performance of these services, Saintly obtained a nonrecourse loan of $3,270,000 from Security Pacific National Bank.

On petitioners' 1975 through 1977 Federal income tax returns they reported the following losses and income from the four trusts:

```
1975 ... Loss . . . ($50,709.60)
1976 ... Loss ... (20,753.92)
1977 ... Income ... 1,544.28
```

On January 1, 1978, Coen, the trustee of the four trusts, irrevocably renounced his power to add beneficiaries to each trust. As a result, the trusts ceased to be grantor trusts and petitioner, the grantor, was no longer considered the owner of the trusts under section 674(a). Petitioners reported no gain or loss from the trusts on their 1978 return.

In August 1981 respondent sent petitioners a notice of deficiency. Relying on section 1.1001-2(c), EXAMPLE (5), Income Tax Regs. (hereinafter referred to as example 5 or the regulation), [FN3] respondent determined that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets, i.e., the partnership interests in Saintly via Metro, by the grantor to the four trusts. [FN4]

I. VALIDITY OF THE REGULATION.

Petitioners contend that example 5 is invalid as an unreasonable interpretation of sections 671, 674 and 1001. Petitioners argue that the grantor of a trust should be 'treated as the owner' only for the limited purpose of attributing to him items of income, deductions, and credits. This contention embodies petitioners' arguments that (1) the trust should be treated as the partner and owner of the partnership interest *671 and (2) the trust maintains a separate transactional identity. According to petitioners, the interpretation of 'owner' in example 5 to mean owner of the trust's assets is inconsistent with section 671. Respondent contends, however, that example 5 is a valid interpretation of the applicable statutory provisions. We agree with respondent.

It is well established that regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.' Commissioner v. South Texas Lumber Co., 333

We note, however, that Regulations must, by their terms and in their application, be in harmony with the statute. A regulation which is in conflict with or restrictive of the statute is, to the extent of the conflict or restriction, invalid.' Citizen's National Bank of Waco v. United States, 417 F.2d 675, 679 (5th Cir. 1969), quoting Scofield v. Lewis, 251 F.2d 128, 132 (5th Cir. 1958).

The Supreme Court has ruled that statutory terms should be given their 'usual, ordinary and everyday meaning.' Old Colony Railroad Co. v. Commissioner, 284 U.S. 552, 561 (1932). We agree with respondent's contention that defining 'owner * * * of a trust' under section 674 (and section 671) to mean owner of the trust's assets is consistent with the usual, ordinary and everyday meaning of the word. Application of the grantor trust provisions generally results in nonrecognition of the trust (or a portion thereof) as an entity separate from the grantor. See Estate of O'Connor v. Commissioner, 69 T.C. 165, 174 (1977).

Petitioners set forth several arguments toward establishing that 'owner' as defined in example 5 is inconsistent with the intended meaning of section 671. First, they appeal to the language of section 671. Section 671 states in part:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the *672 trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. * * *

Petitioners assert that the plain language of section 671 limits the attributes of ownership to the imputation of income, deductions, and credits only. We disagree. There is nothing on the face of the statute which tells us that that is the exclusive attribute of ownership. Section 671 specifies one result of being an 'owner,' but it does not specifically limit the meaning to that result.

Second, petitioners point to the legislative history of section 671. Petitioners assert that the Senate and House Committee Reports [FN5] indicate that Congress intended to limit the attributes of ownership to the reporting of income, deductions, and credits. Petitioners argue that the stated purpose for enacting sections 671 through 679 was to bring together 'the rules for determining taxability of trusts falling within the purview of section 22(a) as well as those covered by sections 166 and 167 (of the Internal Revenue Code of 1939) . . . .

[FN6] As such '(t)hese provisions generally adopt the approach of the (Clifford) regulations (and the two provisions of existing law). . . . '

[FN7] Petitioners state that prior to 1954, the existing grantor trust rules attributed only income to the grantor. They assert that congressional intent in using the word 'owner' was to remedy the preexisting condition by also allowing deductions, losses and credits attributable to the trust to flow through to the grantor's individual tax return along with the items of income.

We find petitioners' argument to be unpersuasive. The authorities cited in support of
petitioners' argument do not specifically state that 'owner' was used solely as a device to include items of deductions, losses, and other allowances. Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word 'owner,' we will apply the usual, ordinary and everyday meaning of the word.

Third, petitioners argue that a grantor trust maintains its existence as a transactional entity separate and distinct from its grantor for Federal income tax purposes. In support of their contention, petitioners direct us to several cases. Petitioners' reliance upon these cases is misplaced.

Petitioners rely heavily upon W & W Fertilizer Corp. v. United States, 527 F.2d 621 (Ct. Cl. 1975), in which the Court of Claims addressed the issue of whether a corporation's subchapter S status was automatically terminated when a shareholder transferred his stock into a grantor trust of which he was the grantor. The Commissioner contended that when the shareholder transferred his stock to the trust, the subchapter S election terminated because having a trust as a shareholder disqualified the corporation as a 'small business corporation.' The taxpayer, however, argued that a separate trust entity did not exist because the grantor was considered the 'owner' of the trust corpus. After examining the language of sections 671 and 1371(a) and their legislative history, the court held that 'ownership' extended only to the attribution of income, deductions, and credits from the trust.

In W & W Fertilizer Corp., the court rendered its decision on the basis of the congressional policy inherent in restricting the ownership of subchapter S corporations to individuals and estates. The intent was to provide a narrow benefit to certain classes of taxpayers. A specific requirement of form was established. Hence, when the grantor trust was examined, its specific form rather than the substance was accepted. The court wrote:

The 'grantor trust rules' treat the grantor as if he were the owner in cases where he has reserved to himself some of the powers normally attendant to outright ownership. Thus, their design is to expand the coverage of the taxing statute. On the other hand, Subchapter S was enacted as a remedial measure to relieve qualifying small business corporations of a tax otherwise payable. Section 1371(a)(2) limits the benefits of the Act to corporations whose stock is owned solely by individuals or estates. Where such a deliberately specific qualification is imposed, we must strictly apply it lest the narrow benefit intended by Congress be unduly broadened. Hence, the 'grantor trust rules,' with the very purpose of expansion, and the qualification requirements of section 1371(a), with their restrictive purpose, are not analogous, and their comparison is not supportive of the taxpayer in this case. (527 F.2d at 627-628.)

We, therefore, think that W & W Fertilizer Corp. has limited applicability. It is an exceptional example where form of ownership controls in order that congressional intent be carried out. We are not concerned in the instant case with a statute that requires that a specific form be satisfied. Moreover, the effect of the decision in W & W Fertilizer Corp. is not that the grantor is not considered the owner of the trust corpus for other tax purposes but that there is a disqualification from a benefit that was not intended to be bestowed upon a particular form of ownership.

Petitioners also cite Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975), affg. T.C. Memo. 1974-61, and Estate of O'Connor v. Commissioner, 69 T.C. 165 (1977). We agree with respondent, however, that these cases more...
aptly support respondent's position than that of petitioners.

In Swanson v. Commissioner, supra, life insurance policies on the grantor's life were transferred to grantor trusts for valuable consideration. The Commissioner contended that pursuant to section 101(a)(2) each of the trusts was required to recognize as gross income a proportionate amount of the proceeds of the policies that matured up on the grantor's death. The taxpayer claimed that the transfer was to the grantor/insured, and therefore, an exception to section 101(a)(2) had been met. At issue in Swanson was whether the trusts and the grantor/insured were the same entity per the definition of 'owner' under section 671. While this Court did not directly address this issue, the Eighth Circuit, in its affirmance of our opinion held that 'owner' under section 671 meant 'owner' in the legal sense of the word, and held that the policies had in fact been transferred to the grantor/insured. The Eighth Circuit declared:

*675 We cannot accept the government's contention that in this case Swanson, the grantor of the grantor-trusts, is not deemed the owner of the trusts for any purpose other than that of taxing trust income to him, and trusts, therefore, retain their identity as a separate tax entity under Section 101(a)(2)(B). (518 F.2d at 63.)

Estate of O'Connor v. Commissioner, supra, involved a testamentary marital trust in which the decedent's wife held certain rights which made the trust a grantor trust. Subsequent to the establishment of the trust, the decedent's wife assigned all of her interest in the trust to a section 501(c)(3) charitable foundation. One issue in Estate of O'Connor was whether the estate was entitled to a distribution deduction under section 661(a) for amounts passed through the marital trust to the foundation. The resolution of that issue turned upon whether the foundation/grantor should be treated as the 'owner'. If the foundation were treated as the 'owner,' then the trust entity would be ignored, and the estate would be deemed to have made its distributions directly to the foundation and not through the trust. This Court held that the trust was not a recognizable tax entity, and disallowed the estate's deduction. [FN10] In so holding we stated:

When a grantor or other person has certain powers in respect of trust property that are tantamount to dominion and control over such property, the Code 'looks through' the trust form and deems such grantor or other person to be the owner of the trust property and attributes the trust income to such person. See secs. 671, et seq. By attributing such income directly to a grantor or other person, the Code, in effect, disregards the trust entity. (69 T.C. at 174.)

Petitioners also rely upon Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), wherein the issues were whether the grantor of irrevocable trusts was (1) entitled to a new cost basis when he purchased shares of corporate stock from the trusts, which he originally contributed to the trusts, and (2) entitled to a deduction for interest paid to the trustee on the promissory note used to purchase the stock. The Commissioner contended that the step-up in basis and the interest deduction should be disallowed because the grantor/owner had in effect purchased the stock from himself and had paid interest to himself. The District Court held for the Commissioner, but the Second Circuit reversed. In reversing the District Court, the Second Circuit wrote:

Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/owners' be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself. (Footnote reference omitted.) Rather, the statute envisions (1) that the income and deductions of the grantor and
the trust will be computed in the normal fashion, the trust being treated as a fully independent tax-paying entity, and (2) that the relevant 'items of income, deductions, and credits against tax' that would ordinarily appear on the trust's return will instead 'be included in computing the taxable income and credits of the grantor.' * * * Consistently with the objective of Clifford to prevent high-bracket taxpayers from shifting income to low-bracket trusts over which they retain or exercise excessive controls, section 671 dictates that, when the grantor is regarded as 'owner,' the trust's income shall be attributed to him--this and nothing more. [735 F.2d at 709] (fn. ref. omitted.)

We need not comment on the result reached by the Second Circuit in Rothstein, nor on the rationale applied by the court in reaching such result. [FN11] In that case, the court was concerned with a trust while it was still in effect, and the court had to decide whether the tax consequences for the taxpayer-grantor were governed by the specific provisions of sections 671 et seq. or whether to apply the general doctrine that he was to be treated as the owner. The court concluded that those consequences were governed by the specific statutory provisions. Since the transaction at issue in that case was different from that at issue in this case, the court was not concerned with the validity of any regulations. However, the case before us involves a significantly different issue. Here, we must decide what are the tax consequences when a grantor trust is terminated as such. There are no specific statutory provisions relating to such a transaction, and we do have a Treasury regulation dealing specifically with the transaction. Under such circumstances, it is not at all clear that the Second Circuit would apply its rationale to those facts, and we believe that our case is entirely distinguishable.

*677 In the instant case there is an interplay between section 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of section 1001. These sections require the recognition of gain upon the sale or disposition of a partnership interest where the amount realized exceeds the adjusted basis of the partnership interest. The basis of a partnership interest includes the partner's share of partnership liabilities. Secs. 722 and 752. As the adjusted basis of the partnership interest is often reduced by partnership losses resulting from depreciation and other write-offs, the goal is to force a recapture upon disposition. This is accomplished by including as amounts realized liabilities previously included in basis. Crane v. Commissioner, 331 U.S. 1 (1947).

This scheme of taxation is frustrated here if petitioners are allowed to escape recapture through a formalistic, piecemeal application of the law. The trusts were created with a built-in defect, causing them to be grantor trusts. The trusts then invested in a limited partnership interest that produced significant paper losses for the grantor. At the 'cross-over' point, when the partnership began to generate income, the defect in the trusts was cured and the tax burden was placed on the lower bracket beneficiaries. A formalistic approach, as suggested by petitioners, would result in a finding that ownership never changed hands--since the trusts have technically been the owners of the partnership interests--which would then allow petitioners to escape recapture.

Although Edgar v. Commissioner, 56 T.C. 717 (1971), was not cited by either party, we think it necessary to comment upon that opinion in light of the instant case. In Edgar, we held that a grantor who was also the income beneficiary of a grantor trust could not be treated as the owner of the corpus portion of the trust. Accordingly, we held that the loss generated by a partnership interest owned by the trust was not deductible.
on the grantor's individual tax return, because the loss belonged to the corpus portion of the trust, while the grantor was owner only of the income portion. The key issue in Edgar was the definition of 'portion' in section 677. In Edgar we determined that under section 677 a grantor who was also an income beneficiary could only 'own' the income portion of the trust. We did not imply in Edgar that it was not possible to own the entire trust, i.e., income and corpus. Our previous cases presuppose this. See, e.g., Estate of O'Connor v. Commissioner, 69 T.C. 165 (1977); Swanson v. Commissioner, T.C. Memo. 1974-61, affd. 518 F.2d 59 (8th Cir. 1975). See also section 1.671-3(a)(1), Income Tax Regs. In the instant case, the trust became a grantor trust by virtue of section 674(a):

The grantor shall be 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.

Because the trustee, the nonadverse party, has a power of disposition over all of the corpus and income, the grantor must be considered owner of the whole trust, both income and corpus. Edgar, therefore, is distinguishable from the instant case.

Petitioners also contend that even if the grantor is the owner of the trust assets, a mere change in the trust's status is not a disposition triggering the recognition of gain. On brief petitioners argue that a sale or other disposition did not occur, noting that no transfer documents were ever executed, nor was there any other method of conveyance at the time of trust perfection. While this is true in form, a different event took place in substance.

The situation at hand is analogous to cases dealing with part-sale, part-gift transactions. Under section 1.1001-1(e), Income Tax Regs., if a transfer of property is in part a sale and in part a gift, the transferor must recognize gain to the extent his amount realized exceeds his adjusted basis in the property. This doctrine has been applied by the courts to situations where the transferred gift property is subject to a debt. To the extent the debt assumed by the transferee exceeds the transferor's adjusted basis in the property, a disposition is deemed to occur, and a corresponding gain must be recognized by the transferor. Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980), affg., 72 T.C. 780 (1979); Johnson v. Commissioner, 495 F.2d 1079 (6th Cir. 1974), affg., 59 T.C. 791 (1973). See Diedrich v. Commissioner, 457 U.S. 191 (1982). Here, the grantor's proportionate share of the partnership's nonrecourse liability exceeded his adjusted basis in the partnership interest. Therefore, a disposition is deemed to have occurred, and gain must be recognized.

Petitioners finally contend that, applying section 704(e) and section 1.704-1(e)(2), Income Tax Regs., to the facts of the instant case, the trustee of the four trusts is the 'partner' for purposes of subchapter K. Petitioners argue that since the grantor is not the partner for purposes of subchapter K, section 741, which governs the recognition of gain or loss by the 'transferor partner' in the case of a sale or exchange of the transferor's interest in a partnership, is not applicable in the instant case. Respondent contends that an examination of the ownership tests contained in section 1.704-1(e)(2), Income Tax Regs., is unnecessary and inappropriate in a grantor trust situation. Rather, respondent argues that section 671 et seq. (the grantor trust provisions) and the principle of substance over form result in the grantor being the owner of the partnership interest.

We do not agree with respondent's contention that an examination of the ownership test of the family partnership rules is inappropriate in a grantor trust situation. Section 1.671-1(c), Income Tax Regs., provides, in part, as follows:
Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. * * * NOR ARE THE RULES AS TO FAMILY PARTNERSHIPS AFFECTED BY THE PROVISIONS OF SUBPART E EVEN THOUGH A PARTNERSHIP INTEREST IS HELD IN TRUST. * * * (Emphasis added.)

In addition, this Court has noted that the language of section 704(e) is sufficiently broad to cover non-family partnership situations even though section 704(e) is primarily directed toward family partnerships. 'Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 126 footnote 4 (1977), citing Evans v. Commissioner, 54 T.C. 40, 51 (1970), affd. 447 F.2d 547 (7th Cir. 1971).

We do agree, however, with respondent that the grantor trust provisions result in the grantor being treated as the owner of the partnership interest. We do not accept petitioners' contention that the application of section 704(e) and the regulations thereunder overrides the grantor trust provisions and necessitates the opposite conclusion.

*680 We do not think that a detailed analysis of the interrelationship of the grantor trust provisions and section 704(e) nor a reconciliation of the various tax principles involved would be helpful in resolving the issues in this case. In general, we think that where there exists a complex arrangement of tiered partnership interests placed in a grantor trust, both subchapter K and subpart E of subchapter J are applicable. In computing income, deductions, and credits of the various taxpayers involved, subchapter K is applied to the partnerships and subpart E operates to tax the grantor on the income, deductions and credits. Thus, in general, the grantor is treated as the owner of the partnership interest for tax purposes. Application of section 704(e) and the regulations thereunder to conclude that the trustee rather than the grantor is the owner of the partnership interest under section 704(e) is ineffective to change this scheme of taxation [FN12] because section 704(e) does not operate to override subchapter E.

