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Department of the Treasury

Washington, DC 20224

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Telephone Number:

Refer Reply To:
CC:PSI:2- PLR-148901-02
Date:
June 27, 2003

A =

B =

C =

D =

E =

X =

Trust =

D1 =

Country 1 =

Country 2 =

State =

City =

Year 1 =

Year 2 =

Year 3 =

Dear :

This responds to a letter August 30, 2002, and subsequent information, submitted on behalf of Trust by its authorized representative, requesting rulings concerning certain additions to Trust and the proposed division of Trust.

The information submitted states that A was a citizen of Country 1 and a permanent resident of Country 2. B and his wife, C, had a long and close relationship with A and his immediate and extended family. During that period, B represents that no employer-employee relationship existed between A and B. A established Trust for the benefit of B, C, and their two children, D and E, on D1. B represents that Trust was established by A in recognition of his longstanding personal relationship with B and C. Further, B represents that only A's funds were used to establish Trust and that the funds transferred to Trust by A did not constitute compensation to B or an indirect transfer by B to Trust. B, C, D, and E are all citizens and residents of the United States. B and C are the trustees of Trust.

Trust was initially funded with cash transferred directly from A's accounts in Country 2. After Trust was funded, the trustees purchased stock in X, a Country 1 company, traded on the City stock exchange. X has no United States assets. The trustees subsequently sold the stock and used the proceeds to purchase United States assets. No distributions have been made from Trust to any of Trust beneficiaries.

Article 10 of Trust provides that the trustee shall receive such fees for services actually rendered to the trust estate as are reasonable.

Article 2 of Trust provides that the beneficiaries of Trust are B, C, D, E and the descendants of B or C.

Article 3(a) of Trust provides that the trustee has the sole and absolute discretion to distribute to or for the benefit of any of the beneficiaries so much of the net income and principal as the trustee deems necessary or advisable for the beneficiary's maintenance, support, health and education. Distributions by the trustee may be in unequal amounts and may be to the complete exclusion of other beneficiaries of Trust.

Article 3(a) also provides that:

> The provisions of this paragraph are not intended to relieve any person legally liable for a beneficiary's support from liability therefor. No distribution shall be made in a manner that discharges a legal obligation (including a legal obligation to support) of any person other than the beneficiary to whom the distribution is made.

Article 3(b) of Trust provides that Trust will terminate upon the death of the last to die of the beneficiaries, at which time, the trust estate will be divided into equal shares, one for each child of B and C who died leaving living descendants. The shares will be further divided into equal shares for the descendants per stipes of each child and held in separate trust to be distributed to each descendant upon that descendant reaching age 25. Article 13 provides that Trust will terminate no later than 21 years after the death of the last to die of A and all the descendants of B and C who were living on the date that Trust was established.

Article 12 of Trust provides that the situs of Trust shall be State and Trust is to be governed by State law.

After Trust was established, B and C made interest-free and/or below market interest loans to Trust during Year 1, Year 2, and Year 3. The principal of each of the loans has been repaid by Trust but no interest payments were made to B and C by Trust.

Additionally, notwithstanding the provisions of Article 10 directing that the trustee shall receive such fees for services actually rendered to Trust as are reasonable, B and C have not paid themselves any trustee fees for services to Trust.

In addition, pursuant to the advice of their representatives, B and C treated themselves as the owners of Trust for federal income tax purposes under § 678 of the Internal Revenue Code. Accordingly, they included on their federal income tax return, items of income that should have been reported on Trust's income tax return. B and C represent that they will file amended returns for themselves and for Trust for the open years. Trust will report the income that is required to be reported by Trust and pay the income tax liability for those years.

Ruling 1

Section 671 provides that when the grantor or another person is treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deduction, 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 of the Code in computing the taxable income or credits against tax of an individual.

Sections 673 through 678 specify the circumstances under which the grantor or another person will be treated as the owner of a portion of a trust.

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

Section 677(a) provides that the grantor will 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, or (2) 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) the person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would cause a grantor to be treated as the owner of such a portion of the trust within the principles of §§ 671 to 677 inclusive.

Section 678 (b) provides that § 678(a) shall not apply with respect to a power over income if the grantor of the trust is otherwise treated as the owner under the provisions of §§ 671 through 677.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

At the time of the initial funding of Trust, B and C did not transfer any property to Trust. Rather, A contributed all of Trust's property to Trust. Therefore, based on our analysis of Trust documents and the representations submitted, we conclude that at the initial funding of Trust by A, Trust was not a grantor trust, nor would any trustee or beneficiary of Trust be considered the owner of any portion of Trust under §§ 671 through 679 of the Code.