II. RETROACTIVE APPLICATION OF THE REGULATION.

Petitioners argue that if Example (5), is upheld, it should not be applied retroactively. Section 1.1001-2, Income Tax Regs., was promulgated on December 11, 1980, while the grantor trust in the instant case was perfected in 1978.

In the Treasury explanation accompanying the regulation, the government stated that the regulation would have retroactive effect by reasoning that 'these amendments merely clarify the existing regulations by setting forth the long-established ruling and litigating position of the Internal Revenue Service.' T.D. 7741, 1981-1 C.B. 430, 431. Petitioners dispute this by pointing out that while the rest of section 1.1001-2, Income Tax Regs., may represent the government's long-standing litigating position, example 5 does not. Petitioners argue that (1) no previous regulation addressed the issue; (2) in several previous cases [FN13] the government argued a position contrary to that taken in example 5; and (3) the only *681 pronouncement which treats the subject in the same manner as example 5 was promulgated only three years previously [FN14] --hardly a longstanding precedent.

Generally, regulations are applied retroactively unless the Secretary provides otherwise. See, 7805(b); Helvering v. Reynolds, 313 U.S. 428 (1941); Wendland v. Commissioner, 79 T.C.

We find no abuse of the Secretary's discretion in the instant case. This is not a case where the regulation in question alters settled prior law upon which the taxpayer justifiably relied and the alteration causes the taxpayer to suffer inordinate harm. See Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939); Wilson v. United States, 588 F.2d 1168, 1172-1173 (6th Cir. 1978). In fact, respondent's position on the issue in the instant case was published in Rev. Rul. 77-402, 1977-2 C.B. 222, in the year prior to the year in issue. Petitioners were thus aware of respondent's position at the time the trusts were perfected. Accordingly, we uphold the retroactive application of example 5.

III. CAPITAL GAIN VERSUS ORDINARY INCOME.

As previously noted, the trusts invested in Saintly via another partnership, Metro. Metro did not have any unrealized receivables or substantially appreciated inventory. Saintly, however, did have unrealized receivables. [FN15] As a result, respondent determined that the gain on the disposition of the partnership interest by petitioners should be taxed as ordinary income.

Petitioners argue that because the trusts' investments were in Metro, and not in Saintly directly, the disposition that occurred was a disposition of a partnership interest in Metro, not Saintly. Accordingly, they conclude that the gain should be taxed as capital gain and not ordinary income. We disagree.

Section 741 provides that in the case of a sale or exchange of an interest in a partnership, gain shall be recognized to the transferor and it shall be considered as gain from the sale or exchange of a capital asset, except as provided in section 751. Section 751(a) generally requires ordinary income treatment for the portion of the gain attributable to unrealized receivables or inventory items of the partnership. [FN16]

Legislative intent in enacting section 751 was to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests . . . . [FN17] It is clear that had petitioners invested directly in Saintly instead of using Metro as an intermediary, section 751 would have required ordinary income treatment. For purposes of the application of section 751, we see no reason to distinguish between a direct investment in Saintly and an indirect investment through the use of another partnership. To the contrary, to allow petitioners to escape ordinary income treatment would severely restrict the impact of section 751 in a tiered partnership context. Neither the language of sections 741 or 751, nor the applicable legislative history supports such a result. Accordingly, the gain on the disposition must be taxed as ordinary income. [FN18]

Decision will be entered for the respondent.

FN1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in question.

FN2 All Rule references are to the Tax Court Rules of Practice and Procedure.

FN3 Sec. 1.1001-2(c), EXAMPLE (5), Income Tax Regs., provides:

In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers
expressly retained by C, T is a 'grantor trust' for purposes of subpart E of part I of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a 'grantor trust.' However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 - $1,200).

FN4 Respondent claims petitioners' 1978 taxable income was understated by $49,919.24. (We view as irrelevant the $.76 difference between this amount and that shown in the schedule accompanying the notice of deficiency), Such amount was determined in the following manner:

Petitioners' share of Saintly's unrealized receivables via Metro ....................... [FN1]$52,320.00

Less:
Petitioners' adjusted basis in Saintly via Metro ... [FN2](2,400.00)

Petitioners' realized gain per sec. 1001 and regulations thereunder ..................... 49,919.24

FN1 Petitioners' share of Saintly's unrealized receivables via Metro was determined as follows:
$3,270,000 Saintly's liability in 1/1/78
x 3.6% Metro's interest in Saintly
x 4/9 Petitioners' interest in Metro

FN2 Petitioners' adjusted basis in Saintly via Metro was determined as follows:

\[
\begin{array}{r}
\text{Cash contribution} & \$20,000.00 \\
1975 loss & (50,709.60) \\
1976 loss & (20,753.92) \\
1977 income & 1,544.28 \\
\text{Partnership liability} & 52,320.00 \\
\hline
\end{array}
\]

\[
\begin{array}{r}
\text{Total} & 2,400.76 \\
\hline
\end{array}
\]


FN6 S. Rept. No. 1622, supra at 364; H. Rept. No. 1337, supra at A211.

FN7 S. Rept. No. 1622, supra at 86; H. Rept. No. 1337, supra at 63.

FN8 Petitioners cite the following authorities in support of their proposition: II American Law Institute Federal Income Tax Statute, secs. X850-X860 (Feb. 1954 draft), and accompanying explanations; Bittker, Federal Income, Estate and Gift Taxation, Ch. 80 (1981); Kamin, Surrey & Warren, 'The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries,' 54 Colum. L. Rev. 1237 (1954). Petitioners cite one passage from the accompanying explanations to the ALI reports which they believe to be conclusive of the legislative intent:

The various sections in this subpart provide that 'the grantor shall be treated as the owner' of certain portions of a trust. This seems to be the present rule, giving the grantor the trust's deductions. ** * * The Clifford Regulations, fail to provide that the grantor may take the trust's deductions. ** * *

The scope of the ownership rule is provided in section X850 (corresponding to section 671), which extends the rule to credits against tax, so that if a trust receives interest on partially tax-exempt bonds the grantor may use the credit which is provided by section X450. ** * *

(II American Law Institute Federal Income Tax Statute, supra at 452.) We do not find this to be conclusive or convincing proof that Congress intended to use the word 'owner' only for the purpose of attributing income, deductions, and credits to the grantor.

FN9 Prior to the Tax Reform Act of 1976, a trust was not permitted to be a shareholder of a subchapter S corporation under section 1371.

FN10 While we specifically limited our
analysis to an interplay between section 678 and other provisions of Subchapter J, 69 T.C. at 175, footnote 17, we believe that a similar analysis is appropriate in the instant case.


FN12 We noted this result in Krause v. Commissioner, 57 T.C. 890, 903 (1972), affd. 497 F.2d 1109 (6th Cir. 1974).

FN13 In W & W Fertilizer Corp. v. United States, 527 F.2d 621 (Cl. Cl. 1975), and Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975), affg. T.C. Memo. 1974-61, the Service argued that 'owner' under section 671 meant owner for purposes of income, deductions, and credits--the exact opposite of the position argued by the Service herein.

FN14 Rev, Rul. 77-402, 1977-2 C.B. 222, is essentially the same as section 1.1001-2(e), example (5), Income Tax Regs.

FN15 Petitioners do not contest respondent's determination that Saintly has unrealized receivables or their amount. We will, therefore, treat these issues that have not been raised by petitioners as conceded by them. Rule 34(b)(4).

FN16 Sec. 751(a). SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP.-- The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to, (1) unrealized receivables of the partnership, or (2) inventory items of the partnership which have appreciated substantially in value, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.


FN18 Under new section 751(f), which was added by the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 595, the result would be the same as we reach herein. Section 751(f), which is effective for distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date, is not applicable to the instant case. Also, the fact of its enactment does not in any way affect our disposition of this issue. See S. Prt. 98-169, Vol. I, at 240 (1984).
Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: September 1, 1995
May 31, 1995

Section 2512 -- Valuation of Gift

2512.00-00 Valuation of Gift


Legend

A = ***
B = ***
C = ***
D = ***
Stock = ***

Dear ***

This is in response to your letter dated April 20, 1995, and prior correspondence in which you requested rulings under §§ 671, 2036(a), 2512, 2701, and 2702 of the Internal Revenue Code.

In 1992, A established an irrevocable trust ("Trust") for the benefit of his three children. Trust provided for a separate share for the benefit of each of three children, B, C, and D. Under the terms of the Trust, the beneficiaries of each separate share include the named child, his or her spouse or unmarried surviving spouse, descendants, spouses and unmarried surviving spouses of descendants. A's wife and a bank are named trustees. The Trust establishes a "Protector" to review the performance of the trustees. A and his children can not serve as trustees or Protector.

A transferred assets to the three separate shares of Trust. Each child has also made transfers to his or her respective share. Pursuant to authority conferred upon the Trustees under Item Six of Trust, the trustees divided each share into two portions: one to hold assets transferred by A and one to hold assets transferred by the respective child. With respect to the second portion, the trustees have created a separate trust. Thus, each separate trust estate, consists solely of assets contributed by the respective child.
Each child proposes to sell Stock to his or her respective separate trust (RST). In return for the stock, each child will receive a promissory note from the RST. The trustees of the RST will pay interest for 20 years to each child. A balloon payment of principal will be paid at the end of 20 years. The notes will bear sufficient interest such that the loan will not be characterized as a below market loan under § 7872. The notes provide that payments of interest and principal may be paid in cash or property, but in no event shall any payments be made by promissory notes. The note issued by the RST will be secured by the stock transferred to the RST.

The trusts provide that the Trustees shall distribute to such of the beneficiaries of any such separate share thereof, as the Trustees shall designate, living on any distribution date, all or such amount or amounts of the net income and principal of such separate share as the Trustees shall from time to time determine to be appropriate for any reason whatsoever.

You have requested the following rulings on behalf of B, C, and D.

1. The RST will be considered a grantor trust under §§ 675 and 677. Accordingly, the sale of stock to the RST by the child will not be recognized for income tax purposes by virtue of § 671. Therefore, all items of RST income, deduction and credit will be included in the child's individual income tax returns. No capital gain arising from the sale will be recognized by the child. The trust will assume the child's basis in the Stock. The RST will not be entitled to a deduction for interest paid to the child and the child will not be required to include interest income from the notes in taxable income.

2. The fair market value of the notes issued in consideration for the purchase of stock by each RST will be for purposes of Chapter 12 of the Internal Revenue Code, the face amount of the notes. The sale will not be considered a gift to the extent the fair market value of stock transferred to the RST in exchange for the note does not exceed the face amount of the note.

3. The note issued by the RST to the child will not constitute applicable retained interests under § 2701.

4. Section 2702 is not applicable to the proposed transaction.

Ruling Request 1

Section 671 of the Code provides that where the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against the tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under Chapter 1 of the Code in computing taxable income or credits against the tax of an individual.

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

Section 677(a) of the Code provides in part that a grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such under § 674, whose income without the approval or consent
of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be
distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the
grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that, if a grantor is treated as the owner of an entire trust, the
grantor is the owner of the trust's assets for federal income tax purposes. Therefore, a transfer of assets
to the trust by the grantor who owns the entire trust is not recognized as a sale for federal income tax
purposes.

In the present case, each child will sell stock solely to his or her wholly owned trust (RST). Under
section 677(a) of the Code, each child is the owner of the RST of which he or she is the grantor. Each
child will be considered the owner of his or her respective RST for purposes of section 671 and shall
include in computing his or her taxable income those items of income, deductions, and credits against
tax which are attributable to his or her RST.

In accordance with the holding set forth in Rev. Rul. 85-13, we conclude that none of the children nor
their RST will recognize any gain or loss as a result of the transfers of stock to their RST. Each RST will
assume its respective child's basis in the stock transferred. Each RST will not be entitled to a deduction
for interest paid to the respective child, and each child will not include interest income from the notes in
his or her taxable income.

Ruling Request 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 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall
be considered the amount of the gift.

Section 25.2512-5A(d)(1)(i)(A) provides that, where a donor transfers property in trust or otherwise
and retains an interest therein, the value of the gift is the value of the property transferred less the value
of the donor's retained interest.

Section 1274(d)(1) provides that the applicable federal rate for a debt instrument with a term of over
nine years is the federal long-term rate.

Section 7520 provides that the valuation of annuities, interests for life, terms of years, and remainder
and reversionary interests is to be determined under tables published by the Internal Revenue Service
and based on a discount rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of
the applicable federal mid-term rate in effect under § 1274(d)(1) for the month in which the valuation
date falls.

Section 7872 is applicable to term loans made after June 6, 1984, and to demand loans outstanding
after that date. The section applies to "below-market" loans. A "below-market" loan, in the case of a
term loan (as defined in § 7872(f)(6)), is a loan where the amount loaned exceeds the present value of all payments due under the loan. Under § 7872(d)(2), a "gift loan" that is a below-market loan is recharacterized for gift tax purpose as a transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the amount loaned over the present value of all payments required to be made under the terms of the loan. A "gift loan" is a loan where the foregone interest is in the nature of a gift. Section 7872(f)(3).

Section 7872(f)(1) provides that the present value of any payment is determined by using a discount rate equal to the applicable federal rate as of the date of the loan. In the case of term loans, the applicable federal rate is the applicable federal rate in effect under § 1274(d), compounded semiannually, as of the date the loan is made. Section 7872(f)(2)(A). Following the amendment of § 1274(d) by § 101(b)(1) of the 1985 Imputed Interest Simplification Act, Pub.L. No. 99-121, 1985-2 C.B. 367, the Commissioner prescribes equivalent rates based on compounding periods other than semiannual compounding (for example, annual compounding, quarterly compounding, and monthly compounding), to facilitate application of § 7872 to loans other than those involving semiannual payments or compounding. See, Rev. Rul. 86-17, 1986-1 C.B. 377. Section 7872 generally does not apply to any loan to which section 483 or 1274 applies. Section 7872(f)(8).

In Frazee v. Commissioner, 98 T.C. 554 (1992), the Tax Court addressed the issue of whether, for gift tax purposes, the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by use of a discount rate prescribed under § 7872, or the safe-harbor rate provided under § 483(e). The court also considered the application of the rates prescribed under § 1274. The court concluded that § 7872 applied in determining the gift tax treatment of below-market loans regardless of whether the transaction involved a sale of property or a cash loan. The court reaffirmed its earlier position in Krabbenhoft v. Commissioner, 94 T.C. 887 (1990), aff'd 939 F.2d 529 (8th Cir. 1991), that § 483 does not apply for gift tax purposes. In concluding that § 1274 was not applicable in valuing the note for gift tax purposes, the court stated that § 1274 characterizes installment payments as principal or interest and, where stated interest is inadequate, it imputes interest. On the other hand, the court noted § 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of § 7872 is not limited to loans of cash. Rather, the term "loan" under § 7872 is broadly interpreted to include any extension of credit.

As noted above, for term loans, in determining whether a loan is a below-market loan, § 7872(f)(1) and (2) requires use of a discount rate equal to the applicable federal rate in effect under § 1274(d) on the date the loan was executed. Section 1274(d)(1)(A) uses the applicable federal long-term rate for debt instruments with a term of over nine years. Thus, in general, under § 7872, a promissory note for a term longer than nine years is not treated as a below-market loan if the interest rate on the note is equal to or higher than the applicable federal long-term rate, compounded semiannually.

In the present case, the stated interest rate on the notes will equal the rate prescribed by § 7872. Thus, we conclude that, if the fair market value of the stock transferred to the RST equals the principal amount of the note, the sale of stock to the RST will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the RST's ability to pay the notes is not otherwise in doubt.
Ruling Requests 3 & 4

Section 2701(a) provides that, solely for purposes of determining whether a transfer of an interest in a corporation or partnership 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 right--(A) that is described in §2701(b)(1)(A) or (B); and (B) that is with respect to any "applicable retained interest" that is held by the transferor or an applicable family member immediately after the transfer, shall be determined under §2701(a)(3).

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is--(A) a distribution right, but only if, immediately before the transfer described in §2701(a)(1), the transferor and applicable family members hold control of the entity or (B) a liquidation, put, call, or conversion right.

Section 25.2701-2(b)(1) of the Gift Tax Regulations provides that an applicable retained interest is an equity interest in a corporation or partnership that is either an extraordinary payment right or a distribution right.

Section 25.2701-2(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest.

Section 2702(a) provides that, for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a family 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)) shall be determined as provided in §2702(a)(2).

Under §2702(c)(1), the transfer of an interest in property with respect to which there is 1 or more "term interests" shall be treated as a transfer of an interest in trust.

Section 2702(c)(3) provides that the term "term interest" means--(A) a life interest in property, or (B) an interest in property for a term of years. See also, §25.2702-4(a).

Section 25.2702-2(a)(3) provides that the term "retained" means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

In this case, B, C, and D will sell Stock to their RST, and immediately afterwards, will hold debt. A debt instrument is not an applicable retained interest that is subject to the provisions of §2701. Therefore, we conclude that §2701 does not apply to these transactions.

In this case, B, C, and D will sell Stock to their RST. In exchange, they will receive debt. Under the facts presented here, the debt instrument involved is not a "term interest" within the meaning of §2702(c)(3) and the applicable regulations. Therefore we conclude that the valuation rules provided in §2702 do not apply to these transactions.

The above rulings (2-4) will be considered void if the promissory notes are subsequently determined to be equity or not debt. We express no opinion about whether the notes are debt or equity because that
determination is primarily one of fact (section 4.02(1) of Rev. Proc. 95-3, 1995-1 I.R.B. 85 (94). Nor do we express any opinion as to the collectibility of the notes.

Except as we have specifically ruled herein, we express no opinion about the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. Specifically, we are expressing no opinion regarding the application of § 2511 or 2702 to any other transfers to the RSTs. See, e.g. Rev. Rul. 77-378, 1977-2 C.B. 348. Additionally, we are expressing no opinion regarding the application of § 2036 to the transaction.

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

Sincerely,

Assistant Chief Counsel

(Passthroughs and Special Industries)

By: George Masnik

Chief, Branch 4

Enclosures

Copy for § 6110 purposes

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

END OF DOCUMENT
Estate of Anders Jordahl, Deceased, United States Trust Company of New York, and Wendell W. Forbes, Co-Executors, Petitioners v. Commissioner of Internal Revenue, Respondent

Case Information:

Code Sec(s): 
Docket: Docket No. 5651-73. 
Date Issued: 10/15/1975 
Judge: Opinion by TIETJENS, J. 
Disposition: Deficiencies redetermined.

HEADNOTE

1. ESTATE TAX—Revocable transfers—power to alter or amend—reservation of power to direct investment policy of trustee. Trust of securities and life insurance created on January 8, 1931 by decedent, who named himself a co-trustee, to pay himself the income for life with remainder over, not includable in his gross estate under Section 2038, even though he reserved the right to substitute property of equal value for the trust property. The power of substitution amounted to a power to direct investment policy; so it had to be exercised in good faith in accordance with fiduciary standards and couldn't be used to shift benefits in the trust. Neither could the power be used to deplete the trust since the substituted property had to be of equal value.

Reference(s): 1975 P-H Fed. ¶120,384.1(5); 120,384.7.

2. ESTATE TAX—Proceeds of life insurance—incidents of ownership. Proceeds of insurance policies on decedent's life that he transferred to trust he created and of which he was a co-trustee, not includable in his gross estate. His right to receive dividends as trustee wasn't incident of ownership. His right, as trustee, to borrow on the policies wasn't incident of ownership since he could borrow only to pay premiums if income was insufficient, and the possibility of income being insufficient was too remote to be considered an incident of ownership.


Syllabus

Official Tax Court Syllabus

On Jan. 31, 1931, decedent created a trust and named himself one of three trustees. The corpus of the trust included insurance policies on the decedent's life and other income-producing assets. The trustees were instructed to pay the premiums out of the assets of the trust and to pay over any remaining income to the decedent. At no time was income insufficient to pay the premiums. On his death his daughter was to receive the income until she reached age 50 at which time she was to receive the principal. The decedent retained the power to substitute securities, property...
nd policies "of equal value" for those transferred to the trust. Held: Decedent did not have the power to alter, amend or revoke the trust as defined under sec. 2038(a)(2), I.R.C. 1954, because his power of substitution was no greater than a settlor's power to direct investments. Nor were the insurance proceeds includable under sec. 2042(2), I.R.C. 1954, because the right to substitute other policies "of equal value" did not give him a right to the "economic benefits" of the policies and because his powers as trustee were strictly limited.

Counsel

Robert D. Whoriskey and Alfred Grotell, for the petitioners.

Marion L. Westen, for the respondent.

PINION

Letjens, Judge:

The Commissioner determined a deficiency of $310,891.80 in the Federal estate tax of Anders Jordahl (hereafter decedent).

The issue for decision is whether any of the assets, including the proceeds of insurance policies on decedent's life, held in a trust established by decedent are includable in decedent's gross estate under section 2038 or section 2042. 1

This case was fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The facts which we deem necessary for decision will be referred to below.

Petitioners are the executors under the will of decedent, who died a resident of Franklin Township, Somerset County, N.J. On the date of filing of the petition in this case, the legal residence of petitioner Wendell W. Forbes was Somerset, N. J. On that date, petitioner United States Trust Co. of New York maintained its principal address and place of business in New York, N. Y.

By agreement dated January 8, 1931, decedent, as donor, created a trust. The trust agreement designated decedent, Mary Dyas Jordahl (decedent's wife), and Guaranty Trust Co. of New York (now doing business as Morgan Guaranty Trust Co. of New York and hereafter referred to as Guaranty) as original trustees. Mary Dyas Jordahl died on June 25, 1967, and no successor trustee was appointed in her place. The first article of the agreement provided as follows:

FIRST: During the lifetime of the Donor, the Trustees shall pay the premiums which may become due and payable on the policies or any of them from the income of the trust or from cash seasonably furnished from time to time for that particular purpose by the Donor. In order to afford the Donor an opportunity to furnish cash seasonably for the payment of premiums should the income of the trust be insufficient for that purpose, the Trustees, if, in their opinion they will or may not have on hand sufficient income to pay a premium about to fall due, shall give to the Donor notice in writing to that effect; to effect the continued payment of the premiums on the policies, the Trustees are authorized in their discretion to retain in their hands an undistributed balance of cash income in such amount as may seem to them necessary. Should the income of the trust be insufficient or should the Donor fail to furnish cash seasonably to pay the premiums of all the policies, then the Trustees at their sole and unrestricted option and for the purpose of obtaining funds with which to pay premiums on any policy, may sell, at public or private sale, without notice to the Donor or to any other person, property and securities other than the policies constituting the principal of the trust, may borrow upon the policies or any of them or as the assignee of any policy, may exercise options for automatic application of loan provisions to the payment of future premiums, it being understood that said methods of obtaining funds are permissible only and not mandatory upon the Trustees and the Donor hereby expressly releases the Trustees from all liability for failure to avail themselves of said methods or any of them and from the consequences of such failure. The Trustees are authorized in their sole discretion to select from time to time the policies for the payment of premiums on which money actually available shall be applied in the event that premiums of all the policies may not be provided for. Unless the income of the trust or unless cash seasonably furnished by the Donor shall be sufficient to enable the Trustees to pay such premiums, the Trustees shall be under no obligation to pay them nor to see that payment is made by the Donor or otherwise and the Trustees shall be under no liability to anyone in case such premiums are not paid nor...
for any result of the failure to make such payments. The Trustees shall be responsible for the proceeds of
the policies only when, as and if collected by or paid to them and the Trustees shall not be liable to any
one if for any reason whatsoever the policies or any of them shall lapse or be otherwise uncollectible
unless such lapse or uncollectibility results from the negligence of the Trustees in failure to pay premiums
out of the income of the trust actually in hand or out of cash actually in hand and seasonably furnished
for that particular purpose by the Donor. In the event that after the payment of premiums on the policies
and the retention of the balance of income in suitable amount there shall be a further balance of income
remaining, the Trustees shall distribute such balance remaining to the Donor.

The second article vested the trustees with all right, title and interest in the policies and authorized them to "exercise
and enjoy all options, rights and privileges therein and beneficial interests thereunder as fully and effectually as the
donor might have done." Decedent reserved any disability benefits under the policies. There were no provisions for
disability benefits under the life insurance policies owned by the trust.

The fourth article of the trust provided, in part:

FOURTH: The Trustees shall receive and hold the proceeds of the policies as well as the proceeds of any
other policies which may hereafter be made subject to the terms hereof upon the uses and trusts and for
the purposes herein set forth ***

Under the sixth article of the agreement, "Upon the death of the Donor, the Trustees *** [were to] hold, manage,
invest and reinvest the proceeds of any insurance policies which come into their hands and the securities and other
property constituting the trust fund" to pay income to Helen Jordahl Prescott until she should have attained the age of
50, at which time the trustees were to "transfer, assign and pay over the principal of said trust" to her. If she were to
die before she reached 50, the remainder was to go to her issue or, if none, to the donor's residuary estate or heirs.

The ninth article provided:

NINTH: The Donor hereby expressly reserves the privilege of depositing with or making payable to the
Trustees under this agreement additional [pg. 95]policies of insurance on Donor's life and of substituting
other policies of equal value for those at any time on deposit with the Trustees hereunder, and such
additional or substituted policies shall be subject in all respects to the terms of this agreement.

The Donor further expressly reserves the privileges of depositing with the Trustees under this agreement
any additional securities or property and the right to substitute other securities or property for those at
any time on deposit with the Trustees hereunder, provided that the securities or property so substituted
shall be of equal value to the securities and/or property so replaced and such additional securities and/or
property shall be subject in all respects to the terms of this agreement.

Other relevant articles provided as follows:

NINETEENTH: The trust hereby created shall be deemed to be a New York trust and shall in all respects
be governed by the laws of the State of New York.

TWENTY-SECOND: The Donor hereby declares this trust to be irrevocable.

Pursuant to the agreement, decedent transferred to the trust securities which had an aggregate inventory value of
82,353.75 and four life insurance policies on decedent's life. The four policies consisted of the following:

Northwestern Mutual Life Insurance Company, Policy No. 2117951, for $50,000, issued on November 5,
1928, maturing at death, annual premium $2,420.50.

Northwestern Mutual Life Insurance Company, Policy No. 2117952, for $50,000, issued on November 5,
1928, maturing at death, annual premium $2,420.50.

Equitable Life Assurance Society of the United States, Policy No. 1596861, for $5,000, 20-year payment
issued on May 10, 1909, fully paid up.

Northwestern Mutual Life Insurance Company, Policy No. 1394342, for $5,000, 20-year endowment

1/23/2007
The terms of the policies held in trust on the date of decedent's death provided that the owner had the right to change beneficiaries, to determine the application of dividends, to assign the policies, to borrow against them, to elect certain options on surrender or lapse, and to determine and change the manner in which proceeds were to be paid.

During decedent's lifetime no additional policies were deposited with the trustees nor were any substitutions of policies made. On February 28, 1940, the trustees surrendered the 20-year endowment policy, issued by Northwestern Mutual, which had matured on February 4, 1940.

Income from property owned by the trust was far in excess of the premiums payable plus other administrative expenses. Distributions of excess income were made to decedent in each year of the trust's existence except for 1933 through 1936 and aggregated $214,891.51. The value of the property owned by the trust was $691,099.08 including he proceeds of the insurance policies as of decedent's date of death.

The Commissioner determined that all of the trust assets, including the proceeds of the insurance policies, were includable in decedent's gross estate. He argues that section 2038(a)(2) requires the inclusion in decedent's gross estate of all of the assets held by the trust at decedent's death. He also argues that, under section 2042(2), at least he proceeds of the policies are includable in decedent's gross estate.

The Commissioner apparently rests his determination that all of the trust assets are includable in decedent's gross estate on decedent's power, under the ninth article of the trust agreement, to substitute securities, property, and policies for those transferred to the trust in the first place. The Commissioner argues that decedent could have exchanged property with the trust so as to "alter, amend, or revoke" the trust within the meaning of section 2038(a)(2).

We do not believe that decedent's power to substitute property was a power to "alter, amend, or revoke" the trust. The trust agreement specifically provided that any property substituted should be "of equal value" to property replaced. Decedent was thereby prohibited from depleting the trust corpus. Compare: Commonwealth Trust Co. of Pittsburgh v. Driscoll, 50 F.Supp. 949 (W.D. Pa. 1943), aff'd. per curiam 137 F.2d 653 (3d Cir. 1943), cert. denied 321 U.S. 764 (1944); and Chandler v. Commissioner, 119 F.2d 623 (3d Cir. 1941), affg. 41 B.T.A. 165 (1940). See Fifth Ave. Bank of New York v. Nunan, 59 F.Supp. 753, 757 (E.D. N.Y. 1945).

This Court and others have considered cases involving settlors who have retained the power to direct trustees as to investments, and, where settlors have been bound to act in good faith and in accordance with fiduciary standards, the retained powers over investment have not been treated as powers to alter, amend, or revoke. Estate of Ralph Budd, 19 T.C. 468, 476 (1968); Estate of James H. Graham, 46 T.C. 415, 429 (1966); Estate of Willard V. King, 37 T.C. 173, 981 (1962); Estate of Henry S. Downe, 2 T.C. (pg. 97 967 (1943); Estate of George W. Hall, 6 T.C. 933 (1946); United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Fifth Ave. Bank of New York v. Nunan, supra. See also United States v. Byrum, 408 U.S. 125 (1972).

Decedent's power to substitute property "of equal value" would modify or alter the trust no more than those powers to direct investments involved in the cases cited above. Moreover, like the settlors involved in those cases, decedent was bound by fiduciary standards. Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of "equal value" indicates that the power was held in trust. Carrier v. Carrier, 226 N.Y. 114, 123 N.E. 135 (1919); Application of Esty, 75 N.Y.S. 2d 905 N.Y. County Sup. Ct. 1947); Heyman v. Heyman, 33 N.Y.S. 2d 235 (N.Y. County Sup. Ct. 1942); Osborn v. Bankers Trust Co., 158 Misc. 392, 5 N.Y.S. 2d 211 (N.Y. County Sup. Ct. 1938); Stix v. Commissioner, 152 F.2d 562, 563 (2d Cir. 1945), affg. 4 T.C. 1140 (1945); 1 Restatement of Trusts 2d, sec. 185.

The Commissioner argues that decedent could, through substitution, institute investment in highly productive property to deprive the remaindermen of benefits or, similarly, in unproductive property to deprive an income beneficiary of property. We do not believe that decedent could have used his power to shift benefits in such a manner. Substitutions resulting in shifted benefits would not be substitutions of property "of equal value." In Estate of Willard V. King, supra at 980, we considered New York law and an argument similar to that proposed by the Commissioner:

Under these circumstances we think that although the decedent, under his broad discretionary powers with respect to investment, might invest in properties producing either a high or a low return of income, such powers would have to be exercised in good faith in accordance with his fiduciary responsibility and could not be used for the purpose of attempting to favor any beneficiary or class of beneficiaries to the

https://checkpoint.riag.com/servlet/com.tta.checkpoint.servlet.CPJSPServlet?usid=c5e3f1fbd46&StyleSh...

1/23/2007
detriment of the other beneficiaries. [2]

The Commissioner also contends that, when, on occasion, decedent waived his right to income and commissions, both of which, the Commissioner argues, were required to be paid, decedent altered or amended the trust. [3] We do not believe that the 20 article required the trustees to accept commissions, for it states merely that the trustees are "entitled" to commissions. In any event, we believe that any waiver of commissions or right to income may be treated as the deposit of additional property authorized by the ninth article of the agreement. Since decedent was authorized to add property to the trust, his leaving cash in the trust may not be seen as a violation of the agreement or an amendment "in fact." [4]

The Commissioner's review of the trust's history serves no meaningful function. We are not convinced on this record that decedent and Guaranty engaged in any improper investments that may be construed as de facto amendment of the trust. And we find no evidence that decedent's dealings with the trust involved substitutions for less than equal value.

Under the first article of the agreement, the trustees, including decedent, were given power to sell and pledge property and policies and were released from liability for failure to do so in the event that the trust income and payments by decedent were insufficient to pay policy premiums. We need not consider whether decedent might have utilized that power and release from liability to alter effectively the trust, for income was never insufficient to pay premiums and, accordingly, decedent never held the discretionary power. Sec. 20.2038-1(b), Estate Tax Regs.; Estate of Ralph Budd, 49 T.C. 468, 474 (1968); Estate of Frederick M. Kasch, 30 T.C. 102 (1958); Daisy Christine Patterson, Executrix, 36 B.T.A. 407 (1937). See also Estate of Lena R. Arents, 34 T.C. 274, 281 (1960), revd. on another issue 297 F.2d 894 (2d Cir. 1962), cert. denied 369 U.S. 848 (1962).

Nevertheless, the Commissioner asserts that, even if the securities and other property in the trust are not includable in decedent's gross estate, the proceeds of the three insurance policies are includable under section 2042(2). We have examined those powers and rights decedent had with respect to the policies and conclude that, at his death, he did not possess any "incidents of ownership" within the meaning of that section.

As trustee, decedent received dividends on the policies, and, as beneficiary, decedent was entitled to those dividends not used as income to pay premiums. However, it is well established that, since dividends "are nothing more than a reduction in the amount of premiums paid," the right to dividends is not an incident of ownership. Estate of Chester H. Bowers, 23 T.C. 911, 917 (1955). See also Estate of Newcomb Carlton, 34 T.C. 986, 996 (1960), revd. on another issue 298 F.2d 415 (2d Cir. 1962); Estate of Louis J. Dorson, 4 T.C. 463 (1944); D. W. Blacksher et al., Executors, 38 B.T.A. 998, 1005 (1938).