Accordingly, B and C included on their federal income tax returns, items of income that should have been reported on Trust's income tax return, and they paid income tax on these items that should have been paid by Trust. The satisfaction of Trust's income tax liability by B and C constitutes a gratuitous transfer to Trust. Similarly, the foregone interest imputed on the interest-free loans made by B and C to Trust that was not repaid by Trust constitutes a gratuitous transfer to Trust. Therefore, B and C have made gratuitous transfers to Trust. To the extent of those transfers (other than those amounts that are refunded to B and C as a result of the filing of amended tax returns), B and C are the grantors of Trust. Therefore, to the extent of those transfers to Trust (other than those amounts that are refunded to B and C as a result of the filing of amended tax returns), B and C are the owners of a portion of Trust under § 677.

Ruling 2

Additionally, B and C believe that as a result of one or more of the actions described above, they may have made constructive transfers to Trust such that they would be considered transferors of Trust for generation-skipping transfer tax purposes. Accordingly, if this is the case, the trustees propose to sever Trust into two separate but identical trusts. One severed trust (the GST Exempt Trust) will be funded with that portion of Trust that is currently exempt from GST tax in accordance with the provisions of § 26.2663-2 of the Generation-skipping Transfer Tax Regulations. The other severed trust (the GST Non-Exempt Trust) will be funded with the balance of Trust corpus. The terms of both trusts will be identical in all respects to the terms of Trust. Further, Trust will be severed on a fractional basis.

Under § 2501(a)(1), a tax is imposed on the transfer of property by gift during each calendar year by an individual, resident or nonresident.

Section 2501(a)(2) provides that, except as provided in § 2501(a)(3), § 2501(a)(1) does not apply to the transfer of intangible property by a nonresident not a citizen of the United States.

Section 2511(a) provides that:

> Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply 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; but in the case of a nonresident not a citizen of the United States, [the gift tax] shall apply to a transfer only if the property is situated within the United States.

Section 25.2511-3(a)(1) of the Gift Tax Regulations provides that, for nonresident donors who are not citizens of the United States (and to which the exceptions under § 2501(a) do not apply), the gift tax applies only to the transfer after 1966 of real property and tangible personal property situated in the United States at the time of the transfer.

Section 25.2511-3(b)(1) provides that for purposes of applying the gift tax to the transfer of property owned and held by a nonresident not a citizen of the United States at the time of the transfer, real property and tangible personal property constitute property within the United States only if they are physically situated therein.

Section 2601 imposes a tax on every generation-skipping transfer (GST), made by a transferor to a skip person. A GST is defined under § 2611(a) as: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip. In general, under § 2652(a)(1) and § 26.2652-(1)(a)(1), the individual with respect to whom the property was last subject to Federal estate or gift tax is the transferor of the property for GST tax purposes.

Section 26.2652-1(a)(2) provides that, for GST purposes, a transfer is subject to federal gift tax if a gift tax is imposed under § 2501(a) (without regard to exemptions, exclusions, deductions, and credits). A transfer is subject to federal estate tax if the value of the property is includible in the decedent’s gross estate as determined under § 2031 or § 2103.

Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate.

Section 2641(a) provides that the term "applicable rate" means with respect to any GST transfer, the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), the inclusion ratio with any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the "applicable fraction". The applicable fraction, as defined in § 2642(a)(2) is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator is the value of the property transferred to the trust or involved in the direct skip.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of $1,000,000 (adjusted for inflation under § 2631(c)) which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2642(a)(3)(A) provides, generally, that if a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter.

Section 2642(a)(3)(B)(i) provides, generally, that for purposes of § 2642(a)(3)(A), the term "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if the single trust was divided on a fractional basis, and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(B)(ii) provides that if a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

Section 2642(a)(3)(B)(iii) provides that the term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

Section 2642(a)(3)(C) provides that a severance pursuant to § 2642(a)(3) may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Secretary.

Section 26.2654-1(a)(2) of the Estate and Gift tax regulations provides that if there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of the GST tax.

Section 2663 provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the GST tax, including regulations (consistent with the principles of the estate and gift tax) providing for the application of the GST tax in the case of transferors who are nonresidents not citizens of the United States.

Section 26.2663-2 provides rules for applying the GST tax to transfers by a transferor who is a nonresident not a citizen of the United States (NRA). Section 26.2663-2(a)(2) provides that the GST tax applies to a taxable distribution or a taxable termination to the extent that the initial transfer of property to the trust by a NRA transferor, whether during life or at death, was subject to the federal estate or gift tax within the meaning of § 26.2652-1(a)(2).

Section 26.2663-2(c)(1)-(3) provides rules for determining the applicable fraction with respect to a trust created by an NRA transferor that is in part subject to GST tax and in part not subject to GST tax.