As trustee, decedent's powers over the policies were strictly limited under the first article of the agreement. [5] In the event that income was not available and cash was not furnished by decedent, the trustees, "at their sole and unrestricted option," were authorized to sell property other than the policies and to "borrow upon the policies or any of them or as the assignee of any policy, *** [to] exercise options for the automatic application of loan provisions to the payment of future premiums." If the income of the trust and cash furnished by the decedent were limited, the trustees could select which policies to maintain. Such use of the policies was not mandatory, and, unless the income of the trust or the cash furnished by the decedent was sufficient, the trustees were under no obligation to pay premiums. [pg. 100]

We do not see how decedent's power under that first article may be termed an incident of ownership. Income from the trust was never insufficient to pay premiums on the policies, and, accordingly, decedent never "possessed" the power to exchange the cash surrender value of the policy for other property in which he would have had an income interest. Compare Estate of Myron Selznick, 15 T.C. 716 (1950), affd. per curiam 195 F.2d 735 (9th Cir. 1952). The possibility that income might have been insufficient, a possibility which decedent, as a fiduciary, could not effectuate, seems too remote to be considered an incident of ownership which decedent possessed. See Estate of Newcomb Carlton, 34 T.C. at 998. See also, Estate of Walter Dawson, 57 T.C. 837, 841 (1972), affd. without published opinion 480 F.2d 917 (3d Cir. 1973). [6]

As we construe the trust agreement, decedent, as trustee, had no other power with regard to the insurance policies. Under the fourth article, the trustees were required to "receive and hold the proceeds of the policies," and, under the sixth, the trustees were required to "hold, manage, invest and reinvest the proceeds of any insurance policies which

https://checkpoint.riag.com/servlet/com.tta.checkpoint.servlet.CPJSServlet?usid=c5e3f1bd46&StyleSh...
ome into their hands" along with the other property of the trust. We are not convinced that, under these directions, the trustees could exercise options as to the payment of proceeds, especially in light of the requirement of the sixth article, section 1, that, when Helen Jordahl Prescott shall have attained the age of 50 years, the trustees must "pay over the principal of said trust to *** [her], absolutely and forever."

As we construe the agreement, decedent, as trustee, retained none of the incidents of ownership mentioned by the Commissioner in his briefs or his Estate Tax Regulations, sections 20.2042-1(a)(2) and 20.2042-1(c)(4): decedent could not assign the policies, and he had no power to change the beneficial ownership or beneficiaries or to determine the manner of payment of proceeds. He could have borrowed on the policies or elected options on surrender or lapse only if income was insufficient to pay premiums, but income was, in fact, always sufficient.

Finally, the Commissioner argues that decedent's reservation of "the privilege of *** substituting other policies of equal value[pg. 101] for those at any time on deposit with the trustees" allowed decedent to reacquire full ownership of the policies in the trust. We cannot imagine, and the Commissioner does not suggest, a way in which decedent could have reacquired a policy in the trust without substituting an almost identical policy, for the requirement of equal value would seem to demand equal cash surrender and face value, comparable premiums, and a similar form of policy. Decedent's power to reacquire was, in effect, a power to exchange at arm's length. Decedent could not have deprived any beneficiary of an interest or have increased his own share in the trust or in the policies. Decedent may have had the power to reacquire specific policies, but he did not, until reacquisition, possess incidents of ownership in them, for any reacquisition would have required the surrender of nearly identical policies and of nearly identical incidents. To recover any of the benefits of the policies, decedent would have had to surrender comparable benefits. Certainly such power, in effect to purchase the policies, cannot be considered an "incident of ownership." And certainly the possession of such a right to substitute cannot be seen as a right to the "economic benefits of the policy." Sec. 20.2042-1(c)(2), Estate Tax Regs. See also Estate of Hector R. Skifter, 56 T.C. 1190, 1197 (1971), affd. 168 F.2d 699 (2d Cir. 1972). Any substitution of policies would have had no substantive effect on the respective rights of decedent and the other beneficiaries in the trust and its assets. Accordingly, we hold that decedent's power to substitute policies "of equal value" cannot be considered an incident of ownership.

Decision will be entered under Rule 155.

All statutory references are to the Internal Revenue Code of 1954 unless otherwise stated.

2]

It is true that decedent was the income beneficiary of the trust during his life, but we note that Helen Jordahl Prescott was also a potential income beneficiary and that, under certain conditions, her issue would be entitled to income and not principal until they were 21. We therefore assume that decedent's fiduciary obligation not to reduce the income of the trust would have been enforced. However, even if decedent could have invested without limitation in less productive assets, we should not consider such a power subject to sec. 2038. Any investment in less productive assets and decedent's waiver of his income rights should be construed as a transfer by decedent of a portion of his income interest to the succeeding income beneficiaries and remaindermen. In other words, at most, decedent reserved a power to alienate a portion of his income interest.

We do not understand the Commissioner to argue that the power to augment the trust is a power to alter or amend the trust and we see no reason to so hold. See 3 Mertens, Law of Federal Gift and Estate Taxation, sec. 25.14, p. 647 (1959). Even where a trustee is not explicitly authorized to receive additional property from a settlor, according to at least one commentator, he may receive such property. 1 Scott, Trusts 406 (3d ed.). See Uniform Trustees' Powers Act, sec. 3(c)(2). See also In Re Rausch's Will, 258 N.Y. 327, 179 N.E. 755 (1932); Wells Fargo Bank & Union Trust Co. v. Superior Court, 32 Cal. 2d 1, 193 P.2d 721 (1948). Decedent's fiduciary obligations would have prohibited him from using such a power to shift interests in property already in the trusts. Carlton's Estate v. Commissioner, 298 F.2d 115, 417-418 (2d Cir. 1962), revg. 34 T.C. 988 (1960), which is factually distinguishable from the instant case but, discusses those fiduciary restrictions which, under New York law, would limit decedent's power.
Although the Commissioner and petitioners apparently agree that sec. 2036(b) prohibits the inclusion of all of the assets of the trust under sec. 2036(a), we note that later additions to the trust may be subject to sec. 2036(a). See, for example, Estate of James L. Thomson, 58 T.C. 880 (1972), affd. 495 F.2d 246 (2d Cir. 1974).

The broad powers contained in the policies themselves and transferred under the second article of the agreement are, we believe, limited by the terms of the agreement. See the concurring opinion in Carlton's Estate v. Commissioner, 298 F.2d at 420. See also Estate of Bert L. Fuchs, 47 T.C. 199 (1966); Estate of Sidney F. Bartlett, 54 T.C. 1590, 1597-1598 (1970).

We do not consider whether such a possibility should be treated as a reversionary interest under sec. 2042(2), for neither party has raised the question or given us guidance in determining the value of such possibility.
Reportable and list transactions—transactions of interest—potential for abuse and tax avoidance—toggling grantor trusts.

Headnote:

IRS issued guidance on new transactions it is designating “of interest” as potentially abusive/tax avoidance under new “reportable transaction” regulatory scheme. Subject transactions involve those using grantor trust, and purported termination and subsequent re-creation of grantor trust status, for purposes of creating tax loss greater than any actual economic loss sustained and avoiding gain recognition. Transactions same or substantially similar to those described are also identified as “of interest” for purposes of Reg § 1.6011-4(b)(6) and Code Sec. 6111; and Code Sec. 6112; effective 8/14/2007. Persons entering same, and material advisors making tax statement with respect thereto, on or after 11/2/2006, are subject to disclosure and list maintenance requirements.

Reference(s): ¶ 61,115.01(30); ¶ 61,125.01(10); Code Sec. 6111; Code Sec. 6112;

Full Text:

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that uses a grantor trust, and the purported termination and subsequent re-creation of the trust's grantor trust status, for the purpose of allowing the grantor to claim a tax loss greater than any actual economic loss sustained by the taxpayer or to avoid inappropriately the recognition of gain. The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction. This notice identifies this transaction, and substantially similar transactions, as transactions of interest for purposes of § 1.6011-4(b)(6) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code. This notice also alerts persons involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

Facts

In one variation of the transaction, Grantor purchases four options. The value of each one of the options is expected to move inversely in relation to at least one of the other options over a relevant range of values so that, before expiration of any one of the options, there will be a gain in two options (gain options) and a substantially offsetting loss in the other two options (loss options). Grantor creates Trust and funds Trust with the options and a small amount of cash. Grantor gives a short-term unitrust interest in Trust to Beneficiary and retains a noncontingent remainder interest in Trust. The remainder interest is structured to have a value as...
determined under § 7520 that equals the fair market value of the options. Grantor takes the position that
Grantor's remainder interest is a qualified interest under § 2702. Because of the retained remainder interest,
Grantor treats Trust as a trust owned by Grantor under subpart E ( § 671 and following), part I, subchapter J,
chapter 1 of the Code (a grantor trust). The trust agreement also provides that Grantor will have the power,
exercisable in a nonfiduciary capacity, to reacquire Trust corpus by substituting other property of an equivalent
value (the substitution power) and that this substitution power will become effective on a specified date in the
future. See § 675(4).

After establishing and funding Trust, Grantor sells the remainder interest in Trust to an unrelated person
(Buyer) for an amount equal to the fair market value of the remainder interest (which is equal to the fair
market value of the options). Grantor claims that the basis in the remainder interest is determined by
allocating to the remainder interest a portion of the basis in all of the Trust assets (based on the respective fair
market values of the remainder and unitrust interests at the time of the sale). Therefore, Grantor claims there
is no gain recognized on the sale of the remainder interest because Grantor's basis in the remainder interest is
the same as the amount realized (prearranged to be equivalent to the fair market value of the options). Buyer
gives Grantor an installment obligation (Note), cash, or other consideration for the remainder interest. Grantor
claims that the sale of the remainder interest has terminated (toggled off) the grantor trust status of Trust so
that, during the period after the sale and before the effective date of the substitution power, Trust is no longer
a grantor trust under § 671.

Grantor claims that, once the substitution power becomes effective, Trust's grantor trust status is restarted
(toggled on). The loss options are then closed out. The amount Grantor paid for those options (the original
basis of those options) is greater than the amount Trust receives when the loss options are closed out. Grantor
claims that Trust's status as a grantor trust causes Grantor to recognize the loss on the two loss options.
Grantor calculates the loss based on the difference between the amount realized and the original basis in the
loss options, even though Grantor previously used a portion of the basis in the Trust assets (equivalent to the
basis in all of the options) to eliminate Grantor's gain on the sale of the remainder interest. Trust's remaining
assets then consist of the two gain options, the contributed cash, and amounts received, if any, upon the
termination of the loss options.

Buyer then purchases the unitrust interest in Trust from Beneficiary for an amount equal to the actuarial value
of that interest (which equals or approximates the amount of cash Grantor contributed to Trust), making Buyer
the owner of both the remainder interest and the unitrust interest. Trust then terminates (by operation of law
or Buyer's action), and Trust's assets are distributed to Buyer. Buyer claims a basis in the assets (the gain
options and the cash) from Trust equal to the amount paid by Buyer for the two separate interests in Trust.
Grantor does not treat the termination of Trust as a taxable disposition by Grantor of the assets of Trust.

The gain options are exercised or sold, or otherwise terminate, and Buyer claims to recognize gain on the gain
options only to the extent that the amount realized exceeds the basis Buyer allocates to the gain options. The
transaction has been structured so that any gain recognized would be minimal. If Buyer purchased the
remainder interest from Grantor with a Note, Buyer uses the proceeds from the options to pay the Note. If
Grantor borrowed to purchase the options, Grantor repays the loan from the Note proceeds.

In another variation of the transaction, the facts are the same as described above except for the following.
Grantor contributes to Trust liquid assets such as cash or marketable securities, rather than options. Grantor's
basis in the contributed assets equals or is approximately equal to the fair market value of the assets at the
time of contribution. Before the specified date on which Grantor's substitution power becomes effective,
Grantor sells the remainder interest in Trust to Buyer for an amount equal to the fair market value of the
remainder interest and claims to recognize no gain or a minimal gain or loss for the same reason as described
above. As in the prior variation, Grantor claims that the sale terminates (toggles off) Trust's grantor trust
status. After the substitution power becomes effective, Grantor substitutes appreciated property for Trust's
liquid assets. The fair market value of the substituted property is equivalent to the fair market value of the
liquid assets. Grantor claims that, once the substitution power becomes effective (prior to the exchange),
Trust's grantor trust status is restarted (toggled on), and, therefore, the substitution will not cause Grantor to
recognize gain.

As described above, Buyer purchases the unitrust interest in Trust from Beneficiary, terminates Trust, and

receives Trust's assets on distribution. For tax purposes, Grantor does not treat the termination of Trust as a
disposition by Grantor of the appreciated assets in Trust. Buyer claims a basis in the assets of Trust (the
appreciated property and cash) equal to the amount paid by Buyer for the interests in Trust.

One of the purported tax consequences of the first variation of the transaction is that Grantor sells the
remainder interest and receives an amount substantially equal to the fair market value of the (non-cash)
assets contributed to Trust but nevertheless claims a tax loss attributable to those assets even though Grantor
has not suffered an equivalent economic loss. One of the purported tax consequences of the second variation
of the transaction is that Grantor avoids the recognition of gain on the disposition of the appreciated assets
substituted for the original assets contributed to Trust.

These transactions usually occur within a short period of time during the taxable year (typically within 30
days), and, in each case, Grantor claims that the termination and subsequent reestablishment of grantor trust
status, combined with the series of events regarding Trust's assets, result in tax consequences that could not
be achieved without both the toggling off and on of grantor trust status. The transactions in this notice, as
described above, do not include the situation where a trust's grantor trust status is terminated, unless there is
also a subsequent toggling back to the trust's original status for income tax purposes.

Transaction Of Interest

Effective Date

Transactions that are the same as, or substantially similar to, the transactions described in this notice are
identified as transactions of interest for purposes of §1.6011-4(b)(6) and §6111 and 6112 effective August
14, 2007, the date this notice was released to the public. Persons entering into these transactions on or after
November 2, 2006, must disclose the transaction as described in §1.6011-4. Material advisors who make a tax
statement on or after November 2, 2006, with respect to transactions entered into on or after November 2,
2006, have disclosure and list maintenance obligations under §§6111 and 6112. See §§1.6011-4(h) and §§
301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations.

Independent of their classification as transactions of interest, transactions that are the same as, or
substantially similar to, the transaction described in this notice may already be subject to the requirements of
§§6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have
gathered enough information to make an informed decision as to whether this transaction is a tax avoidance
type of transaction, the IRS and Treasury Department may take one or more actions, including removing the
transaction from the transactions of interest category in published guidance, designating the transaction as a
listed transaction, or providing a new category of reportable transaction.

Participation

Under §1.6011-4(c)(3)(i)(E), Grantor, Buyer, and Beneficiary are participants in this transaction for each year
in which their respective tax returns reflect tax consequences or a tax strategy described in this notice.

Time for Disclosure

See §1.6011-4(e) and §301.6111-3(e).

Material Advisor Threshold Amount

The threshold amounts are the same as those for listed transactions. See §301.6111-3(b)(3)(i)(B).

Penalties

Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the
penalty under §6707A. Persons required to disclose these transactions under §6111 who fail to do so may be
subject to the penalty under § 6707(a). Persons required to maintain lists of advisees under § 6112 who fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662 or § 6662A.

Drafting Information

The principal author of this notice is Tolsun N. Waddle of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Waddle at (202) 622-3070 (not a toll-free call).

END OF DOCUMENT -
© 2007 Thomson/RIA. All rights reserved.
Private Letter Rulings

Private Letter Ruling 200730011, 07/27/2007, IRC Sec(s). 671

UIL No. 674.00-00; 678.00-00

Trusts—grantor trusts—power to control beneficial enjoyment—person other than grantor treated as substantial owner.

Headnote:

Grantor is treated as owner of both trusts under Code Sec. 674(a); and Code Sec. 678(b); where sole trustee/grantor's spouse has power to withhold any distribution of principal for distribution at later time to current income beneficiary. So, grantor's taxable income and credits will include all items of income, deductions, and credits against tax of both trusts under Code Sec. 671; .

Reference(s): Code Sec. 671; Code Sec. 674; Code Sec. 678;

Full Text:

Number: 200730011

Release Date: 7/27/2007

Third Party Communication: None

Date of Communication: Not Applicable

Index Number: 674.00-00; 678.00-00

Person To Contact: [Redacted Text]

[Redacted Text], ID No. [Redacted Text]

Telephone Number: [Redacted Text]

Refer Reply To:

CC: PSI:B03

Attachment 8

Dear [Redacted Text]:

This letter responds to your letter dated June 25, 2006, and subsequent correspondence requesting a ruling that Trust 1 and Trust 2 are grantor trusts under § 671 of the Internal Revenue Code.

Facts

The information submitted states that on Date 1, A created Trust 1 for the benefit of C, and Trust 2 for the benefit of D (collectively Trusts). B, A's spouse, is the sole trustee of Trusts (Trustee).

Article III of Trusts provides, in part, that in each calendar year the beneficiary has the power to withdraw from the trust estate amounts (not to exceed the annual gift tax exclusion) added thereto during the calendar year except for additions made by will or other testamentary disposition and by a custodian for the beneficiary. The withdrawal power is not cumulative from year to year but must be exercised within thirty days after the Trustee's mailing of notice of transfer of assets to the trust estate.

Paragraph 4.1 of Article IV of Trusts provides, in part, that the Trustee shall distribute one-third of the principal at age thirty, one-half of the principal balance at age thirty-five and the remainder of the principal at age forty to the beneficiary. Until the beneficiary attains age twenty-five, the Trustee may pay to or for the beneficiary's benefit as much principal or net income as the Trustee deems necessary or proper in its sole discretion for the support, health, maintenance, and education of the beneficiary. After the beneficiary attains age twenty-five, the Trustee shall pay the entire net income to the beneficiary in quarter annual or more frequent installments, and the Trustee shall pay to or for the beneficiary's benefit as much principal as the Trustee deems necessary or proper in its sole discretion for the support, health, maintenance and education of the beneficiary.

Paragraph 4.5 of Article IV of Trusts provides, in part, that notwithstanding the other provisions in Article IV, B, in her sole and unfettered discretion may direct the Trustee during her lifetime or in her Last Will and Testament to (i) distribute all or any part of the net income for the benefit of the current income beneficiary sooner than otherwise provided in Article IV, (ii) withhold any distribution of net income and accumulate such net income for distribution at a later time to the current income beneficiary as part of the principal of the trust estate, (iii) distribute all or any part of the principal to or for the benefit of the current income beneficiary sooner than otherwise provided in Article IV, or (iv) withhold any distributions of principal for distribution at a
later time to the current income beneficiary.

**LAW AND ANALYSIS**

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual. Section 672(a) provides for purposes of subpart E, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

Section 672(e)(1)(A) provides that a grantor shall be treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest.

Sections 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as owner of a portion of a trust.

Section 674(a) provides that the grantor shall be 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)(5)(A) provides that § 674(a) shall not apply to a power to distribute corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument.

Section 674(b)(6) provides that § 674(a) shall not apply to the power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable (A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternative takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or creditors of his estate, or (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) the person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Section 678(b) provides that § 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under the provisions of subpart E other than § 678.

Section 1.671-3(b)(3) of the Income Tax Regulations provides, in part, that a grantor includes both ordinary income and other income allocable to corpus in the portion the grantor is treated as owning if the grantor is treated under § 674 or § 676 as an owner because of a power over corpus which can affect income received within a period such that the grantor would be treated as an owner under § 673 if the power were a reversionary interest.
CONCLUSION

Under the terms of Trusts, B, A's spouse, has the power to withhold any distribution of principal for distribution at a later time to the current income beneficiary. Therefore, we conclude that A is treated as the owner of the entire Trust 1 and the entire Trust 2 under §§ 674(a) and 678(b). Accordingly, there shall be included in computing the taxable income and credits of A all items of income, deductions, and credits against tax of Trust 1 and Trust 2 under § 671.

Except as expressly provided herein, we express or imply no opinion concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion on the federal tax consequences of an intended merger of Trusts and on whether other trusts involved in the contemplated merger are grantor trusts for federal tax purposes.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

Sincerely,

/s/

Mary Beth Collins
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

A copy of this letter

A copy for § 6110 purposes

END OF DOCUMENT -
© 2007 Thomson/RIA. All rights reserved.

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: February 10, 2006
          October 24, 2005

Section 2033 -- Property in Which Decedent Had an Interest

2033.00-00 Property in Which Decedent Had an Interest

Section 2036 -- Transfers With Retained Life Estate (Included v. Not Included in Gross Estate)

2036.00-00 Transfers With Retained Life Estate (Included v. Not Included in Gross Estate)

Section 2038 -- Revocable Transfers (Included v. Not Included in Gross Estate)

2038.00-00 Revocable Transfers (Included v. Not Included in Gross Estate)

Section 2512 -- Valuation of Gift

2512.00-00 Valuation of Gift

Section 677 -- Income for Benefit of Grantor

677.00-00 Income for Benefit of Grantor

Section 678 -- Person Other Than Grantor Treated as Substantial Owner

678.00-00 Person Other Than Grantor Treated as Substantial Owner

CC:PSI:04-PLR-123436-05

Re:

Legend:

Grantor =

Spouse =

Trust =
Dear ***:

This is in response to a letter dated April 27, 2005, in which you requested rulings concerning the federal estate, gift and income tax consequences of the retention and proposed exercise of a power to substitute Trust assets, as described below.

The facts are submitted and represented to be as follows: On Date, Grantor established an inter vivos, irrevocable trust (Trust). Trust was funded with cash and marketable securities. Trustee is not a descendant of Grantor and is not otherwise related or subordinate to Grantor within the meaning of § 672(c) of the Internal Revenue Code.

Article 1, Section 1.1A of Trust provides that during Grantor's life, the trustee may distribute as much income and principal of Trust to Spouse as the trustee determines for any reason not prohibited by the trust agreement. If Grantor is not living, the trustee shall distribute to Spouse as much trust property as trustee determines for her health, maintenance and support and may distribute as much additional trust property as trustee determines for any reason not prohibited by the trust agreement. Any income not distributed within 65 days of the end of a calendar year shall be added to principal.

Under Section 1.1B of Article 1, Spouse has the power, exercisable during her lifetime, to appoint trust property to any one or more of Grantor's issue, in such amounts or proportions and upon such terms, conditions or trusts as Spouse determines. However, in no event may Trustee make a distribution that is in lieu of any obligation of Spouse to support any person.

Article 1, Section 1.2 provides that at Spouse's death, the trustee shall distribute the trust property to any one or more persons or entities, excluding Spouse's creditors, Spouse's estate and the creditors of Spouse's estate, in such amount or proportions and upon such terms, conditions or trust as Spouse appoints by will. The trustee shall distribute any unappointed trust property to Grantor's issue, per stirpes. If none of Grantor's issue is then living, the trustee will distribute the trust property equally among those of Grantor's siblings who are then living or to the issue, per stirpes, of any sibling who is then deceased.

Article II provides, generally, that Spouse shall have the right to withdraw an amount equal to the value of each qualifying contribution. A qualifying contribution is a contribution of principal from Grantor to the trust to the extent that, when added to all prior contributions from Grantor during the calendar year, the total does not exceed the lesser of (i) the amount of annual exclusion from gift tax prescribed under section 2503(b), or the corresponding provisions of any future internal revenue law then available to Grantor with respect to Spouse for such calendar year and (ii) the maximum amount that may lapse under section 2514(e) and 2041(b)(2) without constituting the release of a general power of
appointment. Contributions that are not qualifying contributions are excess contributions. Upon the receipt of a qualifying contribution, the trustee shall give Spouse notice of Spouse’s right to withdraw. The right to withdraw terminates upon the expiration of 30 days after the receipt of such notice.

In accordance with Article VI, Sections 6.1 and 6.3, Trustee has the power to invest, dispose of and otherwise deal with property in Trust, in his sole and absolute discretion, without the approval or consent of any other person.

Article VII, Section 7.7 of Trust provides that Grantor may acquire any or all property constituting Trust principal by substitution of other property of equivalent value to the property acquired, measured at the time of substitution. The instrument provides that Grantor’s power to acquire Trust property under this section may only be exercised in a fiduciary capacity. Action in a fiduciary capacity is defined as action that is undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law.

Grantor proposes to exercise his power of substitution under Section 7.7, as follows. Grantor will transfer shares of B, a publicly traded company, to Trust in exchange for shares of C (also a publicly traded company), that are currently held in Trust. In addition, to the extent necessary, Grantor either will transfer to Trust, or withdraw from Trust, cash or cash equivalents in an amount necessary such that the total value of the assets Grantor is transferring to Trust will be equal to the total value of the assets Grantor is acquiring from the Trust incident to the substitution. It is represented that the value of the B stock and the C stock subject to the exchange, will be determined in accordance with section 25.2512-2(b)(1) of the Gift Tax Regulations.

Grantor requests the following rulings:

1. The retention by Grantor of the power of substitution will not cause the property of Trust to be included in Grantor’s gross estate under §§ 2033, 2036(a), 2036(b), 2038 or 2039.

2. The exercise by Grantor of the power of substitution as proposed will not constitute a gift to Trust by Grantor, for federal gift tax purposes.

3. Trust is a grantor trust under § 671 in its entirety with respect to Grantor.

4. Neither Grantor nor Trust will recognize any income or loss by reason of the exercise of the power of substitution.

Ruling Request 1

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides that the value of the gross estate shall include 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 the 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 fact 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 from the property.

Section 2036(b) provides in part that (1) for purposes of § 2036(a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property and (2) for purposes of § 2036(b)(1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of § 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

Section 2037(a) provides that the value of the gross estate shall include 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, if (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

Section 2038(a)(1) provides that the value of the gross estate shall include 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 adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death.

Section 2039 provides that the value of the gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement if, under such contract or agreement, an annuity or other payment was payable to the decedent during life.

In Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1, under the terms of an inter vivos trust created by the decedent, the decedent reserved the power to substitute other securities or property for those held by the trustee, provided that the property substituted was of equal value to the property replaced. The court held that the decedent's reserved power to substitute other securities or property of equal value was not a power to alter, amend or revoke the trust within the meaning of § 2038(a)(2). Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust, and thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.
In the instant case, under Article VII, Section 7.7, Grantor has retained the power to acquire Trust property by substituting other property of equivalent value to the property acquired, measured at the time of substitution. Under the terms of Trust, the Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity.

Based solely on the facts and representations submitted, we conclude that the retention by Grantor of the power of substitution, as described above, will not cause the property of Trust to be included in Grantor's gross estate under § § 2033, 2036(a), 2036(b), 2038 or 2039.

Ruling Request 2

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 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 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

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 is deemed to be a gift and is included in computing the amount of gifts made during the calendar year. However, under § 25.2512-8 of the Gift Tax Regulations, a transaction which is bona fide, at arm's length, and free from any donative intent will be considered as made for an adequate and full consideration in money or money's worth.

Under § 25.2512-1, the value of property, for gift tax purposes, is the price at which such property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Section 25.2512-2(b)(1) provides that, in general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond.

In the instant case, under the terms of Trust, Grantor may substitute property of equivalent value for Trust property. Grantor proposes to transfer shares of B stock to Trust in exchange for shares of C stock that are currently held in Trust. It is represented that the value of the B stock and the C stock subject to the proposed exchange will be determined in accordance with § 25.2512-2(b)(1) of the Gift Tax Regulations as of the date of the exchange. In addition, to the extent necessary, Grantor either will transfer to Trust, or withdraw from Trust, cash or cash equivalents in an amount necessary such that the total value of the assets Grantor is transferring to Trust will equal the total value of the assets Grantor is acquiring from the Trust incident to the substitution. Based solely on the facts and representations submitted, we conclude that the exercise by Grantor of the power of substitution, as described above, will not constitute a gift to Trust by Grantor for federal gift tax purposes.

Ruling Requests 3 and 4
Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 672(e)(1)(A) provides that the grantor shall be treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest.

Section 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as owner of a portion of a trust.

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

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Section 678(b) provides that § 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom § 679 applies) is otherwise treated as the owner under the provisions of subpart E other than § 678.

Rev. Rul. 85-13, 1985-1 C.B. 184, provides that if a grantor is treated as the owner of the entire trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes.

The power granted to Spouse to withdraw amounts contributed to Trust will result in Spouse being treated as the owner of the portion of Trust subject to her withdrawal power, unless as provided in § 678(b), Grantor is treated as the owner.

Under the terms of Trust, both income and corpus are payable to Spouse during Grantor's life. Accordingly, Grantor is treated as the owner of Trust under § 677(a). Because Trust is a grantor trust under § 677 with respect to Grantor, it is a grantor trust in its entirety with respect to Grantor notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under § 678. Accordingly, all items of income, deductions, and credits against tax of Trust are included in computing the Grantor's taxable income and credits.

In addition, because Grantor is treated as the owner of the entire Trust, the proposed transfer of assets of Trust to grantor in exchange for other assets will be disregarded for federal income tax purposes.
Therefore, in accordance with Rev. Rul. 85-13, neither Grantor nor Trust will recognize any income or loss under § 61 or § 1001 by reason of Grantor's exercise of the substitution power.

Any ruling contained in this letter is 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 the ruling, it is subject to verification on examination.

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

The 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.

Sincerely,

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

Enclosure: Copy for section 6110 purposes

cc

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

END OF DOCUMENT
Legend

A =

B =

C =

Trust =

State1 =

State2 =

Foundations =

Dear:

This responds to a letter dated October 28, 2005, submitted on behalf of A, A's father B, and A's brother C by their authorized representative, requesting rulings under §§ 671 and 2501 of the Internal Revenue Code.

FACTS
According to the information submitted, on D1, A, a resident of State1, executed Trust, which is governed by the laws of State2. A State2 corporate trustee is appointed as trustee.

Article 4.1 of Trust provides that during the lifetime of A, the trustee shall pay over or apply such sums of net income and principal, including all or none thereof, as (a) the Distribution Committee by unanimous agreement shall appoint, or (b) A and one member of the Distribution Committee by unanimous agreement shall appoint, to or for the benefit of one or more members of the "Class." The "Class" is defined in Article 3.3 as consisting of A, A's spouse (if and when A marries), A's father B, A's mother, any descendant's of A's father or mother, including A's descendants, A's brother C, any descendants of C, and any Qualified Charity (defined as an organization described in §§ 170(c), 2055(a) and 2522(a)). Any net income not so paid over or applied shall be accumulated and added to the principal of Trust at least annually and thereafter shall be held, administered and disposed of as a part of the Trust corpus.

Article 4.2 provides that upon the death of A, the residue of the Trust, after providing for payment of estate taxes, is to be distributed in accordance with A's exercise of a limited testamentary power to appoint the Trust property. A may exercise the power in any valid manner provided that: (a) the power may not be exercised in favor of A, A's estate, A's creditors or the creditors of A's estate; and (b) A must expressly refer to and exercise the power in a valid will or codicil in order for the appointment to be effective. A may, at any time and from time to time during A's life, by a written, acknowledged instrument delivered to the trustee, release the power of appointment with respect to any or all of the property subject to the power or may further limit the persons or entities in whose favor or the extent to which the power may be exercised.

Trust provides that if, or to the extent that, A does not effectively exercise A's power of appointment, the residue of Trust is to be distributed as follows: (a) if B and C survive A, then one half to each of them outright and free of trust, or 100% to the survivor; or (b) if neither B nor C survive A, then to A's descendants who survive A, per stirpes. If none of A's descendants are then living, then the residue is to be distributed to Foundations in a specified order, or if none of the Foundations are then in existence, to Qualified Charities to be selected by the trustee.

Article 8.1 provides that the Distribution Committee shall initially consist of B and C. During A's lifetime, there shall always be two members of the Distribution Committee, each of whom must be an adult member of the Class; provided that (1) neither A nor A's spouse may be a member of the Distribution Committee; and (2) if there are less than two competent adult individual members of the Class, a parent or guardian (other than A or A's spouse) of any member of the Class who is a minor or not a competent adult may serve as a member of the Distribution Committee. In the event that either B or C predeceases A, then A's oldest living descendant who is not a
member of the Distribution Committee shall become the successor member of the Distribution Committee. If no living descendant of A is able to serve, the surviving member of the Distribution Committee is to appoint a successor. Neither A nor any member of the Distribution Committee shall exercise the powers of appointment granted under Article 4 in a fiduciary capacity and none of them shall be deemed to be a fiduciary owing any fiduciary duties to themselves or any other person.

The following rulings have been requested:

1. So long as the Distribution Committee is serving, no portion of the items of income, deductions, and credits against tax of Trust shall be included in computing the taxable income, deductions, and credits of A under § 671.

2. The contribution of property to Trust by A will not be a completed gift subject to federal gift tax.

3. Any distribution of property from Trust to A by the Distribution Committee will not be a completed gift subject to federal gift tax.

Ruling 1

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 672(a) provides, for purposes of subpart E, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

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

Section 673(a) provides that the grantor shall be treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 674(a) provides, in general, that the grantor shall be 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) shall 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.

Under § 675 and applicable regulations, the grantor is treated as the owner of any portion of a trust if, under the terms of the trust agreement or circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust.

Section 676(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of part I, subchapter J, chapter 1, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 677(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Based solely on the facts and representations submitted, we conclude an examination of Trust reveals none of the circumstances that would cause A to be treated as the owner of any portion of Trust under §§ 673, 674, 676, or 677.

We further conclude that an examination of Trust reveals none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of A under § 675. Thus, the circumstances attendant on the operation of Trust will determine whether A will be treated as the owner of any portion of Trust under § 675. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office with responsibility for such examination.

**RULINGS 2 AND 3**

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(b) of the Gift Tax Regulations provides that a gift is complete as to any property with respect to which the donor so parted with dominion and control as to leave the donor with no power to change the disposition of the property, whether for the donor’s own benefit, or for the benefit of another. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

Section 25.2511-2(b) provides an example where the donor transfers property in trust to pay the income to the donor, or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor’s descendants. The regulation concludes that no portion of the transfer is a completed gift. However, if the donor had not retained a testamentary power of appointment, but had instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift.

Section 25.2511-2(f) provides that the relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by death of the donor, is regarded as the event which completes the gift and causes the gift tax to apply. See also, Estate of Sanford v. Commissioner, 308 U.S. 39 (1939).

Section 2514(b) provides that, in the case of a power of appointment created after October 21, 1942, the exercise or release of the general power of appointment shall be deemed a transfer of property by the individual possessing such power.

Section 2514(c) provides that the term “general power of appointment” means a power exercisable in favor of the individual possessing the power, the individual’s estate, the individual’s creditors, or the creditors of the individual’s estate.

Section 25.2514-1(c)(1) provides that a power of appointment is not a general power if by its terms it is exercisable only in favor of one or more designated persons or classes other than the possessor or his creditors, or the possessor’s estate or the creditors of the estate.

Section 2514(c)(3)(B) provides that, in the case of a power of appointment created after October 21, 1942, which is exercisable by the possessor only in conjunction with another person, if the power is not exercisable by the possessor except in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to the exercise of the power in favor of the possessor, then the
power is not a general power of appointment. For purposes of § 2514(c)(3)(B), a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the possessor's power.

Section 25.2514-3(b)(2) provides that a co-holder of a power of appointment has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y.