State law authorizes the division of an existing trust. State law provides that the trustee may, unless expressly prohibited by the terms of the instrument establishing the trust, divide a trust into two or more separate trusts without a judicial proceeding if the trustee reasonably determines that the division of the trust could result in a significant decrease in current or future federal income, gift, estate, generation-skipping transfer taxes, or any other tax imposed on trust property. If the trustee divides the trust, the terms of the separate trusts must be identical to the terms of the original trust, but differing tax elections may be made for the separate trusts.

When Trust was established on D1, and when A initially funded Trust, A was a citizen of Country 1 and a permanent resident of Country 2. Consequently, for purposes of the GST tax, A was a nonresident alien, not a citizen of the United States. Trust was funded with cash transferred directly from A's accounts in Country 2 to Trust. Thus, although A, a nonresident alien, transferred cash, which is tangible personal property for purposes of § 2501(a)(2), the funds were not physically situated within the United States prior to the transfer. Therefore, pursuant to § 25.2511-3(b)(1), the transfer of cash was not a transfer that was subject to the gift tax under § 2501(a).

Consequently, generation-skipping transfers from Trust, to the extent attributable to A's transfer of cash to Trust, will not be subject to the GST tax. See § 26.2663-2(a)(2).

Under the facts presented, the waiver by B and C of the trustee fees does not constitute an addition by B and C to Trust. None of the accountings filed by Trust included any claim for commissions, and B and C thus far have taken no action which is inconsistent with a continuing intention to serve on a gratuitous basis. See Rev. Rul. 66-167, 1966-1 C.B. 20. Accordingly, we conclude that, under the facts in this case, the trustees' failure to pay themselves trustee fees authorized by Trust is not treated as an addition to Trust for GST tax purposes.

However, the payment by B and C, in their individual capacity, of Trust's income tax liability relieved Trust of a liability that was properly imposed on Trust. The satisfaction of Trust's income tax liability by B and C constitutes a constructive addition by B and C (other than those amounts that are refunded to B and C as a result of the filing of amended income tax returns) to Trust. Cf. § 26.2601-1(b)(1)(v)(C) regarding constructive additions to trusts created prior to September 25, 1985, that are otherwise exempt from GST tax. Similarly, the foregone interest imputed on the interest-free loans made by B and C to Trust that were not repaid by Trust were additions to Trust. See § 7872(a)(1) and § 2652(a)(1)(A). These additions are treated as transferred to Trust by B and C when B and C relinquished or waived their right to payment of the interest.

In accordance with § 2652(a)(1) and § 26.2652-(1)(a)(1), B and C are treated as the transferors of Trust to the extent of the value of the corpus that is attributable to these transfers to Trust.

As described above, the trustees propose to divide Trust, on a fractional basis, into two identical trusts in order to segregate the portion of Trust that is subject to GST tax from the portion that is not subject to GST tax. Trust will be severed in accordance with applicable State law. Further, as severed, the new trusts will provide for the same succession of interests and beneficiaries as are provided in Trust. Accordingly, we conclude that if Trust is severed in accordance with § 2642(a)(3)(B)(ii), the severance of Trust as proposed into a trust that is not subject to GST tax (the GST Exempt Trust) and a trust that is subject to GST tax (the GST Non-exempt Trust), will be a qualified severance under § 2642(a)(3). For purposes of determining the applicable fraction of Trust immediately before the severance, as required under § 2642(a)(3)(B)(ii), the rules of § 26.2663-2(c)(1)-(2) will generally apply.

Accordingly, based on the facts submitted and the representations made, and assuming Trust is severed as discussed above, we conclude that after the severance, the GST Exempt Trust will have an inclusion ratio of zero for GST tax purposes and the GST Non-Exempt Trust will have an inclusion ratio of one for GST tax purposes. In accordance with § 2652(a)(1), the transferors of Trust will be B and C, to the extent of the contributions allocable to each. However, we express no opinion regarding the portion of Trust corpus that is properly allocable to the GST Exempt Trust and the GST Non-exempt Trust.

Ruling 3

Section 643(f) provides that, for purposes of subchapter J, under regulations prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1. For purposes of the preceding sentence, a husband and wife shall be treated as one person.

We conclude that, while the divided Trust will each have the same beneficiaries, they will have different grantors. Therefore, based on the facts and representations submitted, we conclude that the divided Trust will be treated as separate trusts for federal income tax purposes under § 643(f).

Ruling 4

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

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

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

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

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that a partition of jointly owned property is not a sale or exchange because the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result. Similarly, a partition of a trust into several trusts, for the benefit of the same beneficiaries, and under substantially identical terms and conditions, does not constitute a sale or exchange under § 1001.

In this case, after the partition, the beneficiaries will have the same interests in the partitioned trusts and property as in the original trust. The terms of the trusts created by partitioning of the original trust will be identical to the terms of the original trust. Accordingly, the beneficiaries, original trust, and the partitioned trusts will not realized gain or loss under §§ 61 or 1001 as a result of the partition.

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 who requested 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 Trust's authorized representative.

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
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