Section 25.2514-1(b)(2) provides that the term “power of appointment” does not include the powers reserved by a donor to himself or herself. However, no provision of § 2514 or the applicable regulations is to be construed as limiting the application of any other Code section or provision of the regulations.

In this case, A has retained a limited testamentary power to appoint the Trust corpus and accumulated income to any persons (other than A's estate, etc.). In view of this retained power, A's transfer of property to Trust will not be a completed gift subject to federal gift tax. See § 25.2511-2(b).

In addition, B and C, as members of the Distribution Committee, have the power to distribute Trust income and corpus to themselves. However, B's power can only be exercised with the consent of C, or with the consent of A, and C's power can only be exercised with the consent of B, or with the consent of A. Further, on the death of either B or C, the deceased's power will devolve to the surviving Committee member and A jointly (and a new committee member will be appointed). Therefore, B and C will not have a general power of appointment by reason of the joint distribution power. See § 25.2514-3(b)(2). Accordingly, during the period the Distribution Committee consists of B and C, neither B nor C will be treated as making a taxable gift if Trust income or corpus is distributed to A under the terms of Trust.
Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to the taxpayers' authorized representative.

Sincerely,

Audrey W. Ellis
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for section 6110 purposes
Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: March 24, 2006
November 23, 2005

Section 2501 -- Imposition of Gift Tax (Imposed v. Not Imposed)

2501.00-00 Imposition of Gift Tax (Imposed v. Not Imposed)

2501.01-00 Gift v. Not a Gift

Section 671 -- Trust Income, Deductions, and Credits Attributable to Grantors and Others As Substantial Owners

671.00-00 Trust Income, Deductions, and Credits Attributable to Grantors and Others As Substantial Owners

CC:PSI:B02
PLR-134405-05
X =
Y =
Z =
Individual Beneficiary =
Trust =
State 1 =
State 2 =
D1 =

Dear ***:

This letter responds to a letter dated June 23, 2005, submitted on behalf of X, Y, and Z by their authorized representative, requesting rulings under §§ 671 and 2501 of the Internal Revenue Code.

Attachment 11
The information submitted states that X, a resident of State 1, executed Trust on D1, which is governed by the laws of State 2 and has a State 2 corporate trustee.

Paragraph 2.1 of Trust provides that during the lifetime of X, any property that is directed to be held in accordance with the terms and conditions set forth in Article Second shall be held by the trustee, in trust, nevertheless, in a separate trust for the following uses and purposes: to manage, invest and reinvest the same, to collect the income thereof, and to pay over or apply the net income and principal thereof to such extent, if any, including the whole thereof, and in such amounts and proportions, including all to one to the exclusion of the others, and at such time or times as (a) the Power of Appointment Committee by unanimous agreement shall appoint, or (b) X and one member of the Power of Appointment Committee by unanimous agreement shall appoint, to or for the benefit of such one or more members of the class consisting of X, Y (X's sibling), Z, X's descendants, Individual Beneficiary, and a named private foundation (Foundation) (if it is a qualified charitable organization) until the death of X. Any net income (which may be the whole of such income) not so paid over or applied shall be accumulated and added to the principal of Trust at least annually and thereafter shall be held, administered and disposed of as a part thereof.

Paragraph 2.2 provides that upon the death of X, the principal of Trust under Paragraph 2.1 of Article Second, as it is then constituted, and any accumulated accrued and undistributed income, shall be transferred, conveyed and paid over to such person or persons (other than X, X's estate, X's creditors and the creditors of X's estate) to such extent, in such amount or proportions, and in such lawful interests or estates, whether absolute or in trust, as X may appoint by last will and testament by specific reference to this power. X may, at any time and from time to time during X's life by a written, acknowledged instrument delivered to the trustee, release such power of appointment with respect to any or all of the property subject to such power or may further limit the persons or entities in whose favor or the extent to which this power may be exercised.

If the power of appointment is for any reason not effectively exercised in whole or in part, by X, the principal of Trust, as it is then constituted, to the extent not effectively appointed by X upon X's death, shall be disposed of as follows: (a) the lesser of (1) 10% of the principal of Trust, as it is then constituted, together with any accumulated, accrued, and any undistributed income, to the extent not effectively appointed by X upon X's death, or (2) two million dollars shall be transferred, conveyed, and paid over to the Foundation, if it is then in existence and a qualified charitable organization; and (b) the balance of the principal of Trust, as it is then constituted, together with any accumulated, accrued, and any undistributed income, to the extent not effectively appointed by X upon X's death, shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for X's named current spouse (Spouse), if Spouse is then living, one such share for each child of X who is then living, and one such share for the collective descendants who are then living of any child of X who is not then living. From each such share so set aside for the collective descendants who are then living of any child of X who is not then living there shall be set aside per stirpital parts for such descendants. Each child who is then living for whom a share is set aside and each descendant who is then living of a child of X who is not then living for whom a per stirpital part is set aside is referred to as a "primary beneficiary." The share set aside for Spouse, if Spouse is then living shall be transferred, conveyed, and paid over to Spouse. The share or part of a share set aside for a primary beneficiary shall be held in a separate trust in accordance with the terms and conditions set forth in Article Third of Trust. If Spouse is not then living
or is not then married to X, and no descendant of X is then living, the balance of the principal of Trust, as it is then constituted, together with any accumulated, accrued, and any undistributed income, to the extent not effectively appointed by X upon X's death, shall be disposed of in accordance with the terms and conditions set forth in Article Fourth of Trust.

Article Fourth provides that any property that is directed to be disposed of in accordance with the terms and conditions set forth in Article Fourth shall be divided into shares for the benefit of certain named individuals and Foundation (if it is then in existence and a qualified charitable organization) as provided therein.

Paragraph 12.4 provides that the Power of Appointment Committee shall initially consist of Y and Z. At all times, at least two persons who are beneficiaries under Trust (other than X, Spouse, or any successor spouse of X), or who are parents or guardians (other than X, Spouse, or any successor spouse of X) of such beneficiaries if there are less than two adult beneficiaries, shall be members of the Power of Appointment Committee. In the event that either Y or Z shall die before the death of X, Individual Beneficiary shall become the successor member of the Power of Appointment Committee. If any additional member of the Power of Appointment Committee dies before the death of X, the then eldest living descendant of X who is not a member of the Power of Appointment Committee shall become the successor member of the Power of Appointment Committee. Any member of the Power of Appointment Committee shall exercise the power of appointment granted under Article Second only in a non-fiduciary capacity and shall manifest any exercise of the power of appointment granted under Article Second by an acknowledged instrument in writing delivered to the trustee.

You have requested the following rulings:

1. So long as the Power of Appointment Committee is serving, no portion of the items of income, deductions, and credits against tax of Trust shall be included in computing the taxable income, deductions, and credits of X under § 671.

2. The contribution of property to Trust by X will not be a completed gift subject to federal gift tax.

3. Any distribution of property from Trust to X by the Power of Appointment Committee will not be a completed gift subject to federal gift tax.

RULING 1

Section 671 provides that where it is specified in subpart E of part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 672(a) provides, for purposes of subpart E, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting 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 673(a) provides that the grantor shall be treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 674(a) provides, in general, that the grantor shall be 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) shall 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.

Under §675 and applicable regulations, the grantor is treated as the owner of any portion of a trust if, under the terms of the trust agreement or circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust.

Section 676(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of part I, subchapter J, chapter 1, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 677(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under §674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Based solely on the facts and representations submitted, we conclude an examination of Trust reveals none of the circumstances that would cause X to be treated as the owner of any portion of Trust under §§673, 674, 676, or 677.

We further conclude that an examination of Trust reveals none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of X under §675. Thus, the circumstances attendant on the operation of Trust will determine whether X will be treated as the owner of any portion of Trust under §675. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office with responsibility for such examination.

RULINGS 2 AND 3
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(b) of the Gift Tax Regulations provides that a gift is complete as to any property with respect to which the donor has so parted with dominion and control as to leave the donor with no power to change the disposition of the property, whether for the donor's own benefit, or for the benefit of another. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

Section 25.2511-2(b) provides an example, where the donor transfers property in trust to pay the income to the donor, or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor's descendants. The regulation concludes that no portion of the transfer is a completed gift. However, if the donor had not retained a testamentary power of appointment, but had instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift.

Section 25.2511-2(c) provides that a gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title in himself or herself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Under § 25.2511-2(e), a donor is considered as possessing a power if it is exercisable by the donor in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property.

Section 25.2511-2(f) provides that the relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by death of the donor, is regarded as the event which completes the gift and causes the gift tax to apply.

In Estate of Sanford v. Commissioner, 308 U.S. 39 (1939), the taxpayer created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust in whole or in part, and to designate new beneficiaries other than himself. Six years later, in 1919, the taxpayer relinquished the power to revoke the trust, but retained the right to change the beneficiaries. In 1924, the taxpayer relinquished the right to change the beneficiaries. The Court held that a donor's gift is not complete, for purposes of the gift tax, when the donor has reserved the power to determine those others who would ultimately receive the property. Accordingly, the Court concluded that the taxpayer's gift was complete in 1924, when he relinquished his right to change the beneficiaries of the trust.

Section 2514(b) provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing such power.
Section 2514(c) provides that the term "general power of appointment" means a power exercisable in favor of the individual possessing the power, the individual's estate, the individual's creditors, or the creditors of the individual's estate.

Section 25.2514-1(c)(1) provides that a power of appointment is not a general power if by its terms it is exercisable only in favor of one or more designated persons or classes other than the possessor or his creditors, or the possessor's estate or the creditors of the estate.

Section 2514(c)(3)(B) provides, that in the case of a power of appointment created after October 21, 1942, which is exercisable by the possessor only in conjunction with another person, if the power is not exercisable by the possessor except in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to the exercise of the power in favor of the possessor -- such power shall not be deemed a general power of appointment. For purposes of § 2514(c)(3)(B), a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the possessor's power.

Section 25.2514-3(b)(2) provides, in part, that a co-holder of a power of appointment has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a co-holder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y. See also, Rev. Rul. 79-63, 1979-1 C.B. 302, holding that the co-holder with the decedent of a power to appoint trust property to the decedent during decedent's life does not have a substantial adverse interest to the exercise of the power, if the co-holder will receive the trust corpus only in the event the decedent fails to exercise decedent's testamentary limited power of appointment over the trust property.

Section 25.2514-1(b)(2) provides that the term "power of appointment" does not include the powers reserved by a donor to himself or herself. However, no provision of section 2514 or the applicable regulations is to be construed as limiting the application of any other Code section or provision of the regulations.

In this case, X has retained a limited testamentary power to appoint the Trust corpus and accumulated income to any persons (other than X's estate, etc.) In addition, X has retained a lifetime power to appoint the Trust corpus to X with the consent of either one of Y or Z, the members of the Power of Appointment Committee, individuals who would not have a substantial adverse interest in the disposition of the transferred property for purposes of § 2511. See, Rev. Rul. 79-63, 1979-1 C.B. 302. In view of these retained powers, X's transfer of property to Trust will not be a completed gift subject to federal gift tax. See, § 25.2511-2(b); § 25.2511-2(c); § 25.2511-2(e). However, X will be treated as making a taxable gift at such time as trust corpus is distributed to a beneficiary other than X, or if, during X's lifetime, X releases the testamentary power to appoint the Trust property. § 25.2511-2(f).
In addition, Y and Z as members of the Power of Appointment Committee, have the power to distribute Trust income and corpus to themselves. However, Y's power can only be exercised with the consent of Z, and Z's power can only be exercised with the consent of Y. Further, on the death of either Y or Z, the deceased's power will devolve to the survivor and Individual Beneficiary jointly. Therefore, Y and Z will not have a general power of appointment by reason of the joint distribution power. § 25.2514-3(b)(2). Accordingly, neither Y nor Z will be treated as making a taxable gift if Trust income or corpus is distributed to X under the terms of Trust.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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 the taxpayers' authorized representative.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel (Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

END OF DOCUMENT
Transfers with retained life estate—value of gross estate—trust with tax reimbursement clause.

Headnote:

IRS addresses issues presented with respect to trust whose grantor is treated as its owner: gift tax consequences when grantor pays income tax attributable to inclusion of the trust's income in grantor's taxable income; and, estate tax consequences if, pursuant to governing instrument or applicable local law, grantor may or must be reimbursed by trust for that income tax.

Reference(s): ¶ 20,365.01(32)eg; Code Sec. 2036;

Full Text:

Issues

With respect to a trust whose grantor is treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (subpart E), what are the gift tax consequences when the grantor pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, and what are the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor may or must be reimbursed by the trust for that income tax?

Facts

In Year 1, A, a United States citizen, establishes and funds Trust, an irrevocable inter vivos trust, for the benefit of A's descendants. The governing instrument of Trust requires that the trustee be a person not related or subordinate to A within the meaning of § 672(c) of the Internal Revenue Code. A appoints a trustee that satisfies this requirement. Trust is governed by the laws of State. Under the terms of Trust, A retains no beneficial interest in or power over Trust income or corpus that would cause the transfer to Trust to constitute an incomplete gift for federal gift tax purposes, or that would cause Trust corpus to be included in A's gross estate for federal estate tax purposes on A's death. However, A retains sufficient powers with respect to Trust so that A is treated as the owner of Trust under subpart E.

During Year 1, Trust receives taxable income of $10x. Pursuant to § 671, A includes the $10x in A's taxable income. As a result, A's personal income tax liability for Year 1 increases by $2.5x. A dies in Year 3.
date of A's death, the fair market value of Trust's assets is $150x.

Situation 1: Neither State law nor the governing instrument of Trust contains any provision requiring or permitting the trustee to distribute to A amounts sufficient to satisfy A's income tax liability attributable to the inclusion of Trust's income in A's taxable income. Accordingly, A pays the additional $2.5x liability from A's own funds.

Situation 2: The governing instrument of Trust provides that if A is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee shall distribute to A for the taxable year, income or principal sufficient to satisfy A's personal income tax liability attributable to the inclusion of all or part of Trust's income in A's taxable income. Accordingly, the trustee distributes $2.5x to A to reimburse A for the $2.5x income tax liability.

Situation 3: The governing instrument of Trust provides that if A is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to A for the taxable year, income or principal sufficient to satisfy A's personal income tax liability attributable to the inclusion of all or part of Trust's income in A's taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes $2.5x to A to reimburse A for the $2.5x income tax liability.

**Law And Analysis**

Under § 671, if the grantor of a trust is treated as the owner of any portion of the trust under subpart E, those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing the taxable income of the grantor.

Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident. Section 2511(a) provides that the gift tax 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 the gift tax applies only to the extent that property is transferred for less than an adequate and full consideration in money or money's worth.

Section 25.2511-2(b) of the Gift Tax Regulations provides that a gift is complete and subject to gift tax to the extent the donor has so parted with dominion and control as to leave in the donor no power to change the disposition of the property, whether for the benefit of the donor, or any other person.

Section 25.2511-1(c)(1) provides that the gift tax applies with respect to any transaction in which an interest in property is gratuitously passed or conferred on another regardless of the means or device employed. Thus, the gift tax may apply if one party forgives or fails to collect on the indebtedness of another. Section 25.2511-1(a); Estate of Lang v. Commissioner, 64 T.C. 404 (1975), aff'd, 613 F.2d 770 [45 AFTR 2d 80-1756](9th Cir. 1980); Rev. Rul. 81-264, 1981-2 C.B. 185. Similarly, the gift tax applies if one person gratuitously pays the tax liability of another. Doerr v. United States, 819 F.2d 162 [59 AFTR 2d 87-1275](7th Cir. 1987) (donor's payment of the donee's state gift tax liability constitutes an additional gift to the donee).

Section 2036(a)(1) provides that the value of the gross estate shall include 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 the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before death the possession or enjoyment of, or the right to the income from, the property.

Section 20.2036-1(b)(2) of the Estate Tax Regulations provides that the use, possession, right to income, or other enjoyment of transferred property is treated as having been retained by the decedent to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the decedent. Estate of
Prudowsky v. Commissioner, 55 T.C. 890 (1971), aff'd, 465 F.2d 62 [30 AFTR 2d 72-5856](7th Cir. 1972) (property held under the state Uniform Gifts to Minors Act was included in the decedent's gross estate under § 2036(a)(1) because decedent, as custodian, retained the power to use the property to satisfy the decedent's legal obligation to support the minor for whose benefit the custodianship was established); Richards v. Commissioner, T.C.M. 1965-263, aff'd, 375 F.2d 997 [19 AFTR 2d 1856](10th Cir. 1967) (trust corpus includible in decedent's gross estate under § 2036(a)(1) because mandatory distributions of trust income to the decedent's spouse satisfied the decedent's spousal support obligation). On the other hand, § 2036 generally does not apply when trust property may be used to satisfy the decedent's legal obligations only in the discretion of the trustee, whether or not the discretion is exercised by the trustee. Commissioner v. Estate of Douglas, 143 F.2d 961 [32 AFTR 1108](3d Cir. 1944), acq. 1944 C.B. 7; Estate of Mitchell v. Commissioner, 55 T.C. 576 (1970), acq. 1971-2 C.B. 3.

In the present situations, Trust includes provisions that cause A to be treated as the owner of Trust under subpart E and, as a result, to be liable for any income tax attributable to Trust's income. Thus, even though A is not a Trust beneficiary, any income tax A pays that is attributable to Trust's income is paid in discharge of A's own liability, imposed on A by § 671.

In Situation 1, A's payment of the $2.5x income tax liability does not constitute a gift by A to Trust's beneficiaries for federal gift tax purposes because A, not Trust, is liable for the taxes. In contrast, in the situation presented in Doerr v. United States, cited above, the donor's payment was for the donee's tax liability and, as a result, the payment constituted an additional gift to the donee. In addition, no portion of Trust is includible in A's gross estate for federal estate tax purposes under § 2036, because A has not retained the right to have trust property expended in discharge of A's legal obligation.

In Situation 2, the governing instrument of Trust requires the trustee to reimburse A from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. A's payment of the $2.5x income tax liability does not constitute a gift by A, because A is liable for the tax. The trustee's distribution of $2.5x to A as reimbursement for the income tax payment by A is not a gift by the trust beneficiaries to A, because the distribution from Trust is mandated by the terms of the trust instrument.

However, A has retained the right to have trust property expended in discharge of A's legal obligation. A's retained right to receive reimbursement attributable to Trust's income causes the full value of Trust's assets at A's death ($150x) to be included in A's gross estate under § 2036(a)(1). The result would be the same if, under applicable state law, the trustee must, unless the governing instrument provides otherwise, reimburse A for A's personal income tax liability attributable to the inclusion of all or part of the Trust's income in A's taxable income, and the governing instrument does not provide otherwise.

In Situation 3, the governing instrument of Trust provides the trustee with the discretion to reimburse A from Trust's assets for the amount of income tax A pays that is attributable to Trust's income. As is the case in Situation 1 and Situation 2, A's payment of the $2.5x income tax liability does not constitute a gift by A because A is liable for the income tax. Further, the $2.5x paid to A from Trust as reimbursement for A's income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to A. In addition, assuming there is no understanding, express or implied, between A and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy A's obligation would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses A from Trust assets for the amount of income tax A pays that is attributable to Trust's income. The result would be the same if the trustee's discretion to reimburse A for this income tax is granted under applicable state law rather than under the governing instrument. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes.

Holdings

When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries. If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under § 2036(a)(1). If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate.

Prospective Application

The Internal Revenue Service will not apply the estate tax holding in Situation 2 of this revenue ruling adversely to a grantor's estate with respect to any trust created before October 4, 2004.

Drafting Information

The principal author of this revenue ruling is Elizabeth Madigan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Ms. Madigan at (202) 622-3090 (not a toll-free call).

END OF DOCUMENT -
© 2007 Thomson/RIA. All rights reserved.
Sales of stock to employee stock ownership plans—disposition of qualified replacement property (QRP)—grantor retained annuity trust.

Headnote:

Provided that taxpayer is treated as owner of QRP held in GRAT under Code Sec. 671; and Code Sec. 675; at time of transfer, transfer of QRP to GRAT isn't disposition of QRP under Code Sec. 1042(e);

Reference(s): Code Sec. 1042; Code Sec. 671; Code Sec. 675;

Full Text:

Number: 200709011

Release Date: 3/2/2007

Index Number: 1042.01-00

Refer Reply To: CC:TEGE:EB:QP2-PLR-123646-06

Person To Contact: [Redacted Text]

Telephone Number: [Redacted Text]

Date: November 01, 2006

LEGEND:

Taxpayer =

Company =

Year Y =
Year Z =

Dear [Redacted Text]:

This responds to your letter dated [Redacted Text], which was submitted on your behalf by your authorized representative concerning whether the transfer of qualified replacement property to and from a grantor retained annuity trust would result in a disposition under section 1042(e) of the Internal Revenue Code.

Taxpayer participated as a significant shareholder in the establishment of an employee stock ownership plan (ESOP) for Company. Taxpayer represents that the ESOP satisfied the requirements under section 4975(e)(7). The ESOP was established prior to Taxpayer's retirement and purchased Company shares from Taxpayer and other existing shareholders in Year Y.

In Year Z, Taxpayer and other Individual shareholders again sold Company shares to the ESOP. Taxpayer represents that the sale of Taxpayer's Company shares to the ESOP met the requirements for the sale of qualified securities under section 1042(b) and that the Company shares constituted qualified securities under section 1042(c)(1).

After both the Year Y and Year Z sale of Taxpayer's Company shares, the Taxpayer represents that he elected to defer recognition of long term capital gain on the sale of Company shares to the ESOP under section 1042(a) and purchased qualified replacement property (QRP) (as defined in section 1042(c)(4)) within the replacement period (as defined in section 1042(c)(3)). Taxpayer represents that he intends to transfer the QRP to a trust intended to be a grantor retained annuity trust (GRAT) within the meaning of section 2702. The trust provides that the Taxpayer shall have the power, solely in a nonfiduciary capacity and without the approval of any person in a fiduciary capacity, to reacquire the trust principal by substituting other property of equivalent value.

You have requested the following rulings:

1. That the transfer of QRP to a GRAT does not constitute a disposition under section 1042(e);
2. That the exercise of Taxpayer's power held during the term of the GRAT in a non-fiduciary capacity to substitute cash or other QRP assets of at least equal value does not constitute a disposition under section 1042(e);
3. That the transfer of QRP to the Taxpayer as a periodic annuity payment does not constitute a disposition under section 1042(e);
4. That the transfer of QRP at the termination of the GRAT to the trust beneficiaries does not result in a disposition under section 1042(e).
5. That, if the Taxpayer dies while the GRAT is still in existence, an interim or final annuity payment in the form of QRP made to the Taxpayer's successor in interest, that is, an estate or inter-vivos trust, does not constitute a disposition under section 1042(e).

Since you have not requested a ruling concerning whether the sale of securities to the ESOP or the election by the Taxpayer to defer recognition of gain satisfied the requirements of section 1042 or section 1.1042-1T of the Temporary Income Tax Regulations, we express no opinion on that issue. For purposes of your ruling request we will assume that the property purchased by the Taxpayer constitutes QRP as defined in section 1042(c)(4) and that section 1042(e) applies to such property.

Under section 1042(a), a taxpayer or executor may elect in certain cases not to recognize long-term capital gain on the sale of "qualified securities" to an ESOP (as defined in section 4975(e)(7)) or eligible worker owned cooperative if the taxpayer purchases "qualified replacement property" (as defined in section 1042(c)(4)) within the replacement period of section 1042(c)(3) and the requirements of section 1042(b) and section 1.1042-1T are satisfied.

Section 1042(d) provides that a taxpayer's basis in QRP purchased during the qualified replacement period will be reduced by the amount of gain not recognized by reason of the application of section 1042(a). If more than one item of QRP is purchased, the basis of each item of QRP shall be reduced by an amount determined by...
multiplying the total gain not recognized by reason of the application of section 1042(a) by a fraction the numerator of which is the cost of such item of QRP, and the denominator of which is the total cost of all items of such property.

Section 1042(e)(1) provides that "[i]f a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property."

The legislative history of section 1042(e) indicates that it was added to the Internal Revenue Code as part of the Tax Reform Act of 1986 to coordinate the requirement that deferred gain be recognized on the disposition of any QRP with other nonrecognition provisions of the Code. "Effective for dispositions made after the date of enactment, the Act overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time." S. Rep. 99-313, 99th Congr., 2nd Sess., 1032 (1986), 1986-3 C.B. v. 3, 1032. Limited exceptions to this rule are provided in section 1042(e)(3). Thus, gain realized from the disposition of any QRP by a taxpayer who made an election under section 1042 must be recognized at the time of the disposition regardless of any other nonrecognition provisions of the Code that may otherwise have applied.

Section 1042(e)(3) provides that the recapture rules of section 1042(e)(1) shall not apply to any transfer of QRP that occurs: (1) in any reorganization (within the meaning of section 368) unless the person making the election under section 1042(a)(1) owns stock representing control of the acquiring or acquired corporation and such property is substituted basis property in the hands of the transferee; (2) by reason of the death of the person making the election; (3) by gift; or (4) in any transaction to which section 1042(a) applies.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

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

Section 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1.675-1(a) of the Income Tax Regulations provides, in general, that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.

Section 1.675-1(b)(4)(iii) provides that the circumstances which may cause administrative controls to be considered exercisable primarily for the benefit of the grantor include the existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term "powers of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that if a grantor is treated as the owner of any portion of an entire trust, the grantor is the owner of the trust's assets for federal income tax purposes.

The circumstances surrounding the administration of the trust will determine whether the power of
administration is exercisable in a fiduciary or nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the Internal Revenue Service office where the returns are filed. Therefore, we cannot determine at this time whether the Taxpayer will be treated as the owner of the trust under § 675(4)(C). Provided that the circumstances indicate that the power of administration is exercisable in a nonfiduciary capacity, the Taxpayer will be treated as the owner of the trust under §§ 671 and 675.

We assume for purposes of this ruling that the Taxpayer is treated as the owner of the QRP transferred to the purported GRAT under the rules of sections 671 and 675. The Taxpayer represents that he will not relinquish any powers during the term of the trust that would cause the GRAT to fail to be a trust in which the Taxpayer is the owner of the trust under sections 671 and 675 of the Code.

Therefore, based on the facts presented and representations made, we conclude the following:

(1) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of the transfer, the transfer of QRP to the grantor retained annuity trust does not constitute a disposition of the QRP under section 1042(e);
(2) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of exercise, the exercise of Taxpayer's power held during the term of the GRAT in a non-fiduciary capacity to substitute cash or other QRP assets of at least equal value does not constitute a disposition of the QRP under section 1042(e);
(3) Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of any annuity payments under the trust, the transfer of QRP to the Taxpayer as a periodic annuity payment does not constitute a disposition of the QRP under section 1042(e);
(4) Provided that the funding of the GRAT with QRP constituted a completed gift of the remainder interest for Federal transfer tax purposes, the transfer of QRP to the trust beneficiaries pursuant to the terms of the trust does not result in a recapture of gain deferred under section 1042(a) because of the operation of section 1042(e)(3)(C).
(5) If the Taxpayer dies while the GRAT is still in existence, an interim or final annuity payment in the form of QRP made to the Taxpayer's successor in interest, (an estate or inter-vivos trust) will not result in a recapture of gain deferred under section 1042(a) because of the operation of section 1042(e)(3)(B).

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.

This ruling does not express an opinion as to validity of the grantor retained annuity trust under section 2702 of the Code.

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

Sincerely yours,

Robert D. Patchell
Chief, Qualified Plans Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:

Certain death benefits—transfer for valuable consideration.

Headnote:

In two different factual situations, IRS concluded that transfer of life insurance contract between two grantor trusts that are treated as owned by same grantor isn't transfer for valuable consideration under Code Sec. 101(a)(2); but that transfer of contract to grantor trust treated as wholly owned by insured is transfer to insured under Code Sec. 101(a)(2)(B); and "transfer for value" limits under Code Sec. 101(a)(2); don't apply. Transfer to trust is treated as transfer to grantor under Code Sec. 101(a)(2)(B);.

Reference(s): ¶ 1015.02(25); Code Sec. 101;

Full Text:

Issue

Is the grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life treated as the owner of the contract for purposes of determining whether a transfer of the contract (a) is a transfer for a valuable consideration within the meaning of § 101(a)(2) of the Internal Revenue Code, and (b) if so, is a transfer to the insured within the meaning of § 101(a)(2)(B)?

Facts

Situation 1. TR1 and TR2 are grantor trusts, both of which are treated as wholly owned by G under subpart E of Part I of subchapter J of the Internal Revenue Code. TR2 owns a life insurance contract upon the life of G. TR2 transfers the life insurance contract to TR1 in exchange for cash.

Situation 2. The facts are the same as in Situation 1, except that TR2 is not a grantor trust.

Law And Analysis

Section 61 defines gross income as all income from whatever source derived, including gains derived from dealings in property.

Section 101(a)(1) provides that, except as otherwise provided in §§ 101(a)(2), 101(d), and 101(f), gross income does not include amounts received under a life insurance contract if such amounts are received by
reason of the death of the insured.

Section 101(a)(2) provides, generally, that if a life insurance contract, or any interest therein, is transferred for a valuable consideration, the exclusion from gross income provided by § 101(a)(1) shall not exceed an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee.

The term "transfer for a valuable consideration" is defined for purposes of § 101(a)(2) in § 1.101-1(b)(4) of the Income Tax Regulations as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy.

Section 101(a)(2)(B) provides that § 101(a)(2) does not apply to a transfer of a life insurance contract or any interest therein to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

In Rev. Rul. 85-13, 1985-1 C.B. 184, a grantor acquired the corpus of a trust in exchange for the grantor's unsecured promissory note. The ruling concludes that the grantor is considered to have borrowed the corpus of the trust and, as a result, is treated as the owner of the trust under § 675(3). Because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes. In addition, because the grantor is therefore considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.

In Situation 1, because G is treated as the owner of both TR1 and TR2 for federal income tax purposes, G is treated as the owner of all the assets of both trusts, including both the life insurance contract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of § 101(a)(2).

In Situation 2, because G is treated as the owner of all the assets of TR1 but not of TR2 for federal income tax purposes, G is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a transfer of the life insurance contract for a valuable consideration within the meaning of § 101(a)(2). Nevertheless, the transfer for value limitations of § 101(a)(2) do not apply, because the transfer to TR1 is treated as a transfer to G, the insured, within the meaning of § 101(a)(2)(B).

**Holding**

The grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of applying the transfer for value limitations of § 101(a)(2). Accordingly, in Situation 1, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for a valuable consideration within the meaning of § 101(a)(2); in Situation 2, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is therefore excepted from the transfer for value limitations under § 101(a)(2).

**Drafting Information**

The principal author of this revenue ruling is Chris Lieu of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Chris Lieu at (202) 622-3970 (not a toll-free call).

END OF DOCUMENT -
© 2007 Thomson/RIA. All rights reserved.
Private Letter Rulings

Private Letter Ruling 200439027, 09/24/2004, IRC Sec(s). 1361

JIL No. 1361.01-02

S corps.—termination—ineligible shareholders.

Leadnote:

Revocable trusts and GRATs will be grantor trusts each of which will be treated as owned by individual, and partnerships and LLCs will be treated as owned by S corp. owners, and will be disregarded as entities separate from heir individual owners. So, S corp. shareholders will continue to be treated as owners of S corp. stock and S election will not be terminated due to ineligible shareholder under Code Sec. 1361(b)(1)(B); .

Reference(s): Code Sec. 1361;

Full Text:

Release Date: 9/24/04

Date: May 07, 2004

Refer Reply To:

C:PSI:B02 - PLR-133925-03

Person To Contact:

Number:

\k

\a

Partnership =

LC =

Trust 1 =

Trust 2 =
The letter responds to your letter dated May 27, 2003, and subsequent correspondence submitted by you as X’s authorized representative on behalf of X, requesting a ruling under § 1361 of the Internal Revenue Code.

The information submitted states that X is an S corporation, currently owned by individuals including A. X is in the business of selling insurance services, but is represented as not being an insurance company subject to tax under chapter L. Pursuant to a series of proposed transactions, stock of X will be transferred to Partnership and Trust 1. Partnership is owned by A, Trust 2, and LLC. LLC is owned by A and Trust 3. A will be the grantor of Trusts 1, 2, and 3. Neither Partnership nor LLC will elect to be treated as an association taxable as a corporation for federal income tax purposes.

Trust 1 and Trust 3 (the Irrevocable Trusts) have substantially identical terms. A is the initial trustee of the revocable Trusts. The Irrevocable Trusts provide that during A’s life the trustee shall pay or apply such sums from income and principal as, in the trustee’s discretion, are necessary or advisable for the health, education, support, and maintenance of A’s spouse and descendants. Upon A’s death, the remaining trust assets are to be distributed or held in trust for the benefit of A’s spouse and descendants in the manner described in the trust instrument.

Trust 2 provides that from the date Trust 2 is funded until the twentieth anniversary of such date, the trustee shall pay to A or A’s estate an annual annuity amount equal to 7.23% of the initial fair market value of the assets of Trust 2. The annuity amount is to be paid from income, accumulated income, and principal in that order. Any excess income is to be added to principal. At the end of the annuity period, the remaining trust assets are to be distributed or held in trust for the benefit of A’s spouse and descendants in the manner described in the trust instrument. The trustee has power to add the spouse of any current beneficiary under any trust created under the terms of the Trust 2 as an additional beneficiary of that trust.

Section 671 provides that where it is specified in subpart E of Part I of subchapter S that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the enfeoffment 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)(5) provides that § 674(a) does not apply to a power to distribute corpus either (A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or (B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. Power does not fall within the powers described in § 674(b)(5) if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

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

Section 1361(a)(1) provides that for purposes of title 26, the term “S corporation” means, with respect to any taxable ear, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(5)), who is not an individual.
Section 1361(b)(2)(B) defines the term "ineligible corporation," for purposes of § 1361(b)(1) to include an insurance company subject to tax under subchapter L.

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

Section 1361(c)(2)(B)(i) provides that in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 301.7701-3(a) of the Procedure and Administration Regulations provides, in part, that a business entity that is not classified as a corporation under 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides that, except as provided in § 301.7701-3(b)(2), a domestic eligible entity is (i) a partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner.

Based solely on the facts and representations submitted, we conclude that Trust 1, Trust 2, and Trust 3 will be grantor trusts each of which will be treated as owned by A and that Partnership and LLC will be treated as owned by A and will be disregarded as entities separate from A. Therefore, A will continue to be treated as the owner of the X stock and the transactions described above will not cause the S corporation election of X to terminate because of an ineligible shareholder under § 1361(b)(1)(B).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express no opinion as to the consequences of proposed transactions under the estate and gift tax provisions of chapters 11 and 12 of subtitle B, including the proper valuation of any property or interest in property for federal estate and gift tax purposes.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X.

Sincerely,

THOMAS HINES
Chief, Branch 2

Office of Associate Chief Counsel
Passthroughs and Special Industries

Enclosures: 2

Copy of this letter

Copy for § 6110 purposes

Copyright 2006 RIA. All rights reserved.

https://checkpoint.riag.com/servlet/com.tta.checkpoint.servlet.CPJSPServlet?usid=c5e3ff244e&StyleShe... 10/11/2006
Reg § 1.671-4. Method of reporting.

(a) Portion of trust treated as owned by the grantor or another person. Except as otherwise provided in paragraph (b) of this section and §1.671-5, items of income, deduction, and credit attributable to any portion of a trust that, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person, are not reported by the trust on Form 1041, "U.S. Income Tax Return for Estates and Trusts," but are shown on a separate statement to be attached to that form. Section 1.671-5 provides special reporting rules for widely held fixed investment trusts. Section 301.7701-4(e)(2) of this chapter provides guidance regarding the application of the reporting rules in this paragraph (a) to an environmental remediation trust.

(b) A trust all of which is treated as owned by one or more grantors or other persons.

(1) In general. In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending upon the type of reportable payments made.

(2) A trust all of which is treated as owned by one grantor or by one other person.

(i) In general. In the case of a trust all of which is treated as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either—

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors.

(A) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must furnish the grantor or other person treated as the owner of the trust with a statement that—

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the...
(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.

(iii) Additional obligations of the trustee when name, TIN, and address of the trust are furnished to payors.

(A) Obligation to file forms 1099. The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) Obligation to furnish statement.

(1) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or other person treated as the owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year;

(ii) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(iv) Examples. The following examples illustrate the provisions of this paragraph (b)(2):

Example (1). G, a United States citizen, creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 679. Under the applicable local law, capital gains must be added to corpus. Since G has a right to receive income, he is treated as an owner of a portion of the trust under section 677. The tax consequences of any items' of capital gain of the trust are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. Because not all of the trust is treated as owned by the grantor or another person, the trustee may not report by the methods described in paragraph (b)(2) of this section.

Example (2). (i)

(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned
by G. The trustee of the trust is T. During the 1996 taxable year the trust has the following items of income and gross proceeds:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$2,500</td>
</tr>
<tr>
<td>Dividends</td>
<td>$3,205</td>
</tr>
<tr>
<td>Proceeds from sale of B stock</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

(B) The trust has no items of deduction or credit.

(ii)

(A) The payors of the interest paid to the trust are X ($2,000), Y ($300), and Z ($200). The payors of the dividends paid to the trust are A ($3,200), and D ($5). The payor of the gross proceeds paid to the trust is D, a brokerage firm, which held the B stock as the nominee for the trust. The B stock was purchased by T for $1,500 on January 3, 1996, and sold by T on November 29, 1996. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to X, Y, Z, A, and D. X, Y, and Z each furnish T with a Form 1099-INT showing the trust as the payee. A furnishes T with a Form 1099-DIV showing the trust as the payee. D does not furnish T with a Form 1099-DIV because D paid a dividend of less than $10 to T. D furnishes T with a Form 1099-B showing the trust as the payee.

(B) On or before February 28, 1997, T files a Form 1099-INT with the Internal Revenue Service on which T reports interest attributable to G, as the owner of the trust, of $2,500; a Form 1099-DIV on which T reports dividends attributable to G, as the owner of the trust, of $3,205; and a Form 1099-B on which T reports gross proceeds from the sale of B stock attributable to G, as the owner of the trust, of $2,000. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$2,500</td>
</tr>
<tr>
<td>Dividends</td>
<td>$3,205</td>
</tr>
<tr>
<td>Information regarding sale of B stock:</td>
<td></td>
</tr>
<tr>
<td>Proceeds</td>
<td>$2,000</td>
</tr>
<tr>
<td>Basis</td>
<td>$1,500</td>
</tr>
<tr>
<td>Date acquired</td>
<td>1/03/96</td>
</tr>
<tr>
<td>Date sold</td>
<td>11/29/96</td>
</tr>
</tbody>
</table>

(C) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(D) T has complied with T's obligations under this section.

(iii)

(A) Same facts as paragraphs (i) and (ii) of this Example 2, except that G contributed the B stock to the trust on January 2, 1996. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$2,500</td>
</tr>
<tr>
<td>Dividends</td>
<td>$3,205</td>
</tr>
<tr>
<td>Information regarding sale of B stock:</td>
<td></td>
</tr>
<tr>
<td>Proceeds</td>
<td>$2,000</td>
</tr>
<tr>
<td>Date sold</td>
<td>11/29/96</td>
</tr>
</tbody>
</table>

(B) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.
Example (3). (i) (A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The only asset of the trust is an interest in C, a common trust fund under section 584(a). T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to C. C files a Form 1065 and a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) showing the name, TIN, and address of the trust with the Internal Revenue Service and furnishes a copy to T. Because the trust did not receive any amounts described in paragraph (b)(5) of this section, T does not file any type of return with the Internal Revenue Service. On or before April 15, 1997, T furnishes G with a statement that shows all items of income, deduction, and credit of the trust for the 1996 taxable year. In addition, T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person. T has complied with T's obligations under this section.

(3) A trust all of which is treated as owned by two or more grantors or other persons.

(i) In general. In the case of a trust all of which is treated as owned by two or more grantors or other persons, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year, and comply with the additional requirements described in paragraph (b)(3)(ii) of this section.

(ii) Additional obligations of trustee.

(A) Obligation to file Forms 1099. The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) Obligation to furnish statement.

(1) The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person;

(ii) Provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) Except for the requirements pursuant to section 3406 and the regulations thereunder, by furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(4) Persons treated as payors.
(i) In general. For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K-1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

(ii) Application to brokers and customers. For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

(5) Amounts required to be included on Forms 1099 filed by the trustee.

(i) In general. The amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to this section do not include any amounts that are reportable by the payor on an information return other than Form 1099. For example, in the case of a trust which owns an interest in a partnership, the trust’s distributive share of the income and gain of the partnership is not includible on any Forms 1099 filed by the trustee pursuant to this section because the distributive share is reportable by the partnership on Schedule K-1.

(ii) Example. The following example illustrates the provisions of this paragraph (b)(5):

Example. (i)

(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The assets of the trust during the 1996 taxable year are shares of stock in X, an S corporation, a limited partnership interest in P, shares of stock in M, and shares of stock in N. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to X, P, M, and N. M furnishes T with a Form 1099-DIV showing the trust as the payee. N does not furnish T with a Form 1099-DIV because N paid a dividend of less than $10 to T. X and P furnish T with Schedule K-1 (Shareholder’s Share of Income, Credits, Deductions, etc.) and Schedule K-1 (Partner’s Share of Income, Credits, Deductions, etc.), respectively, showing the trust’s name, TIN, and address.

(B) For the 1996 taxable year the trust has the following items of income and deduction:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid by M</td>
<td>$12</td>
</tr>
<tr>
<td>Dividends paid by N</td>
<td>6</td>
</tr>
<tr>
<td>Administrative expense</td>
<td>$20</td>
</tr>
<tr>
<td>Items reported by X on Schedule K-1 attributable to trust's shares of stock in X:</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$20</td>
</tr>
<tr>
<td>Dividends</td>
<td>35</td>
</tr>
<tr>
<td>Items reported by P on Schedule K-1 attributable to trust's limited partnership interest in P:</td>
<td></td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$300</td>
</tr>
</tbody>
</table>

(ii) On or before February 28, 1997, T files with the Internal Revenue Service a Form 1099-DIV on which T reports dividends attributable to G as the owner of the trust in the amount of $18. T does not file any other returns.

(B) T has complied with T’s obligation under paragraph (b)(2)(iii)(A) of this section to file the appropriate Forms 1099.

(6) Trusts that cannot report under this paragraph (b). The following trusts cannot use the methods of reporting described in this paragraph (b)—

(i) A Common trust fund as defined in section 584(a);
(ii) A trust that has its situs or any of its assets located outside the United States;

(iii) A trust that is a qualified subchapter S trust as defined in section 1361(d)(3);

(iv) A trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year;

(v) A trust all of which is treated as owned by one grantor or one other person who is not a United States person; or

(vi) A trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

(7) Grantors or other persons who are treated as owners of the trust and are exempt recipients for information reporting purposes.

(i) Trust treated as owned by one grantor or one other person. The trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to this paragraph (b) if the grantor or other person is an exempt recipient for information reporting purposes.

(ii) Trust treated as owned by two or more grantors or other persons. The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to this paragraph (b) if one or more grantors or other persons treated as owners are exempt recipients for information reporting purposes unless —

   (A) At least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and

   (B) The trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

(8) Husband and wife who make a single return jointly. A trust all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under section 6013 is considered to be owned by one grantor for purposes of this paragraph (b).

(c) Due date for Forms 1099 required to be filed by trustee. The due date for any Forms 1099 required to be filed with the Internal Revenue Service by a trustee pursuant to this section is the due date otherwise in effect for filing Forms 1099.

(d) Due date and other requirements with respect to statement required to be furnished by trustee.

(1) In general. The due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust pursuant to this section is the date specified by section 6034A(a). The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing such statement specified in this paragraph (d).

(2) Statement for the taxable year ending with the death of the grantor or other person treated as the owner of the trust. If a trust ceases to be treated as owned by the grantor, or other person, by reason of the death of that grantor or other person (decedent), the due date for the statement required to be furnished for the taxable year ending with the death of the decedent shall be the date specified by section 6034A(a) as though the decedent had lived throughout the decedent's last taxable year. See paragraph (h) of this section for special reporting rules for a trust or portion of the trust that ceases to be treated as owned by the grantor or other person by reason of the death of the grantor or other person.

(e) Backup withholding requirements.

(1) Trustee reporting under paragraph (b)(2)(i)(A) of this section. In order for the trustee to be able to
report pursuant to paragraph (b)(2)(i)(A) of this section and to furnish to all payors the name and TIN of the grantor or other person treated as the owner of the trust, the grantor or other person must provide a complete Form W-9 to the trustee in the manner provided in paragraph (b)(1) of this section, and the trustee must give the name and TIN shown on that Form W-9 to all payors. In addition, if the Form W-9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold. If the Form W-9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W-9, or a copy thereof, to a payor because the Form W-9 contains the address of the grantor or other person and paragraph (b)(2)(i)(A) of this section requires the trustee to furnish the address of the trust to all payors and not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required by this paragraph (e)(1). Thus, a payor may rely on the name and TIN provided to the payor by the trustee, and, if given, on the trustee’s statement that the grantor is subject to backup withholding.

(2) Other backup withholding requirements. Whether a trustee is treated as a payor for purposes of backup withholding is determined pursuant to section 3406 and the regulations thereunder.

(f) Penalties for failure to file a correct form 1099 or furnish a correct statement. A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust as required by paragraph (b) of this section is subject to the penalties provided by sections 6721 and 6722 and the regulations thereunder.

(g) Changing reporting methods

(1) Changing from reporting by filing form 1041 to a method described in paragraph (b) of this section. If the trustee has filed a Form 1041 for any taxable year ending before January 1, 1996 (and has not filed a final Form 1041 pursuant to §1.671-4(b)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)), or files a Form 1041 for any taxable year thereafter, the trustee must file a final Form 1041 for the taxable year which ends after January 1, 1995, and which immediately precedes the first taxable year for which the trustee reports pursuant to paragraph (b) of this section, on the front of which form the trustee must write: "Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust."

(2) Changing from reporting by a method described in paragraph (b) of this section to the filing of a form 1041. The trustee of a trust who reported pursuant to paragraph (b) of this section for a taxable year may report pursuant to paragraph (a) of this section for subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(A) of this section, and therefore furnished the name and TIN of the grantor to all payors, the trustee must furnish the name, TIN, and address of the trust to all payors for such subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(B) or (b)(3)(i) of this section, and therefore furnished the name and TIN of the trust to all payors, the trustee must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee so reports that it is the final return of the trust.

(3) Changing between methods described in paragraph (b) of this section.

(i) Changing from furnishing the TIN of the grantor to furnishing the TIN of the trust. The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(A) of this section for a taxable year, and therefore furnished the name and TIN of the grantor to all payors, may report pursuant to paragraph (b)(2)(i)(B) of this section, and furnish the name and TIN of the trust to all payors, for subsequent taxable years.

(ii) Changing from furnishing the TIN of the trust to furnishing the TIN of the grantor. The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(B) of this section for a taxable year, and therefore furnished the name and TIN of the trust to all payors, may report pursuant to paragraph (b)(2)(i)(A) of this section, and furnish the name and TIN of the grantor to all payors, for subsequent taxable years. The trustee, however, must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee reports pursuant to paragraph (b)(2)(i)(B) of this section that it is the final return of the trust.
Example. The following example illustrates the provisions of paragraph (g) of this section:

Example. (i) On January 3, 1994, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. On or before April 17, 1995, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1994 taxable year showing the items of income, deduction, and credit of the trust. On or before April 15, 1996, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1995 taxable year showing the items of income, deduction, and credit of the trust. On the Form 1041, T states that "pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust." T may report pursuant to paragraph (b) of this section for the 1996 taxable year.

(ii) T reports pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to all payors, for the 1996 and 1997 taxable years. T chooses to report pursuant to paragraph (a) of this section for the 1998 taxable year. On each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) which T files for the 1997 taxable year (or appropriately on magnetic media), T indicates that it is the trust's final return. On or before April 15, 1999, T files with the Internal Revenue Service a Form 1041 with an attached statement showing the items of income, deduction, and credit of the trust. On the Form 1041, T uses the same TIN which T used on the Forms 1041 and Forms 1099 it filed for previous taxable years. T has complied with T's obligations under paragraph (g)(2) of this section.

(h) Reporting rules for a trust, or portion of a trust, that ceases to be treated as owned by a grantor or other person by reason of the death of the grantor or other person.

(1) Definition of decedent. For purposes of this paragraph (h), the decedent is the grantor or other person treated as the owner of the trust, or portion of the trust, under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code on the date of death of that person.

(2) In general. The provisions of this section apply to a trust, or portion of a trust, treated as owned by a decedent for the taxable year that ends with the decedent's death. Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section. A trust, all of which was treated as owned by the decedent, must obtain a new TIN upon the death of the decedent, if the trust will continue after the death of the decedent. See §301.6109-1(a)(3)(i) of this chapter for rules regarding obtaining a TIN upon the death of the decedent.

(3) Special rules.

(i) Trusts reporting pursuant to paragraph (a) of this section for the taxable year ending with the decedent's death. The due date for the filing of a return pursuant to paragraph (a) of this section for the taxable year ending with the decedent's death shall be the due date provided for under §1.6072-1(a)(2). The return filed under this paragraph for a trust all of which was treated as owned by the decedent must indicate that it is a final return.

(ii) Trust reporting pursuant to paragraph (b)(2)(B) of this section for the taxable year of the decedent's death. A trust that reports pursuant to paragraph (b)(2)(B) of this section for the taxable year ending with the decedent's death must indicate on each Form 1096 "Annual Summary and Transmittal of the U.S. Information Returns" that it files (or appropriately on magnetic media) for the taxable year ending with the death of the decedent that it is the final return of the trust.

(iii) Trust reporting under paragraph (b)(3) of this section. If a trust has been reporting under paragraph (b)(3) of this section, the trustee may not report under that paragraph if any portion of the trust has a short taxable year by reason of the death of the decedent and the portion treated as owned by the decedent does not terminate on the death of the decedent.

(i) Effective date and transition rule.

(1) Effective date. The trustee of a trust any portion of which is treated as owned by one or more grantors or other persons must report pursuant to paragraphs (a), (b), (c), (d)(1), (e), (f), and (g) of this section for taxable years beginning on or after January 1, 1996.
(2) **Transition rule.** For taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the manner of reporting of —

(i) A trustee of a trust all of which is treated as owned by one or more grantors or other persons who did not report in accordance with §1.671-4(a) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) as in effect for taxable years beginning prior to January 1, 1996, but did report in a manner substantially similar to one of the reporting methods described in paragraph (b) of this section; or

(ii) A trustee of two or more trusts all of which are treated as owned by one or more grantors or other persons who filed a single Form 1041 for all of the trusts, rather than a separate Form 1041 for each trust, provided that the items of income, deduction, and credit of each trust were shown on a statement attached to the single Form 1041.

(3) **Effective date for paragraphs (d)(2) and (h) of this section.** Paragraphs (d)(2) and (h) of this section apply for taxable years ending on or after December 24, 2002.

(j) **Cross-reference.** For rules relating to employer identification numbers, and to the obligation of a payor of income or proceeds to the trust to furnish to the payee a statement to recipient, see §301.6109-1(a)(2) of this chapter.

---


---

© Copyright 2006 RIA. All rights reserved.